

*finance*matters

Perfecting Security Interests In Copyrights: New Court Ruling Offers Clarity To Lenders And Borrowers

October, 2002

A recent federal case, *Aerocon*¹, has changed the ground rules for perfecting security interests in copyrights. For the last decade, the legal landscape has been uncertain for lenders who needed to have a perfected security interest in a borrower's copyrights. To deal with the uncertainty, lenders often decided to perfect their security interest both on the state level under the Uniform Commercial Code and on the federal level with the U.S. Copyright Office. Federal perfection, however, requires that the copyright be registered with the Copyright Office and borrowers often resist federal copyright registration because of their concern about the risks of publicly disclosing their fundamental trade secrets. Tense, time-consuming and expensive negotiations on this issue have plagued the industry, driven up transaction costs and occasionally delayed essential liquidity for an industry already facing significant challenges.

In response to this uncertainty, the court in *Aerocon* held that a UCC-1 filing is sufficient to perfect a lender's security interest in a copyright that is not registered under the federal Copyright Act. Although lenders and borrowers must still agree on procedures to ensure the lender's continued perfection if copyrights are federally registered subsequent to the loan closing, the lender's ability to perfect its lien in a borrower's copyrights no longer has to drive the borrower's business decision as to whether or not to register its fundamental trade secrets.

The Context: Perfection of Security Interests Under the UCC and the Copyright Act

Commercial borrowers and lenders traditionally rely on state law, the Uniform Commercial Code (the "UCC"), to ensure that, through a perfected security interest, the lender's

rights in the borrower's personal property have priority over the claims of other creditors. The perfection process can be slightly more complex when a borrower's assets are not "hard assets" such as equipment or inventory, but are instead intangible property such as software source code, architectural plans and the like. The UCC provides that a lender may perfect a security interest in a copyrightable asset (a "general intangible" under the UCC) by filing a UCC-1 financing statement at the state level. The UCC, however, expressly provides that federal law governs if the asset is subject to a federal statute which provides for federal registration or perfection.

The federal Copyright Act provides a system for national registration of copyright interests and for secured lenders to perfect their security interests by making public filings in the Copyright Office. Therefore, if a copyright is registered under the Copyright Act, a lender must perfect a security interest in that copyright with the federal Copyright Office.

The Dilemma of Perfecting in Unregistered Copyrights

But how does a lender perfect in a copyright that is not registered with the Copyright Office? Certainly for many technology companies registration under the Copyright Act is not necessarily desirable. Registration can help a technology company by enabling it to sue others for infringement and obtain statutory and other damages. However, the process involves a public filing, and software source code is often a technology company's most important trade secret. In addition, copyright registration for ever-changing software code can be quite burdensome as it may be necessary for the filer to make new filings for every revision, enhancement or upgrade.

The manner of perfecting in an unregistered copyright was complicated by two District Courts in the Ninth Circuit² which held that even if the borrower had not registered its copyright with the Copyright Office, a lender could only perfect its security interest in the copyright by filing in the Copyright Office. This created an obvious dilemma: if a copyright is not registered, a lender cannot perfect a lien upon it. As a result of these two district court decisions, many lenders attempted to decrease the risk that the Copyright Act might nullify UCC security interests by requiring borrowers to register their source code under the Copyright Act and by complying with the Copyright Act's perfection provisions. When such requirements were placed on a borrower reluctant to make public registrations of its fundamental trade secrets, financing negotiations were significantly delayed or made more contentious.

Aerocon Resolves the Dilemma

The Ninth Circuit in *Aerocon* resolved this dilemma by holding that a lender may rely on the UCC rules for perfecting a security interest in intellectual property that is *not* registered under the Copyright Act. For federally registered copyrights, *Aerocon* confirmed that a lender must perfect its security interest by filing in the federal Copyright Office.

In *Aerocon*, Silicon Valley Bank ("SVB") had perfected under the California UCC a security interest in the borrower's assets, including drawings, technical manuals, blue prints and computer software. As none of the borrower's copyrights in these assets was registered, SVB did not perfect under the Copyright Act. When the borrower filed for bankruptcy, a third party that acquired the copyrights from the bankruptcy trustee sued to void SVB's perfected security interest on grounds that the Copyright Act preempted the California UCC. To the relief of borrowers and lenders, the Ninth Circuit narrowed the risks feared by lenders by concluding that the Copyright Act preempted the UCC only with respect to *registered* copyrights. In *Aerocon* all the borrower's copyrights were *unregistered*, so the Ninth Circuit ruled in favor of SVB.

A word of caution is in order. All of the court decisions referred to in this article are Ninth Circuit, California or Arizona decisions and are not binding in all jurisdictions. Therefore, there may be contrary decisions in the future in other jurisdictions.

Practical Tips for the Lender

The Ninth Circuit in *Aerocon* expressly recognized that a risk remains for lenders who file only under the UCC. If a borrower registers a copyright subsequent to closing the loan (e.g., in order to sue someone for copyright infringement), the lender's perfection status under the UCC would be impaired by the federal filing. In such a case, a subsequent creditor (or a bankruptcy trustee) could then prime the first lender by registering its security interest with the Copyright Office.

Because of these risks, diligent lenders will: (1) analyze this risk in relation to the value of the copyright to the total collateral value in the transaction; (2) include loan covenants requiring disclosure of copyright registrations by the borrower at least 30 days prior to the registration, to provide the lender enough time to coordinate the requisite federal copyright office filings; and (3) obtain the agreement of the borrower to execute and deliver any additional documents necessary to perfect the copyright lien at the Copyright Office.

The Ninth Circuit in *Aerocon* provides welcome clarity to technology borrowers and lenders. It resolves longstanding legal uncertainties and creates a sensible framework for perfecting security interests in copyrights. Let us hope this decision is followed by courts in other jurisdictions.

For more information, please contact:

Philip A. Herman 617.574.4114
pherman@goulstonstorrs.com

Pamela M. MacKenzie 617.574.4106
pmackenzie@goulstonstorrs.com

Please visit our website at www.goulstonstorrs.com for a complete list of our Commercial Finance Group.

¹*Aerocon Engineering, Inc. v. Silicon Valley Bank (In re World Auxiliary Power Company)*, 2002 WL 31017352 (9th Cir. 2002).

²*Zenith Productions, Ltd v. AEG Acquisition Corp. (In re AEG Acquisition Corp.)*, 161 B.R. 50 (B.A.P. 9th Cir. 1993); and *In re Avalon Software Inc.*, 209 B.R. 517 (D. Ariz. 1997).

This client advisory should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only, and you are urged to consult your own lawyer concerning your situation and any specific legal questions you may have.