

## Perfecting Security Interests in Computer Programs -Collateral Protection

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Failure to properly perfect a security interest in computer software can be fatal to the holder of the security interest. Valid and enforceable security interests are critical to parties in the financing of transactions, such as a bank or venture capital investor lending money secured by computer programs (or other intellectual property) or the seller of a company who is receiving partial cash and the balance in a note from the buyer secured by the intellectual property assets (and other assets) of the seller's company. The computer software securing the transaction involves several types of intellectual property interests, each of which must be considered in determining the creation and perfection of the security interest and the administration of the collateral. Registration of rights to intellectual property, generally a good idea in any case, now – according to one court – may determine the validity of the security interest.

### Security Interest In Copyrights

Copyright is one of the most important property rights recognized in computer software. How do you perfect a security interest in computer software copyrights? By possession of a copy of the software? By filing a U.C.C.-1 financing statement with the Secretary of State? By filing with the Copyright Office? Does registration of the copyright make a difference?

A fundamental concept concerning copyrights, and relevant to using computer programs as collateral, is to distinguish the “copy” of the work from its intangible “contents.” Unless there are contractual or statutory restrictions to the contrary, one who possesses a “copy” of a copyrighted work can exercise control over that copy, for example, give it to a friend or business associate. However, the owner of the copy cannot

exercise any of the exclusive rights of the copyright owner, such as the right to make a copy or to transfer ownership of the right to make such copies. As such, mere possession of a “copy” of a computer program is insufficient to perfect a security interest in the program. *Dabney v. Information Exchange Inc.*, Bankruptcy No. A89-00305-WHD, U.S. Bankruptcy Court, N.D. Georgia, Atlanta Div., (April 25, 1989).

Two federal courts in California had the opportunity to address the issue: “Is a security interest in a copyright perfected by an appropriate filing with the United States Copyright Office or by a U.C.C.-1 financing statement filed with the relevant secretary of state?” The U.S. District Court for the Central District of California, in *In Re Peregrine Entertainment, Ltd. et. al v. Capitol Federal Savings and Loan Association of Denver*, 116 B.R. 194 (USDC, CD, California, June 28, 1990) held that perfection of a security interest in the copyrights at issue in the case would only be perfected by a filing with the U.S. Copyright Office. The U.S. Bankruptcy Court, N.D. California, in *In re Aerocon Engineering Inc. v. Silicon Valley Bank*, 244 B.R. 149 (USDC, ND, California, December 30, 1999), held, in a decision consistent with the *Peregrine* case, that perfection of a security interest in the copyrights at issue in the case would only be perfected by an appropriate filing with the Secretary of State's office. The pivotal difference between these two cases is the question of whether or not the copyright rights were registered with the U.S. Copyright Office. In *Peregrine* the copyrights were registered and in *Aerocon* they were not registered.

## Copyright Library Is Principal Asset

In *Peregrine, supra*, National Peregrine Inc., (NPI) is a Chapter 11 debtor in possession whose principal assets are a library of copyrights, distribution rights and licenses to approximately 145 films and accounts receivable arising from the licensing of these films to various programmers. Capitol Federal Savings and Loan Association of Denver (CAP FED) extended to NPI's predecessor by merger a \$6 million line of credit secured by what is now NPI's film library. Both the security agreement and the U.C.C.-1 financing statements filed by CAP FED describe the collateral as "[a]ll inventory consisting of films and all accounts, contract rights, chattel paper, general intangibles, instruments, equipment, and documents related to such inventory, now owned or hereafter acquired by the Debtor." CAP FED filed its U.C.C.-1 financing statements in California, Colorado, and Utah, but did not record its security interest in the U.S. Copyright Office.

NPI filed a voluntary petition for bankruptcy on Jan. 30, 1989, and an amended complaint against CAP FED on April 6, 1989. In its amended complaint NPI alleged that the bank's security interest in the copyrights to the films in NPI's library and in the accounts receivable generated by their distribution were unperfected because CAP FED failed to record its security interest with the Copyright Office. NPI contended that, as a debtor in possession, it had a judicial lien on all assets in the bankruptcy estate, including the copyrights and the receivables. Armed with this lien, it sought to avoid, recover and preserve CAP FED's allegedly unperfected security interest for the benefit of the estate.

In its analysis, the *Peregrine* court notes that the U.C.C., Article 9, is applicable to any transaction intended to create a security interest in personal property, including general intangibles. The formal requisites of perfection of a security interest are: (1) a security agreement containing an accurate description of the property is required (note, see *In Re Bedford Computer Corp.*, 62 B.R. 555, D. N.H. (1986), in which a secured party lost its security interest because of a failure to adequately describe the security); (2) value must have been given for the property in which the debtor has rights; (3) the security interest must attach to this property; and finally, (4) the secured

party must have filed the appropriate documents (e.g., financing statement) in the proper place (See, U.C.C. 9-203). "General Intangibles" means "any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. The term includes a payment intangible and software." (See, U.C.C. §9-102(42)).

Several states, including Wisconsin, Ohio, and New York, have adopted the 1999 Revised Uniform Commercial Code (UCC) Article 9-Secured Transactions, which was approved by the National Conference of Commissioners on Uniform State Laws and by the American Law Institute in 1998 and by the American Bar Association, with the amendments approved by the National Conference in 1999 and 2000. The 1972 U.C.C. Official Comments states, "The term 'general intangibles' brings under this Article...copyrights, trademarks and patents, except to the extent that they may be excluded by Sec. 9-104(a)." Sec. 9-104(a) indicates that Article 9 does not apply "...to security interest subject to any statute of the United States, to the extent that such statute governs the rights of parties to and third parties affected by transactions in particular types of property..." Article 9 of the revised U.C.C. in new §9-109(c)(1) now explicitly defers to federal law. This §9-109(c)(1) revision states the preemption in a manner different from previous §9-104(a). Section 9-109(c), deferring to federal law states "This article does not apply to the extent that: (1) a statute, regulation, or treaty of the United States preempts this article..." U.C.C. §9-109(c). 1999 Official Comment 8 to §9-109, in an evident reference to *Peregrine*, states: "Former Section 9-104(a) excluded from Article 9 'a security interest subject to any statute of the United States, to the extent that such statute governs the rights of parties to and third parties affected by transactions in particular types of property.' Some (erroneously) read the former section to suggest that Article 9 sometimes deferred to federal law even when federal law did not preempt Article 9. Subsection (c)(1) recognizes explicitly that this Article defers to federal law only when and to the extent that it must – i.e., when federal law preempts it."

Sec. 205(a) of the U.S. Copyright Act, the *Peregrine* court notes, provides that “[a]ny transfer of copyright ownership or other document pertaining to a copyright may be recorded in the Copyright Office....” Copyright Office Circular 12: “Recordation of Transfers and Other Documents” provides some general comments about this recording procedure. An agreement granting a security interest may be recorded in the Copyright Office. A “transfer” of copyright includes any “mortgage” or “hypothecation of a copyright” whether “in whole or in part” and “by any means of conveyance or by operation of law.” (U.S. Copyright Act Sec. 101 and Sec. 201(d)(1). Citing *Black’s Law Dictionary* (5th ed. 1979), Judge Kozinski, writing the opinion for the district court in *Peregrine*, observes that the terms “mortgage” and “hypothecation” have been defined to include a pledge of property as security or collateral for a debt. The Copyright Office has defined a “document pertaining to a copyright” as one that “...has a direct or indirect relationship to the existence, scope, duration, or identification of a copyright, or to the ownership, division, allocation, licensing, transfer, or exercise of rights under a copyright. That relationship may be past, present, future, or potential.” *Compendium of Copyright Office Practice II*, Sec. 1603.03.

An agreement creating a security interest in the receivables generated by a copyright may also be recorded in the Copyright Office. See, U.S. Copyright Act Sec. 106, which details the exclusive rights of the copyright holder. Recordation of a document in the Copyright Office gives all persons constructive notice of the facts stated in the recorded document when (1) the document, or material attached to it, specifically identifies the work to which it pertains so that, after the document is indexed by the Register of Copyrights, it would be revealed by a reasonable search under the title or registration number of the work; and (2) registration has been made for the work. (17 U.S.C. §205(c)).

Where the copyright rights have been registered in the subject work, perfection under the U.S. Copyright Act preempts the U.C.C. state filing. If state methods of perfection were valid, a third party (such as a potential purchaser of the copyright) who wanted to learn of any encumbrances thereon would have to check, not merely the indices of the U.S. Copyright Office,

but also the indices of any relevant secretary of state. (Consider, U.C.C. §9-301(1): “Except as otherwise provided in this section, while a debtor is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection or non-perfection, and the priority of a security interest in collateral.”) “Because copyrights are incorporeal — they have no fixed situs — a number of state authorities could be relevant... Thus, interested third parties could never be sure that all relevant jurisdictions have been searched. This possibility, together with the expense and delay of conducting searches in a variety of jurisdictions, could hinder the purchase and sale of copyrights, frustrating Congress’ policy that copyrights should be readily transferable in commerce,” *Peregrine, supra; Danning v. Pacific Propeller Inc.*, 620 F.2d 731 (9th Cir., 1980), cert. denied, 449 U.S. 900 (1980) (holding that the Federal Aviation Act’s provision for recording conveyances and the creation of liens and security interests in civil aircrafts preempts state filing provisions).

The Copyright Act provides a scheme for determining priority between conflicting transferees (Copyright Act 205(d)), which differs from the U.C.C. Article 9 priority scheme. Thus, state filings would undermine the priority scheme established by Congress with respect to copyrights. (See, *Bonito Boats Inc. v. Thunder Craft Boats Inc.*, 109 S.Ct. 971 (1989)). Furthermore, a national registration system for copyrights strengthens the economic viability of copyrights by simplifying the transferability of the copyrights for purposes of perfecting a security interest or making an assignment of the copyright.

The 1972 U.C.C. §9-302(4) provides that when a national system for recording security interests exists, compliance with such system “... is equivalent to the filing of a financing statement under this Article, and a security interest in property subject to the statute or treaty can be perfected only by compliance therewith....” The *Peregrine* court held: “The court therefore concludes that the Copyright Act provides for a national registration and ‘specifies a place of filing different from that specified in [Article Nine] for filing of the security interest.’ U.C.C. Sec. 9-302(3)(a). Recording in the U.S. Copyright Office, rather than filing a financing statement under Article Nine, is the proper

method for perfecting a security interest in a copyright.” *Peregrine, supra*. As noted above, the 1999 U.C.C. §9-109(c) expressly defers to the federal law.

In *In re Aerocon Engineering Inc. v. Silicon Valley Bank, supra*. Aerocon Engineering Inc. (“Aerocon”) seeks to avoid the security interest of Silicon Valley Bank (the “Bank”) in certain unregistered copyright works. The copyright works at issue in this case included drawings, blueprints, and computer programs (the “Works”). However, in this case the copyright owners, the debtors in this case, did **not** register the copyright rights in these works with the United States Copyright Office.

Prior to the filing of the bankruptcy, the Bank had loaned money to, or received a guaranty of said loan from, World Auxiliary Power Company, World Aerotechnology Corporation, and Air Refrigeration Systems, Inc., (the “Debtors”) affiliated companies. Pursuant to a security agreement, the Bank received a security interest in the Works, and which security interest, among other things, was to secure the Debtors obligations under the loan and security agreements. The Bank also filed with the Secretary of State of California a UCC-1 financing statement executed by the Debtors. The Bank did not record the UCC-1 or the security agreement in the United States Copyright Office.

Subsequent to the filing of the bankruptcy, Aerocon claims to have purchased, and is therefore the successor-in-interest to, the copyright rights in the Works. The Bank, on the other hand, claimed that its security interest, filed with the Secretary of State of California, gave the Bank the rights to the Works. The Court agreed with the Bank.

In reaching its decision, the Court observed that the United States Copyright Law does not require copyright registration for copyright protection to exist. *See*, 17 U.S.C. §408(a). The exceptions to this rule include (a) in the case of an infringement of the copyright wherein the U.S. owner of the copyright must register the copyright with the U.S. Copyright Office in order to sue a third party for copyright infringement (*See*, 17 U.S.C. §411); and (b) in the case of an infringement, registration is a prerequisite for certain remedies

(*See*, 17 U.S.C. §412). However, the Court noted, if the copyright is registered and the transfer of ownership of a copyright is recorded, the recordation gives third parties constructive notice of the transfer (*See*, 17 U.S.C. §205(c)). And, in the event of a conflict between transfers of the copyright, priority is given to the first transfer executed provided: (1) the transfer (if executed in the U.S.) is recorded within 30 days of the date of execution in manner sufficient to give third parties constructive notice, and (2) the transferee: (a) received the transfer in good faith, (b) for valuable consideration, and (c) without notice of the prior transfer (*See*, 17 U.S.C. §205(d)). *In re Aerocon Engineering Inc. v. Silicon Valley Bank, supra*.

The *Aerocon* Court stated that the *Peregrine* Court’s analysis only works if the copyright is registered. The basis for this distinction rests in the relationship between 17 U.S.C. §205(d), which sets forth a procedure for wrestling with conflicts in priority between conflicting transfers, and 11 U.S.C. §544(a), which sets forth the role of the hypothetical judicial lien holder in determining perfection of security interests. As the *Aerocon* Court concludes: “...unless the copyright was registered in the Copyright Office, a hypothetical judicial lien holder’s recordation of its lien in the Copyright Office would not give it any priority over an unperfected security interest in the same copyright under 17 U.S.C. §205(d)...[which]...only gives priority to a transfer of a security interest recorded in a manner sufficient to give constructive notice to third parties. Recordation of a security interest only gives constructive notice to third parties if the copyright is registered. *See* 17 U.S.C. §205(c).” *In re Aerocon Engineering Inc. v. Silicon Valley Bank, supra*.

Therefore, *Peregrine* and *Aerocon* teach us that registration of the copyright rights is important in the perfection of a security interest. In the case of an unregistered copyright, a filing with the Secretary of State in the appropriate jurisdiction may suffice to perfect the security interest in the copyright. In the case of a registered copyright, a filing with the U.S. Copyright Office may suffice to perfect the security interest in the copyright. A “belt and suspenders” approach to perfection of a security interest in copyright works would include (a) register the copyright with the U.S. Copyright Office; (b) record the security interest both in the

U.S. Copyright office and in the appropriate Secretary of State's office.

It must be remembered that computer programs involve *several* types of intellectual property. For instance, trade secrets arise under state law and are not governed by a federal statute. *United States v. Antenna Systems Inc.*, 251 F. Supp. 1013, D. N.H., (1966). Perfection of a security interest in trade secrets is accomplished by a filing (U.C.C. Form 1) under the U.C.C. similar to other general intangibles.

Although this article focuses primarily on the security interests in the copyrights of computer programs, a filing must be considered to protect the other intellectual property aspects of the computer program. It is suggested that a written financing statement, security agreement and conditional assignment also be used to perfect a security interest in the copyrights of a computer program, web pages and the underlying computer code (e.g., html, java script). A security interest should also be taken in the physical media containing the computer program. Likewise, a separate security interest can be taken in the documentation for the computer program, as well as intangible trade secrets and patent rights. Likewise, registration of the copyright is also strongly suggested because of the constructive notice it provides to protect the secured party. The bottom line is that failure to properly perfect a security interest, and to administer the security interest, may prove fatal to the secured party upon default.

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