

Articles

Don't Judge a Sale by Its License: Software Transfers Under the First Sale Doctrine in the United States and the European Community

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ON JUNE 5, 2000, the Copyright Office of the Library of Congress published a notice in the *Federal Register* requesting public comment on an unusually broad set of intellectual property policy issues¹ pursuant to a congressional mandate expressed in the Digital Millennium Copyright Act² (“DMCA”). The questions posed by the Copyright Office focused on the effect of the DMCA and, more generally, on the

1. See 65 Fed. Reg. 35,673 (June 5, 2000).

2. See Digital Millennium Copyright Act, Pub. L. No. 105-304, 112 Stat. 2860 (1998).

practical impact of new technologies upon sections 109(a) and 117 of the 1976 Copyright Act³ ("the 1976 Act"). While this subject appears at first glance to epitomize the kind of technical legal question that interests primarily an intellectual property law specialist of pedantic disposition, the issues raised by the DMCA are, in reality, of great economic and social importance.

The 1976 Copyright Act is the latest expression of federal public policy on the protection and distribution of expressive works. The DMCA was intended to modernize the Copyright Act to account for the increasingly digitalized world of expression, but Congress, in a display of foresight and humility, chose to leave some issues open to study and future rulemaking. In promulgating the DMCA, Congress recognized the increasing centrality of copyrightable computer software and other digital expressions in developing new technologies of potential or realized social benefit. As such new forms of expression come to replace the traditional, those who create and publish computer software assume augmented economic power and commercial leverage. Congress designed the aforementioned sections of the Copyright Act with the objective of putting the reasonable expectations of purchasers of such software beyond the reach of this leverage. Thus, these provisions of the Copyright Act are designed both to protect the minimum expectations of software purchasers and to preempt certain practices by software publishers that Congress has deemed to be unfair or inefficient.

Section 109(a) of the Copyright Act, known as the First Sale Doctrine,⁴ protects the lawful owner of a copy of a copyrighted work from infringing the copyright in that work by reselling the copy. Section

3. See 17 U.S.C. §§ 109(a), 117 (2000).

4. See 17 U.S.C. § 109(a). Actually, the term "First Sale Doctrine" is something of a misnomer. No actual sale is required for section 109(a) to apply; the copy need merely have been "lawfully acquired." One can acquire ownership by gift, see, e.g., *Walt Disney Prods. v. Basmajian*, 600 F. Supp. 439 (S.D. Tex. 1984), manufacture under license, see, e.g., *United States v. Sachs*, 802 F.2d 839, 842 (6th Cir. 1986), or even salvage, see, e.g., *United States v. Wise*, 550 F.2d 1180 (9th Cir. 1977). Because the difficult issues raised by the Doctrine most often arise in the context of software sales, and for reasons of convenience, we will generally use the term "purchaser" instead of "lawful owner." For application of the First Sale Doctrine, see generally Mark A. Lemley, *Intellectual Property and Shrinkwrap Licenses*, 68 S. CAL. L. REV. 1239, 1246, 1261, 1267-84 (1995); Apik Minassian, *The Death of Copyright: Enforceability of Shrinkwrap Licensing Agreements*, 45 UCLA L. REV. 569, 593 (1997); Kenneth L. Carson and Gail E. Horowitz, *Software and Computer Law: Old Questions to be Answered in the New Millennium*, 43 B.B.J. 10, 18 (1999); Al Harrison and Stephen J. Hyland, *High-Tech Issue: Computer Law*, 34 HOUS. LAW. 16, 20 (1996).

117 immunizes the lawful owner of a copy of a computer program⁵ from committing infringement by copying the software as a necessary step in its normal use (for example, by making copies into a computer's random access memory, or "RAM," in the course of executing the software code). Technological means deployed by the software publisher can adversely impact these prerogatives of copy ownership, namely, the rights to copy the software in the course of its normal use and to resell the copy. For example, a software publisher can insert into a computer program a mechanism that prevents the program from running on a computer different than the one upon which it was originally installed.⁶ Of course, such mechanisms can generally be circumvented by the purchaser's own technological innovations. Yet, section 1201(a)(1)(A) of the DMCA forbids such measures, providing that "no person shall circumvent a technological measure that effectively controls access to a work protected under this title."⁷ As a result, the new legislation protects mechanisms that could potentially prevent software users from exercising their lawful rights under the First Sale Doctrine and section 117.⁸

Congress's interest in reconciling licensing practices and new technologies with sections 109(a) and 117 may be influenced by the increasingly common practice by courts of rejecting the application of those sections in deference to the licensing practices of software publishers. While two decades ago, copy use licensing was relatively uncommon,⁹ nearly every commercial transfer of a copy of software is now accompanied by an explicit license agreement. Such copy use license agreements are nowhere explicitly recognized in the 1976 Copyright Act. In mass-market consumer software transactions, the license agreement is invariably a shrinkwrap or clickwrap agreement.¹⁰ In these agreements, as well as traditionally negotiated contracts,

5. The 1976 Copyright Act defines a "computer program" to be a "set of statements or instructions to be used directly or indirectly in a computer in order to bring about certain results." 17 U.S.C. § 101 (2000).

6. See *infra* note 399 and accompanying text.

7. 17 U.S.C. § 1201(a)(1)(A) (2000).

8. See Suellen W. Bergman, *Do Anti-Circumvention Laws Clash With First Sale Doctrine?*, E-COM. L. & STRATEGY (Sept. 22, 2000), at <http://www.brownraysman.com/publicationsecommerce.htm> (subscribers only).

9. See David A. Rice, *Licensing the Use of Computer Program Copies and the Copyright Act First Sale Doctrine*, 30 JURIMETRICS J. 157, 164 (1990).

10. A shrinkwrap agreement is a license agreement contained inside a box of software, and is sometimes positioned so as to be readable through the transparent shrinkwrap packaging. A clickwrap agreement is an agreement that pops up on a transferee's computer screen, and that must be adhered to (usually by clicking an "Okay" or "I agree" button) before the software may be downloaded to the transferee's computer.

software publishers generally desire to impose restraints on the use and resale of their software in order to optimize the commercialization of their products, the return on research and development investments, and exercise some control over their segment of the software market. Thus, the applicability *vel non* of the First Sale Doctrine affects virtually every software transaction.

Almost contemporaneous with the United States Copyright Office's request for public comment, the *Bundesgerichtshof*, Germany's highest civil law court, rejected a claim by Microsoft Corporation of copyright infringement.¹¹ Microsoft filed suit against a German distributor that had marketed Microsoft products labeled original equipment manufacturer¹² ("OEM"), but had sold them as stand-alone products to the general public, contrary to Microsoft's license restrictions. In order to reach different distribution channels, many software publishers market virtually identical software programs either as stand-alone products, or as discounted OEM versions to be sold only in connection with hardware. By offering the discounted OEM versions as stand-alone versions, the German distributor was able to undercut prices set by its competitors. Microsoft argued that the distribution licenses accompanying its OEM versions did not authorize the marketing of the software as a stand-alone product. The *Bundesgerichtshof* held that the German distributor did not need Microsoft's authorization to market Microsoft's products because, under the First Sale Doctrine, Microsoft's exclusive distribution rights had been exhausted when it transferred the software copies to a distributor from whom the renegade German distributor had acquired them.

Both of these recent events have gained publicity in the United States as well as Europe, and they invite a comparison of the respective perceptions of a common doctrine—the First Sale Doctrine as it applies to computer software. It is not unusual that comparative legal analysis comes to the conclusion that, while concepts and theories of national legal systems differ substantially, the ultimate answer to a specific legal question or problem is the same because the perceived policy interests, whether they be based on perceptions of efficiency or fairness, are similar. With regard to the application of the First Sale

11. See *infra* note 431 and accompanying text.

12. An "OEM" is a designation referring to a business that assembles computers directly from parts for sale to the public. OEM software is software that, according to its license terms, may only be sold by a hardware manufacturer in conjunction with the hardware.

Doctrine to the licensing of computer software, however, it seems to be the other way round. Although the First Sale Doctrine constitutes a well established principle of United States and European intellectual property law,¹³ the policy results and economic consequences of the application of the First Sale Doctrine to software licensing agreements differ substantially in the United States and the European Community.

The acceptance of any particular interpretation of the First Sale Doctrine in a legal system's jurisprudence has substantial consequences for individual users of software and weighs heavily in determining the extent of a licensor's power to define the terms of its license in any licensing transaction. If the First Sale Doctrine is excluded, a consumer who buys a computer game violates federal copyright laws if she trades the game to her little brother in exchange for baseball cards. Excluding the First Sale Doctrine would also allow licensors to prevent the sale of used software in software stores, bookstores, flea markets, and over the Internet. Finally, it means that a business that sells substantially all of its assets to another business may be prohibited from transferring its software to the second business; it may be necessary to wipe the transferred computers clean of all software and sacrifice the price paid for the software. Indeed, the consequences of this legal doctrine transcend these practical considerations; they penetrate the very core of public policy on competition and consumer protection in the software market.¹⁴

13. Unlike "tangible property law" (i.e., real estate and personal property law), the term "intellectual property law" refers to legal rules on exclusivity rights to intangibles, such as works of authorship. "The first sale in the Community of a copy of a program by the rightholder or with his consent shall exhaust the distribution right within the Community of that copy, with the exception of the right to control further rental of the program or a copy thereof." Council Directive 91/250, art. 4, 1991 O.J.

Article 7 of the trademark directive provides:

The trademark shall not entitle the proprietor to prohibit its use in relation to goods which have been put on the market in the Community under that trademark by the proprietor or with his consent. 2. Paragraph 1 shall not apply where there exist legitimate reasons for the proprietor to oppose further commercialization of the goods, especially where the condition of the goods is changed or impaired after they have been put on the market.

Council Directive 89/104, art. 7, 1989 O.J. (L 40).

14. This is not to say that the policy ramifications of the use of licenses as an "alternative" to software sales end at sections 109(a) and 117. Over a decade ago, Professor David Rice of Rutgers Law School pointed out that copy licensing can be used to leverage the copyright monopoly to protect trade secrets by prohibiting reverse engineering, and by creating a contributory infringement right against an innocent renter. *See Rice, supra* note 9, at 159, 185.

This Article reviews the origins and functions of the First Sale Doctrine as it applies to software and attempts to clarify the circumstances under which a software transfer constitutes a “first sale.”¹⁵ This Article revisits the concepts of sales and ownership in order to avoid the common misconception that by labeling a transaction a “license grant,” the final word has been spoken on whether a sale of a software copy has in fact occurred. By eschewing the common judicial dichotomization of a “license” of software and a “sale” of software, this Article shows that the form of the license is almost uniformly epiphenomenal. This Article argues instead that the gravamen of a software transfer is the license itself and therefore such a transfer can involve either a sale or a lease of a software copy, but it must always involve a license in some form. Alternatively, a sale or a lease of a software copy can be accompanied by a sale or a lease of a copyright itself, but under most circumstances, the term “license” indicates only if and to what extent the copyright owner wishes to dispose of some or all of its exclusive rights to a computer program. This Article concludes that such terminology should have no legitimate legal impact on whether the transaction qualifies as a sale of a software copy for purposes of the First Sale Doctrine.

I. Sale and Ownership of Property and the Function of the First Sale Doctrine

The First Sale Doctrine limits certain statutory intellectual property rights of the author of a copyrighted work. The author generally enjoys a number of exclusive rights to his work including the right to undertake, permit, or prohibit the reproduction, rental, and sale of his work and copies thereof.¹⁶ Once the author has first sold a “copy” of his copyrighted work, the First Sale Doctrine states that the author’s right to prohibit further sales is exhausted. Accordingly, a lawful purchaser of a copy of a copyrighted work is free to resell his copy to a third party. In order to understand the meaning and repercussions of this rule, it is helpful to consider more closely the concepts of sale and ownership, and the rights retained by original owners and subsequent purchasers with regard to their property.

15. A “first sale” for these purposes means that the acquirer of software qualifies as the “owner” of the acquired software copy.

16. See 17 U.S.C. § 106 (2000).

A. Sale and Ownership

The term "sale" is commonly understood to mean a transfer of property for payment of a certain consideration, usually in the form of money. Property is commonly conceived of as an object that exclusively belongs to the owner.¹⁷ Intellectual property is intangible, not a physical object, but it is considered "property" in a figurative sense. Ownership is a collection of rights to use, enjoy, and transfer property; the complete dominion, title, or proprietary right in a thing or claim.¹⁸ Under the common law, property, by definition, must have one or more owners and it is inherent in the ownership that such owner or owners have a right to transfer that property, by sale or otherwise.

While there are many differences between tangible and intellectual property, in some ways the legal position of the owner is comparable. As the concept of tangible property is older, and generally more familiar, it is necessary to briefly sum up the situation of an owner of tangible property.¹⁹

1. Sale and Ownership of Tangible Property

A creator or other owner of a particular piece of jewelry can decide for himself whether or not he wants to use the jewelry himself, lend or lease it to others, or sell it outright. As long as he owns the jewelry, he can prohibit and prevent anybody else from using that particular piece of jewelry or melting it down and making something else out of the metal and gems.²⁰ The jewelry is a "chose in possession." If a thief steals the jewelry and sells it, the purchaser will generally not acquire ownership; a thief cannot transfer valid title.²¹ However, if the owner sells the jewelry, the purchaser can resell the jewelry to a sec-

17. See Black's Law Dictionary 1216 (7th ed. 1999) (defining property as "that which belongs exclusively to one. In the strict legal sense, an aggregate of rights, which are guaranteed and protected by the government More specifically, ownership") (citations omitted).

18. See *id.* at 1106.

19. To offer one possible example, an article of jewelry. We limit this discussion to personal property to avoid the idiosyncratic complications of real property law. We also assume that our exemplary piece of jewelry is valuable, yet so unoriginal and generic in shape and form that its design is not protected by any intellectual property laws.

20. For example, the German Civil Code states: "The owner of a *res* may, to the extent not contrary to the law or the rights of third parties, deal with the *res* as he pleases and exclude others from any interference." BGB § 903. The French Civil Code contains a provision of similar effect. See C. Civ. §§ 537, 544 (1999).

21. See *Suburban Motors, Inc. v. State Farm Ins. Co.*, 218 Cal. App. 3d 1354, 1360-61 (1990); 67 AM. JUR. 2D *Sales* § 447 (1985).

ond purchaser, regardless of whether the original owner agrees to such resale or not. Generally, the ability to transfer title by sale is naturally incident to the ownership of tangible property.

Original Owner → First Purchaser → Second Purchaser

However, the original owner could attempt contractually to obligate the first purchaser not to resell the jewelry to a second purchaser. Under the common law, such a nontransferability clause could not impose an obligation *erga omnes*, even if its terms purported to do so, due to a lack of privity between the original owner of the jewelry and third parties such as a second purchaser. The first purchaser's nontransferability undertaking would not "run with the goods;" if valid and enforceable under state commercial law, it would only create personal obligations between the original owner and the first purchaser.

If the first purchaser resells and transfers title to the jewelry to a second purchaser, this would constitute a breach of the first sales contract between the original owner and the first purchaser, but it violates no common law rule. Except in a few rare instances not at issue here,²² such a subsequent sale would not be theft, conversion, trespass to chattels, or any other crime, tort, or even a statutory or regulatory violation. Consequently, the original owner might sue the first purchaser for damages or, with less success, apply for an equitable remedy based solely on a theory of breach of contract. The court would likely find, however, that notwithstanding the first purchaser's contractual agreement not to sell the jewelry, the first purchaser could nevertheless go forward with the sale because the nontransferability clause contravenes the ancient common law prohibition on unreasonable restraints on alienation,²³ or even that it violates antitrust rules.²⁴ Such

22. Obviously, certain kinds of sales of objects to certain kinds of end-users will be illegal under various laws (e.g., the sale of liquor to minors, or the sale of armaments to an embargoed country without a license under the Office of Foreign Assets Control regulations, etc.).

23. See *Wildenstein & Co. v. Wallis*, 595 N.E.2d 828, 832 (N.Y. 1992) ("[T]he common-law rule against unreasonable restraints on the alienation of property, which invalidates unduly restrictive controls on future transfers . . . measures reasonableness of the restraint by its price, duration, and purpose.") (citations omitted). At common law, a general restraint on alienation is ordinarily invalid unless it is reasonable in light of its terms and purpose. See *id.* at 832. The rule was firmly established as far back as the seventeenth century, when Lord Coke wrote:

If a man be possessed . . . of a horse or of any other chattel, real or personal, and give or sell his whole interest or property therein, upon condition that the donee or vendee shall not alien the same, the same is void, because the whole interest and property is out of him, so as he hath no possibility of a reverter; and it is against trade and traffic and bargaining and contracting between man and man.

a clause violates one of the fundamental attributes of property (its alienability) and would be void under the common law and void for reasons of public policy. Nonetheless, under no circumstance could the second purchaser be bound by the nontransferability agreement between the original owner and the first purchaser.²⁵ If the first purchaser, in breach of the contract between the original owner and himself, sold and transferred title to the jewelry to the second purchaser, the second purchaser would generally acquire valid title to the jewelry, become its owner, and be free to resell as he chooses.

2. Sale and Ownership of a Traditional Copyrighted Work

Let us now assume that the original owner instead owned a form of intellectual property; instead of creating unoriginal jewelry, he wrote a book. Generally speaking, an owner of intellectual property can also decide for himself whether or not to sell his intellectual property.²⁶ Like the creator and original owner of jewelry, the author of a book could keep the book to himself or sell it to others. If a thief steals the book from the author's house, the thief could not transfer title to a purchaser, just like with jewelry. If the author sells the book,

2 EDWARD COKE, *COKE ON LITTLETON* § 360 (1794). Similarly, the Supreme Court proclaimed: "The right of alienation is one of the essential incidents of a right of general property in movables, and restraints upon alienation have been generally regarded as obnoxious to public policy, which is best subserved by great freedom of traffic in such things as pass from hand to hand." *Dr. Miles Med. Co. v. John D. Park & Sons Co.*, 220 U.S. 373, 404 (1908) (citation omitted). *See also* *Ford v. Yost*, 186 S.W.2d 896, 899 (Ky. 1944) ("[T]he rule against . . . restraints on alienation of property is one of high public policy. Society is concerned more [with freedom to dispose of one's lawfully acquired property] than are the individual parties.").

24. A contractual provision preempting a purchaser's ability to resell a product might violate the Sherman Antitrust Act, 15 U.S.C. §§ 1–2 (2000), if the provision contributed to the seller's monopolization of a market (or the joint oligopolization by the seller and the purchaser).

25. The seller could conceivably bring an action for tortious interference with a contract against the third party purchaser, but even assuming that the seller's underlying right to prevent resale to be established, the seller would have to show that the third party knew of the seller's contract with the purchaser (and its terms), intentionally interfered with this agreement, and thereby caused the seller damages. *See* RESTATEMENT (SECOND) OF TORTS § 766 (1979). In a common resale context where the purchaser makes no investigation into how a distributor or other seller acquired the goods, knowledge of a contract and its terms would be exceedingly difficult to prove.

26. There are limitations to this rule. For example, sections 107 to 122 of the United States Copyright Act provide for numerous limitations to the exclusive rights of a copyright owner, including compulsory licenses for making and distributing phonorecords (§ 115). *See* 17 U.S.C. §§ 107–122 (2000). According to the United States Lanham Act, a registered trademark that goes unused by its registrant may be canceled or renewal of registration may be refused. *See* 15 U.S.C. §§ 1051(d), 1058(a) (2000).

however, a purchaser could resell it. The rules outlined above under Part I.A.1 apply to the book just as they apply to jewelry.

However, with respect to a copyrighted work of authorship, additional rules apply. Unlike jewelry, a copyrighted work is intangible, even though it may be embodied in a tangible carrier medium. Intellectual property is generally sold on a carrier medium of some kind. Just as it is theoretically possible to separate the notion of the book itself (i.e., paper, glue, and ink) from the intangible words contained in the book (i.e., the expressions that may be memorized and recited without the need for any carrier medium other than the human brain), it is equally possible to separate intangible music (i.e., the sounds expressed in waves or particles through the air) and its carrier medium (e.g., a phonograph record or CD), and intangible software (i.e., machine readable object code) from its carrier medium (e.g., CD, floppy disk, ROM chip).²⁷ Only the intangible property is protected by copyright. This distinction, between carrier media and protected intellectual property is crucial,²⁸ as acknowledged by section 202 of the United States Copyright Act, which provides that “[o]wnership of a copyright, or of any of the exclusive rights under a copyright, is distinct from ownership of any material object in which the work is embodied.”²⁹ Another important distinction is the difference between the intellectual property itself (e.g., words, music, object code) and the right to use or copy the intellectual property (i.e., the license). These distinctions are critical analytical components often missing from an analysis of the sale of a copy of intellectual property. In any “sale” of such a copy, there are three components:

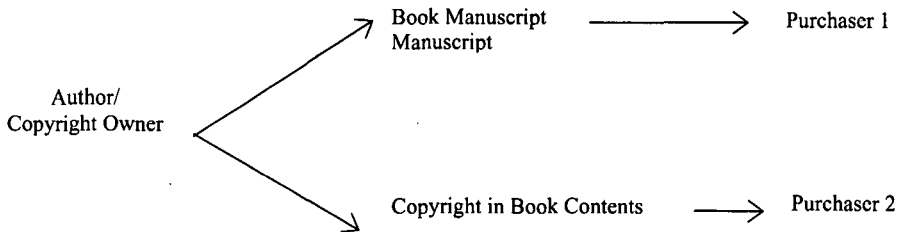
- (1) the relatively unimportant sale of the media (e.g., blank CD, ROM chip, blank paper book);
- (2) the sale of the intangible “copy” of the intellectual property itself (for software, in the form of a mathematical algorithm in object code; for a novel, the words); and
- (3) the *legal rights* to use, reproduce, etc. the intellectual property, which are granted to the copyright owner pursuant to section 106 of the Copyright Act, and which may be licensed in whole or in part, or assigned.

27. See *United States v. Goss*, 803 F.2d 638, 643 (11th Cir. 1986) (distinguishing between the copyrighted “work”—the intangible programming—and the tangible “copy” owned by the defendant).

28. See Rice, *supra* note 9, at 166.

29. 17 U.S.C. § 202 (2000).

The importance of these distinctions can be seen when each element of a sale of a copy of intellectual property is separated. There can be a sale without a license (e.g., the sale of a blank paperback, just like the sale of jewelry), and a license without a sale (e.g., the license of rights to manufacture a copyrighted or patented product in which no ownership rights change hands).



The author of a book not only has exclusive rights to the original physical manifestation of the book he created—the original manuscript—he also has exclusive rights to the intangible value contained therein—the content of the manuscript. If such content qualifies as an original work of authorship, its author has the sole and exclusive rights to permit, prohibit, and undertake the reproduction, sale, and importation of the book.³⁰ Therefore, if a thief refrains from stealing the physical manifestation of the author’s work, but “steals” the intangible content of the author’s book by making copies and selling such copies, the author and original owner of the book has a statutory right to prohibit the thief from doing so.³¹ According to the 1976 Copyright Act, the author can further sue for considerable statutory damages and attorneys’ fees for infringement,³² and request that the court order the thief, and anyone who purchased from the thief, to impound or destroy the illegal copies.³³ For further deterrent effect, there is also a possibility of criminal proceedings being instituted against the thief.³⁴

A sale of a copy only involves a transfer of ownership rights to that copy. A sale of the underlying work protected by the copyright (including all rights to reproduce that work) involves an assignment of the copyrights. While the copyright laws of the United States and most countries in continental Europe differ with respect to some indis-

30. See 17 U.S.C. § 106 (2000).

31. See 17 U.S.C. § 502 (2000).

32. See 17 U.S.C. §§ 504(c)(1)–505 (2000).

33. See 17 U.S.C. §§ 503(b) (civil forfeiture), 506(b) (criminal forfeiture) (2000).

34. See 17 U.S.C. § 506.

posable, non-waivable “moral” rights, authors are generally able to assign or otherwise transfer all commercialization rights with respect to their works of authorship. Therefore, the author of a copyrighted book could sell and assign his exclusive rights to a purchaser, e.g., a commercial publisher. Upon such assignment, the purchaser and assignee alone enjoy the aforementioned exclusive rights to undertake, permit, or prohibit the reproduction, sale, and importation of the book. The assignment of the rights is entirely separable from the sale of the original manuscript, as expressly acknowledged in section 202 of the United States Copyright Act.³⁵ As the owner of that particular copy of the work, the author may choose to keep his original manuscript for sentimental purposes and assign his copyright together with a copy of the manuscript to a purchaser. The author could alternatively sell the original manuscript to one purchaser (e.g., a collector), and assign the copyrights to the content of the book to another purchaser.

If, after the author sold his copyrights to a purchaser, a thief stole the author’s original manuscript and created copies thereof, the thief would infringe upon the author’s tangible property rights to the manuscript (state law trespass to chattels) and the purchaser’s copyright to the content of the manuscript (federal copyright infringement). Even the author could infringe upon the purchaser’s rights if the author made additional copies of his original manuscript after he sold and assigned his copyright to the purchaser.

The author might also decide to retain his copyright and create and market copies of his book himself. If the author creates the first copy of his original manuscript himself, and sells and transfers title to a purchaser of the copy, then the purchaser will become the lawful owner of the book.

Author/Copyright Owner → First Purchaser (Owner of Copy of Book)

As the owner of the book, the purchaser would normally have the common law right to do whatever he pleases with the book. The purchaser could merely use it, by reading it. With modern technology, however, the purchaser could also easily produce and market a large number of copies of the book in paper, electronic, or other forms and deprive the author of some of his potential market opportunities. It would have similar detrimental effects on the author’s marketing chances if the purchaser, without making any copies, rents the book

35. See 17 U.S.C. § 202 (2000).

to numerous third parties, or exploits its contents by public theater performances (e.g., if the book contains a theatrical work). The author would also lose potential marketing chances if the first purchaser merely sold the book to a second purchaser after he read it. Thus, in the absence of laws granting the author exclusive rights to the intangible value represented by the intangible contents of his manuscript, the author would be unable successfully to exploit it commercially. The author would feel less economic incentive to write or publish the book in the first place, and consequently, society would be deprived of at least some valuable works of authorship.³⁶

Copyright law is designed to prevent this unhappy result by granting certain exclusive rights to the creators of intangible values. For this reason, copyright law limits a book purchaser's rights to the intangible value contained in the book. A book purchaser may not create any copies of the book without the author's consent.³⁷ A book purchaser is also prohibited from renting or leasing the book or from exploiting it in public performances.³⁸ However, in order to accommodate other valid economic interests, copyright law does not grant the author a proprietary right to prohibit a book purchaser from reselling his book.³⁹ This is where the copyright law—in the form of the First Sale Doctrine—draws the line. According to this doctrine, after the author has sold a copy of his manuscript, his rights to prohibit the sale of this copy are exhausted.

Author/Original Owner → First Purchaser → Second Purchaser

The term "copy" is defined as "material objects, other than phonorecords, in which a work is fixed by any method now known or later developed, and from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device."⁴⁰ The first lawful purchaser, i.e., someone who acquired the copy with the author's consent, becomes the lawful owner of such copy. According to the First Sale Doctrine, incident to any sale

36. It has been observed that this issue has been thus far addressed only at a theoretical level, with very little empirical evidence adduced to support or refute the notion of excludability as a necessary or adequate incentive to spur the creation of patentable or copyrightable works. See James Boyle, *Cruel, Mean or Lavish? Economic Analysis, Price Discrimination and Digital Intellectual Property*, 53 VAND. L. REV. 2007, 2016–17 (2000); Harvey S. Perlman, *Taking the Protection-Access Tradeoff Seriously*, 53 VAND. L. REV. 1831, 1837 (2000).

37. See 17 U.S.C. § 106 (2000).

38. See *id.*; 17 U.S.C. §§ 109(b)(1)(A), 110 (2000).

39. See 17 U.S.C. § 106.

40. 17 U.S.C. § 101 (2000).

of a copy of a copyrighted work, the purchaser automatically acquires the right to resell the book to a second purchaser for the first purchaser's own profit.⁴¹ This doctrine has been applied consistently to confer resale rights on purchasers of intellectual property for over one hundred years.⁴²

The First Sale Doctrine does not apply to a license where no sale occurs, such as a "pure" publishing⁴³ or other license. Thus, if a book author loaned a copy of his book to a vanity publisher and conferred a license upon the publisher to reproduce the book solely to create copies of the book for the author herself, no sale of a copy has taken place. Should the vanity publisher choose to sell any additional copies of the work, that sale would constitute copyright infringement. Where the possessor of protected work is not its lawful owner, as the case where the publisher merely performs a service and does not publish the copies for sale *by the publisher*, section 109(a) of the Copyright Act does not apply.⁴⁴ Thus, a pure license unaccompanied by a sale of a copy of the work does not implicate the First Sale Doctrine. However, the First Sale Doctrine applies to a sale by a publisher if made with the consent of the copyright owner.

3. Sale and Ownership of a Copyrighted Computer Program

Turning to the focus of this Article, software is a relatively new subject for protection under the First Sale Doctrine and, relatively speaking, copyright law.⁴⁵ As with books, a "copy" is defined as a "material object" in which a copyrighted work is fixed.⁴⁶ With respect to the media, the author again enjoys exactly the same tangible property rights as the owner of jewelry or a book, as outlined above. The author of a copyrightable computer program also enjoys the same intellectual property rights as the author of a book. The software author can keep the program to himself, assign the copyrights to the program to an-

41. See 17 U.S.C. § 109.

42. See, e.g., *Harrison v. Maynard Merrill & Co.*, 61 F. 689, 691 (2d Cir. 1894).

43. A publishing license conveys to the publisher of a work the right to make copies of the work, but does not necessarily grant any ownership interest in the resulting copies.

44. The general practice in most publishing industries is that the publisher obtains a license from the copyright owner (or owns the copyright itself) and pays royalties to the copyright owner based on the real or expected sales of the copies of the work. This identity of copy creation and ownership does not apply, however, in the uncommon case where a copyright owner has outsourced publishing duties but sells the copies himself.

45. Consider the situation of an author of a copyrighted computer program: a computer program consists of data stored on some electronic medium, e.g., a compact disc ("CD") or digital versatile disc ("DVD").

46. 17 U.S.C. § 101 (2000).

other party, or retain the copyrights and create and sell copies of the program.

However, if the software author creates and sells a copy of the program, the purchaser usually finds himself in a significantly different situation than the purchaser of a book. While the purchaser of a book only needs title to the book to enjoy its use, the purchaser of a software copy has to create at least one additional copy of the program before he can use it. In order to use software, a purchaser must upload it from the storage medium—be it a CD, a DVD, or a computer's hard drive—to the temporary random access memory ("RAM") of the computer.⁴⁷ By uploading the electronic data in a different storage unit of the computer, the software purchaser creates a second physical manifestation of the computer program, and courts in the United States qualify such physical manifestation as a copy for purposes of copyright law.⁴⁸ Therefore, in the absence of special exceptions, the purchaser of a copy of software needs the permission of the copyright owner before he can actually enjoy his tangible property rights to his software copy. Because the copyright owner retains all rights to copy the program, the first purchaser is not alone in needing this permission—any subsequent purchaser must obtain it as well. While the First Sale Doctrine may provide that the software author has no right to prohibit resale of the software, the doctrine does not prevent the software author from prohibiting copying of the software he sold. If it did, a second purchaser could create multiple copies of the software, sell them to numerous potential purchasers of the author's software, and deprive the author of the profits of his intellectual property rights.

While the First Sale Doctrine effectively immunizes the purchaser of most forms of copyrighted works from accusations of infringement

47. The random access memory, or RAM, consists of a set of microchips that are active and contain information only when the computer is powered on. For a computer to function, the computer program information must be copied from the storage media to the RAM, where it is immediately accessible to the computer's central processing unit.

48. See, e.g., *MAI Sys. Corp. v. Peak Computer, Inc.*, 991 F.2d 511, 518 (9th Cir. 1993). The final report of the Congress-appointed Commission on New Technological Uses of Copyrighted Works ("CONTU") has taken the position that "[t]he text of the new copyright law makes it clear that the placement of a copyrighted work into a computer . . . is the preparation of a copy Because works in computer storage may be repeatedly reproduced, they are fixed and, therefore, copies." CONTU, *Final Report* 22 (1978). It is interesting to note that this position would seem to lead to the conclusion that electronic transmission of software is a "sale of a copy" if it is ultimately stored on a fixed media (e.g., a computer's hard disk drive). At least one German court came to a different conclusion, 1999 LG Mannheim, CR, 360–62, as further discussed *infra* note 306 and in the accompanying text.

upon resale of the purchased work, it is—by itself—not sufficient to ensure the transferability of computer software. This is where section 117 comes into play.⁴⁹ Section 117 allows the lawful owner of a copyrighted computer program to create copies necessary to using the program without obtaining the permission of the copyright owner.⁵⁰ While the First Sale Doctrine exempts the second purchaser of a software copy from infringement, section 117 attempts to ensure that a second purchaser will also be entitled to use the copy he purchased. Thus, if a software publisher sells a copy of a computer program (e.g., a word processor) to a purchaser (e.g., a software distributor), the purchaser can effectively resell the copy to a second purchaser (e.g., an end-user such as a consumer), and under sections 109(a) and 117 of the Copyright Act, the second purchaser does not infringe the copyright in the software by purchasing or using the software.

In practice, an end user of a computer program is usually prompted to accept an end user software license agreement (“EULA”)

49. 17 U.S.C. § 117 (2000) provides:

Limitations on exclusive rights: Computer programs (a) Making of Additional Copy or Adaptation by Owner of Copy. Notwithstanding the provisions of section 106, it is not an infringement for the owner of a copy of a computer program to make or authorize the making of another copy or adaptation of that computer program provided: (1) that such a new copy or adaptation is created as an essential step in the utilization of the computer program in conjunction with a machine and that it is used in no other manner, or (2) that such new copy or adaptation is for archival purposes only and that all archival copies are destroyed in the event that continued possession of the computer program should cease to be rightful. (b) Lease, Sale, or Other Transfer of Additional Copy or Adaptation. Any exact copies prepared in accordance with the provisions of this section may be leased, sold, or otherwise transferred, along with the copy from which such copies were prepared, only as part of the lease, sale, or other transfer of all rights in the program. Adaptations so prepared may be transferred only with the authorization of the copyright owner. (c) Machine Maintenance or Repair. Notwithstanding the provisions of section 106, it is not an infringement for the owner or lessee of a machine to make or authorize the making of a copy of a computer program if such copy is made solely by virtue of the activation of a machine that lawfully contains an authorized copy of the computer program, for purposes only of maintenance or repair of that machine, if (1) such new copy is used in no other manner and is destroyed immediately after the maintenance or repair is completed; and (2) with respect to any computer program or part thereof that is not necessary for that machine to be activated, such program or part thereof is not accessed or used other than to make such new copy by virtue of the activation of the machine. (d) Definitions. For purposes of this section (1) the “maintenance” of a machine is the servicing of the machine in order to make it work in accordance with its original specifications and any changes to those specifications authorized for that machine; and (2) the “repair” of a machine is the restoring of the machine to the state of working in accordance with its original specifications and any changes to those specifications authorized for that machine.

50. See 17 U.S.C. § 117.

between himself and the software publisher before he may use a software copy acquired from a distributor. The end user is confronted with the EULA either when he opens the packing material (shrink-wrap license) or as a first screen when he installs the software (click-wrap license). In the software license agreement, the software publisher typically purports to grant to the end user the right to use the software program in consideration of the end user's acceptance of numerous restrictions, often including an agreement not to resell, reverse engineer, or copy the software program (other than a single backup copy in case the original is destroyed), and it also requires the user to waive certain statutory warranty rights. In the shrinkwrap or clickwrap business model, the software publisher usually does not require the end user to send an express confirmation of acceptance of the software license agreement to the publisher. Instead, the software author seems to rely on a theory of implied consent by unilateral offer. The legal theory, explicitly accepted only by a few courts, is that the end user impliedly accepts the software license agreement by unwrapping the packaging materials or by proceeding with the installation procedure.⁵¹ Although silence cannot be construed as consent in a commercial context, the purchaser is assumed to have the option of returning the software at no cost if he rejects the terms of the license agreement.⁵² Ironically, the protections under sections 109(a) and 117 against copyright infringement by using or reselling the software may now have been undermined by the terms of the license agreement (i.e. under the state law of contract), but only if these protections can be waived by agreement. Would such a contractual provision, which prohibits the exercise of a right clearly protected by statute, be valid and enforceable? If so, on what legal theory? Part III.A addresses these questions.

51. See, e.g., *ProCD, Inc. v. Zeidenberg*, 86 F.3d 1447, 1452 (7th Cir. 1996).

52. See *id.* Of course, if an end-user already acquires all necessary rights by sections 109 and 117 of the Copyright Act, it appears very doubtful whether he can be deemed to impliedly accept a license agreement under which he does not acquire any relevant rights but primarily accepts disclaimers and waives rights. Also, the widespread use of "restocking fees" by retailers undermines this legal theory, but no court has so far addressed this obvious problem. With *ProCD*, the Seventh Circuit even seemed unaware of this common business practice. In any case, the theory of unilateral offer does not traditionally work in such a situation because, in order to accept a unilateral offer, the offeree must eventually notify the offeror of his acceptance (unless the offer explicitly waives such notice, which rarely occurs in software sales offers). RESTATEMENT (SECOND) OF CONTRACTS § 54(2) (1979). It may be this failure that has caused courts such as *ProCD* to attempt to salvage the contract by characterizing the sale of software as a sale of goods subject to the Uniform Commercial Code. See discussion *infra* Part II.B.

B. Sale Versus Other Forms of Commercialization

Like the jewelry owner, the owner of a copyright to a computer program can “sell” (i.e., assign) his copyright to another person. Alternatively, the owner of the copyright on a computer program can also retain his copyright and merely sell the right to make a certain number of additional copies of the program. For example, an author and owner of a word processing program can sell ten copies of the program on ten CDs, each containing one copy of the software, to a company for a fixed fee. When the company expands, it may require five additional software copies. Instead of shipping additional copies, the company can buy the right to create five additional copies for an additional fixed fee. Given the negligible value of the carrier media, in this case, CDs that may cost twenty cents each, the purchase price is unlikely to depend on whether the software owner ships additional CDs or merely grants the right to make five copies.⁵³ From a commercial perspective, the software seller and the software purchaser reach exactly the same result: they exchange five software copies for a fixed fee. In one alternative—shipment of the multiple CDs—the software owner sells a tangible good containing software, and in the other alternative—granting of the right to make a certain number of additional copies—the software owner sells an intangible right only.

The question, then, is whether the First Sale Doctrine applies to both transactions, or whether, in drafting section 109(a), Congress intended only a “material object”⁵⁴ to qualify as a “copy,” the resale of which is protected by the First Sale Doctrine. Analytically, both are “copies” because both must ultimately be fixed in a material object, generally the hard disk drive (or at least the RAM) of an additional computer. To apply the First Sale Doctrine does not require the sale of a material object containing the work; it requires lawful ownership of such an object. It is very possible that a software purchaser does not receive multiple CDs in the mail, in spite of receiving a license to use multiple copies of the work, but he does ultimately receive those copies, which he makes himself, and that are finally embedded on multiple material objects, whether they be computer hard disk drives or RAM chips in various computers. The only other difference between the transactions is the *pro forma* exchange of a nearly valueless carrier media. It does not appear that the First Sale Doctrine applies. Yet, as

53. Actually, the primary costs of selling additional copies of software come from the cost of printing manuals and attractive boxes, and from overhead (e.g., shipping, shelf and storage space, etc.).

54. 17 U.S.C. § 101 (2000).

discussed below, the great majority of courts in the United States seem to take a different perspective on this issue by characterizing the software transfer alternatively as a “sale” or a “license.”

Traditionally, the term “license” describes the granting of certain rights that the licensor has the power to withhold, e.g., the right to enter upon real property, or the right to exercise certain regulated privileges such as driving.⁵⁵ The generality of the term “license” means that it does not normally imply any particular manner of use, exploitation, or commercialization. Therefore, a “license” and a “sale” are not opposite terms. Rather, their difference is a matter of either nature or scope. A license can be a grant of rights unrelated to any transfer of property rights (e.g., the right to drive). In this case, a license transfers nothing except the privilege not to be encumbered with an action at law (e.g., for driving without a license). Alternatively, a license can be a grant of limited property rights; limited, because a full grant of property rights is a sale. But here, with the exception of real property,⁵⁶ the limited scope of the license must be temporal. Thus, if the nature of a sale is that property is *permanently* exchanged for a consideration, then the primary alternative concept with respect to tangible property seems to be that of a lease.⁵⁷

In a lease, property is transferred only temporarily. Originally, the 1976 Copyright Act provided that renting a legally owned copy of a copyrighted work to another party is not infringement.⁵⁸ The rental of software could only result in contributory infringement of the copyright if the lessor knew that the lessee would use the leased copy to infringe.⁵⁹ Otherwise, the purchaser of a copy of software was free to resell, rent, or otherwise dispose of that particular copy as he or she saw fit.⁶⁰ However, the 1990 Computer Software Rental Act⁶¹ overturned that rule by amending section 109(b) of the Copyright Act to

55. See BLACK'S LAW DICTIONARY 919–20 (7th ed. 1999).

56. A license with respect to real property can be limited with respect to scope without limiting the period of the license. For example, one can grant a perpetual easement, i.e., the right to traverse one's real property but not to create or leave any structure on it.

57. To the best knowledge of the authors, this point was first made in Rice, *supra* note 9, at 167, 186–87. As Rice put it, “the existence or nonexistence of a temporal limit is a critical factor in determining if a copy transfer was effected by a sale or involved the transfer of a lesser possessory interest.” *Id.* See also *id.* at 170 (“If the outcome of a negotiation is in fact a lease, the customer will not acquire the status and privileges of a copy owner.”).

58. See 17 U.S.C. § 109(a) (2000).

59. See *Gershwin Pub. Corp. v. Columbia Artists Mgmt., Inc.*, 443 F.2d 1159, 1162 (2d Cir. 1971).

60. See 17 U.S.C. § 106(3) (2000).

61. Pub. L. No. 101-650 Tit. VIII, § 802, 104 Stat. 5089, 5134 (1990).

prohibit any owner of a copy of software to rent or lease that software to a third party without permission of the licensor, if the copy owner's purpose is to compete directly or indirectly with the owner of the copyright.⁶² Copyright owners remain free to "lease" their software and define the license terms accordingly. But the fact that a license accompanies the lease of the software copy does not turn the lease into "nothing but a license." The transaction will presumably retain all the characteristics of a lease, and be referred to accordingly as a "lease of a copy under a license."

The "rental" (i.e., lease) of certain types of software is fairly common. Some businesses rent computers that are preloaded with an operating system that the businesses lease from the computer rental company. A "rental" or "lease" of a copy of software is different from a sale for three reasons. First, the lessee must return or destroy the rented copy of software (i.e., the program code and often the carrier media as well) after a period of time determined by contract, while the purchaser of a copy of software owns that copy in perpetuity. Second, the lessor retains title to the rented "copy" of software throughout the period of the lessee's possession of it (again, the program code and often the carrier media as well). Third, payment for a sale of a software copy is almost always in the form of a one-time fee, while payment for the lease of software usually corresponds in magnitude to the duration of the lease.

These characteristics of a lease tell nothing about the license to use the software. A license can have almost any attributes; the immense flexibility of the license, which allows the licensor to fashion his own terms while maintaining his statutory rights, is one of the primary characteristics of intellectual property protection. Placing limitations upon the licensee's or lessee's use of the work is inevitable in both license and lease. A lessor generally restrains the lessee from selling the copy without his permission, and because the lessee never takes title to the copy, this restraint does not implicate the common law hostility to restraints on alienation or the First Sale Doctrine. In practice, most software licenses accompanying the transfer of a copy of a work (e.g., mass market consumer software licenses) are perpetual and never require the licensee to renew the license or else return or destroy the copy of the program or the carrier media upon which it was originally encoded at the time of sale. On the other hand, some

62. See 17 U.S.C. § 109(b)(1)(A). The Act did make exceptions for educational and library rentals, firmware not copied in the ordinary use of the hardware, and software for video game consoles.

licenses, usually for business-to-business software sales, terminate after the expiration of a predetermined period of time. In such cases, the terms of the license will almost always require the licensee to return or destroy all copies of the work, just as if the software were leased and no transfer of title to either the carrier media or the software copy itself occurs.

To the extent that courts have distinguished between a "sale" and a "license" based upon the perpetuity *vel non* of the transfer of possession of the software copy or the one-time (as opposed to recurring) payment of a lump sum fee (as opposed to royalties calculated based on revenue percentages, or the length of the time period of use), it is unclear how courts would then differentiate a "license" of software from a "lease" of software. For if a sale is perpetual, a lease is temporary, and a license can be temporary or perpetual, a court must look to other factors to determine when a temporary transfer of rights constitutes a license and when a lease.

II. Applicability of the First Sale Doctrine to Software Transfers Under United States Law

Thus, the main questions addressed in this Article are: (1) What is the effect of a contractual agreement between two parties that states neither the purchaser nor licensee may resell its copy of the software? And, more fundamentally: (2) Under what circumstances does the transfer of the right to make a copy of computer software qualify as a "sale of a copy" for purposes of the First Sale Doctrine?

A. The First Sale Doctrine in the United States Copyright Acts

Under section 202 of the Copyright Act,⁶³ the transfer of ownership of "any material object, including the copy or phonorecord in which the work is fixed, does not of itself convey any rights in the copyrighted work embodied in the object" or transfer ownership of the copyright.⁶⁴ Similarly, as described above, the transfer of the copyright (or exclusive rights in the copyright) does not necessarily transfer ownership of any material object in which the copyright is expressed or embodied. The First Sale Doctrine applies to sales of

63. Pub. L. No. 94-553, 90 Stat. 2541 (1976) (codified as amended at 17 U.S.C. chs. 1-8, 10-12 (2000)). Section 117 was amended four years later to clarify that copies of computer software necessary for use of that software by the lawful owner of a copy of the software does not constitute infringement. Pub. L. No. 96-517, 94 Stat. 3028 (1980) (codified as amended at 17 U.S.C. § 117 (2000)).

64. 17 U.S.C. § 202 (2000).

copies of a copyrighted work, as long as the copies are ultimately fixed in a material object.⁶⁵ The modern expression of the Doctrine is set forth in section 109 of the 1976 Act:

Notwithstanding the provisions of section 106(3), the owner of a particular copy or phonorecord lawfully made under this title, or any person authorized by such owner, is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy or phonorecord.⁶⁶

As noted above,⁶⁷ the First Sale Doctrine was well established in the common law long before its present incarnation in the 1976 Act. It was first codified in the 1909 Copyright Act as section 27, in response to a Supreme Court ruling. In that case, *Bobbs-Merrill Co. v. Straus*,⁶⁸ the plaintiff had sold books to R.H. Macy & Co. with a minimum resale price restraint of one dollar per book. A notice was printed on each book stating that any violation of the resale price maintenance provision would constitute infringement of the book's copyright.⁶⁹ When Macy's sold the book at a lower price, the copyright owner sued for infringement. In upholding Macy's First Sale defense, the court rejected the infringement claim, reasoning that the right to vend only encompasses the right to set the terms of the initial sale and not the right to control the terms of future sales.⁷⁰ The *Bobbs-Merrill Co.* decision effectively immunized a distributor (and any subsequent purchaser) from copyright infringement for reselling a book contrary to a provision of the original or prior sales agreement.

One year after the *Bobbs-Merrill Co.* decision was published, Congress enacted a new copyright law. The 1909 Copyright Act, upon which the 1976 Copyright Act is based, had a provision similar to the First Sale Doctrine in section 27: "[N]othing in this title shall be deemed to forbid, prevent, or restrict the transfer of any copy of a copyrighted work, the possession of which has been lawfully ob-

65. See *supra* text accompanying note 54.

66. 17 U.S.C. § 109(a) (2000). Section 109(b) of the Act forbids the commercial lease or lending of copies of computer programs or phonorecords by owners of copies without authorization from the copyright owner. See *id.*

67. See *supra* note 42 and accompanying text.

68. 210 U.S. 339 (1908).

69. Resale price maintenance is the practice of a manufacturer or upper tier distributor setting a maximum or minimum price restraint on the resale of its goods to a lower tier distributor. The use of resale price maintenance generally carries antitrust consequences. See generally Peter Sullivan, *Albrecht Is Finally Overruled: So What's the Big Deal?*, ANTITRUST REP., Jan. 1998, at 2; Aaron Xavier Fellmeth, *State Oil Co. v. Khan: A New Regime for Resale Price Maintenance?*, ANTITRUST REP., Jan. 1998, at 14.

70. See *Bobbs-Merrill Co.*, 210 U.S. at 351.

tained.”⁷¹ The phrasing of the 1909 Act appeared neutral regarding contractual restrictions on the disposition of copies that had been previously sold, but the purpose of the provision was stated in the House Report. The codification was “not intended to change in any way the existing law, but simply to recognize the distinction, long established, between the material object and the right to produce copies thereof.”⁷² The repugnance at the attempts by copyright owners to control the disposition of copies after their initial disposition was palpable: “[I]t would be most unwise to permit the copyright proprietor to exercise any control whatever over the article which is the subject of copyright after said proprietor has made the first sale.”⁷³ Thus, the legislative history seems to indicate that the 1909 Act was intended to preempt any attempt to limit the right of resale by contract. Thus, under the 1909 Act, the First Sale Doctrine would apply regardless of any contractual agreements.

It was not until 1967, when Congress began reconsideration of the 1909 Act, that a need for a more modern copyright statute that would encompass new media such as television and consumer tape recorders was perceived. To ensure that the Copyright Act adequately dealt with new technology, Senator John McClellan introduced a bill to establish a National Commission on New Technological Uses of Copyright Works⁷⁴ (“CONTU”). Congress passed the bill in 1974, establishing a three year mandate for CONTU to study how the 1909 Copyright Act should be revised to accommodate new technology such as photocopying and computer use.⁷⁵ Although a new Copyright Act was passed with a revised First Sale Doctrine in 1976, the Act was amended in 1980 to incorporate two significant changes suggested by CONTU.⁷⁶ One change was the addition of a definition of “computer program” in section 101,⁷⁷ and the other change was the creation of the new section 117, ensuring a right to make copies of software necessary for the use of the software.

In contrast to the 1909 Act’s neutral wording regarding contractual restrictions on the resale of used copyrighted works, the 1976 Act states affirmatively that the lawful owner of a copy of a copyrighted

71. Copyright Act of 1909, ch. 320, § 27, 35 Stat. 1075, 1084 (1909).

72. H.R. REP. NO. 2222, at 19 (1909).

73. *Id.*

74. Act of Dec. 31, 1974, Pub. L. No. 93-573, 88 Stat. 1873 (1974).

75. See CONTU, *Final Report* 4 (1978).

76. See Act of Dec. 12, 1980, Pub. L. No. 96-517, 94 Stat. 3028 (codified as amended at 17 U.S.C. §§ 101, 117 (2000)).

77. 17 U.S.C. § 101 (2000).

work "is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy."⁷⁸ The 1976 Act is more explicit in endowing the copy owner with a positive right to sell the copy. The new language implies that Congress would consider void any contractual restraints on the disposition of a lawfully acquired copy, i.e., a "material object . . . in which a work is fixed by any method now known or later developed, and from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device."⁷⁹ The House Judiciary Committee apparently did not wish to make any radical changes in the law, but did wish to ensure that the Doctrine applied to future technologies. "As a basic condition of copyright protection, the bill perpetuates the existing requirement that a work be fixed in a 'tangible medium of expression,' and adds that this medium may be one 'now known or later developed'"⁸⁰ However, unlike the legislative history of the 1909 version of the First Sale Doctrine, the House Report on section 109 states that the First Sale Doctrine does *not* mean that conditions on future disposition of copies, imposed by a contract between their buyer and seller, would be unenforceable under state commercial law or the common law of contracts. Instead, the House Report suggests that the seller would need to enforce the restrictions under a theory of breach of contract, rather than copyright infringement.⁸¹ While a copyright owner is thus not able to agree with a first purchaser that the First Sale Doctrine shall not apply, the 1976 Copyright Act apparently is not intended to prevent the first purchaser from promising not to resell the copy.

If the House Report were considered the definitive interpretive resource, the result would be that parties could agree in a contract that—as between them—the purchaser is obligated to refrain from reselling a copy of a computer program. The inapplicability of a copyright infringement remedy has several important implications. First, equitable remedies such as an injunction are generally not available for a breach of contract where money damages would remedy the harm.⁸² Nevertheless, the Copyright Act confers an automatic right

78. See 17 U.S.C. § 109 (2000).

79. 17 U.S.C. § 101.

80. H.R. REP. NO. 1476, at 52 (1976).

81. See H.R. REP. NO. 94-1476, at 5693 (1976). See, e.g., Lemley, *supra* note 4 at 1282; *United States v. Wise*, 550 F.2d 1180, 1187 & n.10 (9th Cir. 1977) ("If a vendee breaches an agreement not to sell the copy, he may be liable for the breach but he is not guilty of infringement.").

82. See *Sampson v. Murray*, 415 U.S. 61, 90 (1974).

upon copyright owners to enjoin infringing acts.⁸³ Second, damages for breach of contract generally include only actual direct and indirect damages, while the copyright owner may recover high statutory damages and attorneys' fees from an infringer.⁸⁴ Third, intentional infringement of a copyright raises the possibility of criminal proceedings being instituted against the infringer,⁸⁵ while breach of contract provides no such possibility. Finally, any party that violates the license terms of a copyright infringes that copyright and thereby incurs liability to the copyright owner. Alternatively, a contract can only bind parties in privity, therefore a third party that purchases from a seller in violation of the seller's contractual obligations to the copyright owner incurs no liability to the copyright owner whatsoever. Of course, the first seller may have a claim against the second purchaser for tortious interference with a contract, but this claim does not give rise to statutory damages and the plaintiff (the first seller) must show that the defendant (the second purchaser) knew of the contract provision at issue and intentionally induced the breach.⁸⁶ For example, if the first purchaser resold his software copy in breach of contract, the second purchaser would acquire the ownership to the software copy even against the will of the copyright owner and such second sale would not constitute an infringement of the copyright owner's copyright or give rise to any cause of action by the copyright owner against the second purchaser. Notwithstanding the importance of the difference between copyright infringement and breach of contract, as discussed below in Part III.A, the First Sale Doctrine is important because it excludes any action by the copyright owner for breach of contract by virtue of a resale of a lawfully owned copy of software.⁸⁷

This will answer the first question posed in Part I.B above: The copyright owner and the first purchaser of a software copy cannot validly agree that the First Sale Doctrine will not apply. However, the second question remains: under what circumstances does the First Sale Doctrine apply? If a software manufacturer labels the standard contract as a "license agreement" containing a clause to the effect that "the parties agree that this is a license and not a sale," should the characterization of the agreement by the parties govern, or should

83. See 17 U.S.C. § 502 (2000).

84. See 17 U.S.C. §§ 504–505 (2000).

85. See 17 U.S.C. § 506 (2000).

86. See *supra* note 25 and accompanying text.

87. Cf. Rice, *supra* note 9, at 170 ("What is effectively foreclosed [by the First Sale Doctrine] is only the use of the contract to expand the *statutory* copyright monopoly and the transformation of breach of contract into copyright infringement.").

some objective criteria be applied to determine whether the Copyright Act mandates that the license agreement be treated as a “sale of a copy” for First Sale Doctrine purposes?

The answer to this question is not obvious. “License agreements” usually contain clauses that are familiar from a sales context as well as their own unique terms. Usually, as with a sales contract, the end user may keep his copy perpetually and pay a lump sum for the software. However, the software manufacturer normally limits the way the user may utilize his software copy and prohibits the user from selling his copy. Neither the Dictionary Act⁸⁸ nor the Copyright Act defines the term “license agreement.” Before focusing on the few efforts undertaken by United States courts to resolve this issue, it may be helpful to examine the substantial case law in other fields of jurisprudence: commercial law and section 117.

B. Uniform Commercial Code Jurisprudence of Software Transfers

The issue of what constitutes a sale of a software copy, as opposed to a license of software, has arisen in many contexts. A common and critical distinction that courts have made in this regard is whether a sale of a copy of software is a “sale” or a “license” for several purposes: determining the applicability of the Uniform Commercial Code; applying “sales tax” or “royalties tax” or gaining the investment tax credit;⁸⁹ applying strict product liability law;⁹⁰ applying bankruptcy laws,⁹¹ and determining patent and trademark exhaustion. Not surprisingly, given the different purposes of the underlying statutes,⁹² the

88. See 1 U.S.C. ch. 1 (2000).

89. See, e.g., *Comshare Inc. v. United States*, 27 F.3d 1142, 1149 (6th Cir. 1994).

90. See, e.g., *James v. Meow Media, Inc.*, 90 F. Supp. 2d 798, 810–11 (W.D. Ky. 2000).

91. *Microsoft v. DAK*, 66 F.3d 1091, 1096 (9th Cir. 1995) (determining that a distribution license agreement, under which a licensee has to pay a lump sum amount for every copy of Word 95 that the licensee creates, is “basically a sale, not a license to use.”). See also RAYMOND T. NIMMER, *THE LAW OF COMPUTER TECHNOLOGY* §§ 7.40–7.173 (3d ed. looseleaf, current as of 2001).

92. The Uniform Commercial Code was designed to facilitate commercial transactions by implementing a legal regime that reproduces, to the extent feasible, the customs of purchasers and sellers of goods. See WILLIAM TWINING, *KARL LLEWELLYN AND THE REALIST MOVEMENT* 302–40 (1973); Richard Danzig, *A Comment on the Jurisprudence of the Uniform Commercial Code*, 27 *STAN L. REV.* 621, 626 (1975). In defining what constitute “goods” for purposes of applying the UCC, courts have properly focused on traditional legal principles of personal property. The First Sale Doctrine, by contrast, has the wholly different statutory purpose of limiting the copyright owner’s ability to constrain the resale of a copy of computer software, thereby protecting the purchaser’s expectation of continued ownership and alienability of the software. The UCC definition of goods embodies custom, while the

criteria behind judicial determinations of what constitutes a "sale" and a "license" differ in these analyses from that undertaken for First Sale Doctrine purposes. This subsection will briefly examine the most voluminous area of judicial analysis—the application of the Uniform Commercial Code—in order to reveal the reasoning that motivates the distinction between sale and license, and to determine whether that reasoning may equally apply to, or otherwise illuminate, section 109(a).

Article 2 of the Uniform Commercial Code ("UCC") applies mainly to sales of "goods" in commerce. It is therefore interesting to consider how courts have applied the UCC to transfers of software copies that the parties call (or, more often, the transferring party calls) a "license."⁹³ If it is true that a software license agreement constitutes a sale of goods for UCC purposes, then the reasons for this designation may aid in deciding whether such transactions also constitute a sale for purposes of the First Sale Doctrine.⁹⁴

Of course, the cases applying the UCC and the First Sale Doctrine base their holdings on legal doctrines existing within differing statutory frameworks. When determining whether to apply the UCC, the pertinent issue is usually whether the transfer of a software copy is a "sale of goods" or a "sale of a service" or a "lease of goods." More precisely, the UCC uses the term "transaction" in section 2-102, which seems to imply that Article 2 applies to any transaction involving trans-

First Sale Doctrine is a purchaser protection measure. The former attempts to increase the efficiency of commercial transactions by arriving at the solution the parties would have negotiated in the absence of the statute, while the latter attempts to put certain aspects of a sale *beyond* negotiation.

93. The question of whether the UCC should apply to software has received extensive treatment in scholarly literature. See, e.g., Douglas E. Phillips, *When Software Fails: Emerging Standards of Vendor Liability Under the Uniform Commercial Code*, 50 BUS. LAW. 151 (1994); Amelia H. Boss et al., *Scope of the Uniform Commercial Code: Survey of Computer Contracting Cases*, 43 BUS. LAW. 1513 (1988); David A. Owen, *The Application of Article 2 of the Uniform Commercial Code to Computer Contracts*, 14 N. KY. L. REV. 277 (1987); Andrew Rodau, *Computer Software: Does Article 2 of the Uniform Commercial Code Apply?*, 35 EMORY L.J. 853 (1986); Robert A. Holmes, *Application of Article Two of the Uniform Commercial Code to Computer Systems Acquisitions*, 9 RUTGERS COMPUTER & TECH. L.J. 1 (1982).

94. See, e.g., *Novell, Inc. v. Network Trade Ctr., Inc.*, 25 F. Supp. 2d 1218, 1229–30 (D. Utah 1997) (*vacated in part on other grounds*, 187 F.R.D. 657 (D. Utah 1999)) ("This Court holds that transactions making up the distribution chain from [plaintiff/licensor] through [defendant/licensee] to the end-users are 'sales' governed by the U.C.C. Therefore, the first sale doctrine applies.").

fer of title,⁹⁵ except this does not include assignments of intangibles such as copyrights and patents.

Insofar as a “software copy” is itself a “good,” it can be sold. Goods are defined in the UCC as “all things . . . which are movable at the time of identification to the contract for sale.”⁹⁶ All carrier media (such as DVDs, CDs, and diskettes) and data in the form of electronic or optical pulses can be moved. Thus, the transfer of a software copy could also theoretically qualify as a sale of goods for purposes of the UCC and most jurisdictions do in fact apply the UCC to software license agreements in most cases.⁹⁷ As one court put it, software is generally considered a “good” for UCC purposes “even though a finished software product may reflect a substantial investment of programming services.”⁹⁸ Courts that have interpreted software licenses to be subject to the UCC have not always conditioned that treatment upon the simultaneous sale of hardware or tangible media.⁹⁹ In other words, it is possible that a court would hold that a “sale” of a copy of software downloaded from the Internet or a bulletin board server (“BBS”) would constitute a “sale of goods” for UCC purposes, even though the software was not sold on a diskette, compact disc, DVD, or other tangible media, and even though no hard copy of any manual accompanied the sale.¹⁰⁰ However, the issue remains judicially undecided.

In two 1991 cases, *Advent Systems Ltd. v. Unisys Corp.*¹⁰¹ and *Step-Saver Data Systems, Inc. v. Wyse Technology*,¹⁰² the United States Court of Appeals for the Third Circuit applied the Pennsylvania UCC to software licenses. In *Advent Systems*, the plaintiff, a computer software publisher, agreed to provide software, hardware, and certain sales and

95. See *Hertz Comm. Leasing Corp. v. Transp. Credit Clearing House, Inc.*, 298 N.Y.S.2d 392, 395 (N.Y. Civ. Ct. 1969), *rev'd on other grounds*, 316 N.Y.S.2d 585 (1st Dep't 1970).

96. U.C.C. § 2-105 (2001).

97. See *ProCD, Inc. v. Zeidenberg*, 86 F.3d 1447 (7th Cir. 1996), *rev'g* 908 F. Supp. 640 (W.D. Wis. 1996); Stephen J. Sand, Annotation, *Validity, Construction, and Application of Computer Software Licensing Agreements*, 38 A.L.R. 5th 1, 20–21 (1998) (citing 20 cases in which the UCC was either directly or indirectly held to apply to agreements involving computer software licenses); Andrew Rodau, *Computer Software: Does Article 2 of the Uniform Commercial Code Apply?*, 35 EMORY L.J. 853 (1986).

98. *Comm. Groups, Inc. v. Warner Comm.*, 527 N.Y.S.2d 341, 344 (N.Y. Civ. Ct. 1988).

99. See *ProCD*, 86 F.3d at 1453–54.

100. This would change if a state were to adopt the Uniform Computer Information Transactions Act (“UCITA”). See National Conf. of Comm'rs on Uniform State L., Uniform Computer Information Transactions Act § 103 (July 29, 1999), at <http://www.law.upenn.edu/bll/ulc/ucita/ucitaAMD.htm>.

101. 925 F.2d 670 (3d Cir. 1991).

102. 939 F.2d 91, 100–01 (3d Cir. 1991).

marketing services to the defendant in a pair of contracts.¹⁰³ Later, the defendant determined that it would prefer to develop its own software and, accordingly, terminated its agreements with the plaintiff.¹⁰⁴ The district court had ruled that UCC Article 2 did not apply to the agreements.¹⁰⁵ Instead the court found that the centrality of the provision of services in the agreements outweighed the provision of goods. The software, customized to a significant degree for the defendant's needs, derived most of its value of the customization service that the plaintiff had provided to the defendant.

On appeal, the Third Circuit reversed. The appellate court first noted that the agreement provided that the defendant "desires to purchase" and the plaintiff "desires to sell . . . certain . . . software licenses."¹⁰⁶ The court then explained that the UCC defines "goods" as all things moveable at the time of identification for sale.¹⁰⁷ Because the software at issue was encoded on carrier media, it was moveable.¹⁰⁸ The court analogized the "sale" of software on a carrier media to the sale of a music CD or book. For example, live music or a live lecture, not being fixed on a carrier medium, is not a good, but it becomes one when fixed on a CD or book. Thus, the court reasoned that software is not a "good" until fixed on a diskette or CD.¹⁰⁹ The district court erred, in the Third Circuit's view, by assuming that specific tailoring of the software for the defendant's purposes constituted a "service," because the UCC defines "goods" to include "specially manufactured goods."¹¹⁰ Although the court claimed that it was not departing from the traditional practice of determining whether "goods" or "services" predominated in a contract as a precondition to applying the UCC, its holding seemed to imply that computer software, no matter how customized it may be, is a UCC "good" as long as it is fixed in a tangible carrier medium. The question of whether software downloaded electronically is a "good" was left open by the court.

In *Step-Saver*, a commercial purchaser had placed telephone orders with the software publisher and followed with written purchase

103. *See Advent Sys., Ltd.*, 925 F.2d at 671.

104. *See id.* at 672.

105. *See id.*

106. *See id.* at 674.

107. *See id.*

108. *See id.* at 675 (citing UCC § 2-105).

109. *See id.*

110. *Id.*

orders.¹¹¹ The publisher sent the software with shrinkwrap licenses containing a highly limited warranty. The purchaser read the licenses, but ignored them. When the software proved defective, the purchaser sued. In its own defense, the publisher pointed to the limited warranty incorporated into the shrinkwrap license. If the license bound the parties, the copyright owner could minimize its liability. However, if the contract was formed at the time of sale (before the purchaser had read the shrinkwrap license), the normal UCC contract remedies would apply. The preliminary issue was what body of law governed the decision of *when* the contract was formed—during the course of the telephone ordering conversation or upon opening the box? If the transfer of the software copy was a sale of goods, then the UCC would govern. Otherwise, the transaction may have constituted a sale of services or another form of commercial transaction governed by the state common law of contracts. The Third Circuit briefly noted that a boxed copy of a program had been transferred for a payment and it therefore held that the contract was formed under UCC section 2-207, which meant that material terms were not modifiable in the “last shot” standard form. In other words, the court affirmed that the contract was a sale of a copy of software for UCC purposes. While the parties argued mainly about the distinction between a sale of goods and a sale of services, the holding implies that the transaction could not fall under any other additional category such as a lease, to which UCC Article 2 does not apply. For purposes of the UCC, the software transfer constituted a sale as opposed to a license.

That holding has been repeated widely outside the Third Circuit since 1991.¹¹² However, in *ProCD, Inc. v. Zeidenberg*,¹¹³ the United States Court of Appeals for the Seventh Circuit adopted a different approach, affirming the applicability of UCC Article 2 to software transfer transactions in which the provision of goods predominate over services. In *ProCD*, the software acquirer read a shrinkwrap license agreement that instructed the acquirer to return the product if he did not agree to the terms of the license.¹¹⁴ The acquirer did not agree, but kept the software on the theory that the license agreement was an unenforceable contract of adhesion.¹¹⁵ The district court held that the acquirer rightfully rejected the shrinkwrap license agreement.

111. See *Step-Saver v. Wyse*, 939 F.2d 91, 95–96 (3d Cir. 1991).

112. See, e.g., *NMP Corp. v. Parametric Tech. Corp.*, 948 F. Supp. 1536, 1542 (N.D. Okla. 1997); *VMark Software, Inc. v. EMC Corp.*, 37 Mass. App. Ct. 587, 610 n.1 (1994).

113. 86 F.3d 1447 (7th Cir. 1996), *rev'g* 908 F. Supp. 640 (W.D. Wis. 1996).

114. See *id.* at 1452–53.

115. See *id.* at 1453.

According to that court, a sale of the software copy occurred at the time of payment, before the purchaser had even read the terms of the license agreement. Crucial to this holding was the court's finding that the UCC governed the transaction in question. The court tried to distinguish between a UCC "sale" and a non-UCC "license" of software based upon the characteristics of the transaction. The district court concluded that a sale has the following characteristics:

1. Purchasers of mass-market software pay a single purchase price rather than a series of royalties;
2. The software publisher does not retain title to the "product" as a security interest; and
3. The rights of the licensee to the software copy are perpetual, like the rights of a purchaser pursuant to a sale.¹¹⁶

Because the transaction at bar was a sale, the UCC applied, and any act manifesting assent to the offer (i.e., the failure to return the software) constituted assent to all the terms of the offer.¹¹⁷

On appeal, the Seventh Circuit reversed.¹¹⁸ While the circuit court upheld the district court's application of the UCC, it differentiated between the commercial (business to business) settings in other cases, that had almost uniformly invalidated shrinkwrap license agreements, and the consumer setting in the case before it. Without providing a detailed explanation, the court ruled that commercial license agreements, in which the bargaining power of parties is more likely to be equal, should afford the licensee *greater* protection than consumer license agreements, in which the licensee is generally at a disadvantage in bargaining power. The court further stated that shrinkwrap agreements are "private transactions" that "affect only their parties."¹¹⁹

116. *ProCD, Inc. v. Zeidenberg*, 908 F. Supp. 640, 651 (W.D. Wis. 1996).

117. The Seventh Circuit's decision in *ProCD* has been praised for injecting "commercial reality" into software sales. See Darren C. Baker, Note, *ProCD v. Zeidenberg: Commercial Reality, Flexibility in Contract Formation, and Notions of Manifested Assent in the Arena of Shrinkwrap Licenses*, 92 Nw. U. L. Rev. 379 (1997). However, the true commercial reality is that a purchaser of a software copy who, after reading the undesirable license terms, returns the software, must generally pay a "restocking fee" of some 5%–25% of the purchase price to the retailer, who acts on the theory that a sale was made *at the time of payment*. Moreover, even if returning the software were a cost-free option, virtually all of the licensor's competitors impose identical license provisions, leaving consumers with no choice but to comply with the shrinkwrap provisions regardless of whether they agree with them. It would be strange to conclude that this is either an efficient or an equitable result.

118. See *ProCD*, 86 F.3d 1447, 1449 (7th Cir. 1996), *rev'g* 908 F. Supp. 640 (W.D. Wis. 1996).

119. *Id.* at 1454.

The Seventh Circuit has not ruled on whether a software license that was a sale for UCC purposes could nonetheless evade the First Sale Doctrine. Judge Easterbrook, writing for the court, merely stated that “[w]hether there are legal differences between ‘contracts’ and ‘licenses’ (which may matter under the copyright doctrine of first sale) is a subject for another day.”¹²⁰

Finally, the Ninth Circuit has specified a transfer of a software copy as a sale of goods subject to UCC in the much-cited case, *RRX Industries, Inc. v. Lab-Con, Inc.*¹²¹ In that case, the purchaser of a computer software system brought an action for breach of contract against the seller based on defects in the system.¹²² After finding that the software was so defective as to constitute a breach of contract, the district court looked to the California Commercial Code to determine whether to award consequential damages to the purchaser.¹²³ On appeal, the Ninth Circuit called upon Seventh Circuit precedent to establish that it should look to “the essence of the agreement” to determine whether it was a sale of “goods” rather than “services.”¹²⁴ The court followed the tradition of weighing whether the sale aspects or the service aspects of the contract predominated.¹²⁵ A fact-based analysis, taking into consideration the pre-established nature of the software programs, led to the conclusion that the provision of training and other services was incidental to the sale of the software as goods.¹²⁶ The court therefore held that the UCC applied to the contract.¹²⁷ District courts throughout the country agree with this interpretation. For example, when a copyright holder argued that it sold a nontransferable license, not “the software itself,” and therefore should not be subject to the UCC, an Arizona district court responded that

120. *Id.* at 1449. In the view of at least one publicist, the result of the court’s ruling, and in particular Judge Easterbrook’s bizarre implication that the characterization of copyright license agreements for UCC purposes has no broad social effects, is to encourage courts to overlook the potential for undermining the Copyright Act’s careful balance between the protection of intellectual property as an incentive for its creation and the freedom of public access to information for the good of society. *See generally* Neil Weinstock Netanel, *Copyright and a Democratic Civil Society*, 106 YALE L.J. 283, 383–85 (1996).

121. 772 F.2d 543 (9th Cir. 1985).

122. *See id.*

123. *See id.* at 546.

124. *Id.* (citing *Pittsburgh-Des Moines Steel Co. v. Brookhaven Manor Water Co.*, 532 F.2d 572, 581 n.6 (7th Cir. 1976)).

125. *See id.*

126. *See id.*

127. *See id.* at 546–47.

the UCC applies to software licenses just as much as it applies to sales of goods.¹²⁸

The cases where courts have reasoned that a “license” is a “sale” for purposes of the UCC due to policy considerations that are common to both the UCC and the Copyright Act are noteworthy because they may shed light on when and why an agreement should be considered a sale or a license (or both) for First Sale Doctrine purposes. The consensus of courts assessing the applicability of the UCC to software transfers base their analyses upon whether support services accompanying the software sale outweigh the software sale itself, or if the provision of services otherwise dominated the contract, or whether the software was sold as a prepublished package (i.e., as a good). It is as yet unclear whether courts would apply this same distinction for First Sale Doctrine purposes, but at least one court has assumed that what must be a sale of software as goods under the UCC must be a sale of copies of software for First Sale Doctrine purposes as well.¹²⁹ The majority of courts continue to base their analyses on the relative importance of the “services” and “goods” components of the contract, which seems largely irrelevant for First Sale Doctrine purposes. This is all the more evident because the applicability of the UCC and the First Sale Doctrine are governed by different policy considerations.

The consequences to the licensor’s avoidance of characterizing the transfer of a copy of software as a UCC sale of goods are very significant. First, as in *Lab-Con*, damages (such as, in that case, consequential damages) provided for in the UCC but not in the common law of contracts become unobtainable. Perhaps more seriously for consumers of mass-market software, the general UCC provisions that ensure a balanced interpretation of the contract and negate underhanded attempts to disclaim liability for wrongful acts would not protect purchasers.¹³⁰ Moreover, the Magnuson-Moss Consumer Warranty Act¹³¹ may be held inapplicable, as it only applies to warranties for the “sale of a consumer product,” which is defined as “tangible personal property which is distributed in commerce.”¹³² Software considered a sale of services for UCC purposes may not qualify as a sale of

128. See *Arizona Retail Sys., Inc. v. Software Link, Inc.*, 831 F. Supp. 759, 761–63 (D. Ariz. 1993).

129. See *Novell, Inc. v. Network Trade Ctr., Inc.*, 25 F. Supp. 2d 1218, 1229–30 (D. Utah 1997), *vacated in part on other grounds*, 187 F.R.D. 657 (D. Utah 1999).

130. See, e.g., U.C.C. § 2-314 (2001) (providing that a warranty of merchantability is implicit in any sale contract unless explicitly disclaimed).

131. 15 U.S.C. §§ 2301–2312 (2000).

132. 15 U.S.C. § 2301(1)(6).

goods under the Magnuson-Moss Act because it does not fit within the definition of a "sale of a consumer product."

On the other hand, if a court infers from the characterization of a software transfer that it is a "sale of services," then the First Sale Doctrine does not apply,¹³³ and the transferee becomes liable for copyright infringement by selling the software contrary to the terms of the license. These two areas of the law have one similarity: software manufacturers are trying to avoid the characterization of the transfer of software copies as a sale, because such characterization leads to the applicability of potentially disadvantageous laws such as implied warranty and liability provisions under the UCC, the Magnuson-Moss Act, and the First Sale Doctrine under copyright laws. It is therefore worth noting that courts applying the UCC seem to assume a sale of goods whenever a software copy is transferred perpetually against a lump sum payment, regardless how the parties to the transfer agreement label the transaction. Whether it is titled "License Agreement" or "Purchase Agreement," courts usually assume that a sale occurred for purposes of the UCC if a physical software copy is transferred in perpetuity for a lump sum payment.

C. Software Transfers Under Section 117 of the 1976 Copyright Act

Section 117 provides that it is not an infringement of a copyright to make an unlicensed copy of a software program "as an essential step in the utilization of the computer program in conjunction with a machine."¹³⁴ The section was added to the code in 1980 to prevent the loading of a software program into random access memory, which creates a copy of the program as recorded either on the CD, hard disk drive, read only memory ("ROM") chip, or other media, from infringing the copyright.¹³⁵ Similar to the First Sale Doctrine, section 117 applies only to "owners of a copy" of software. According to that section,

It is not an infringement for the owner of a copy of a computer program to make or authorize the making of another copy or adaptation of that computer program provided: . . . that such copy or adaptation is created as an essential step in the utilization of the

133. See e.g., *Novell*, 25 F. Supp. 2d at 1229.

134. 17 U.S.C. § 117 (2000).

135. A typical case applying section 117 is *Vault Corp. v. Quaid Software Ltd.*, 857 F.2d 255 (5th Cir. 1988).

computer program in conjunction with a machine and that it is used in no other manner.¹³⁶

In order to determine the applicability of this provision, courts have asked "whether end-users . . . are 'owners' of the software, or merely 'licensees' thereof."¹³⁷ Courts applying the UCC tend to find that the transferees are "owners of a copy" for purposes of section 117 as well as section 109.¹³⁸

In *MAI Systems Corp. v. Peak Computer, Inc.*,¹³⁹ MAI, a computer manufacturer that published its own proprietary operating system, included with the software a license agreement prohibiting its customers from making the software available to any third party.¹⁴⁰ At some point, some of MAI's customers switched from using MAI's services for repair and maintenance of the hardware to those of an independent service provider, Peak. Knowing that Peak had to use MAI's operating system to boot the computer, MAI sued Peak for infringement of the software copyrights, claiming that the copy made into RAM constituted an unlawful copy.¹⁴¹ In spite of section 117, the Ninth Circuit Court of Appeals upheld MAI's contention, finding Peak to have infringed the copyrights. Citing a prior lower court decision,¹⁴² the Ninth Circuit stated in a footnote that, because MAI "licensed its software, the Peak customers do not qualify as 'owners' of the software and are not eligible for protection under section 117."¹⁴³ The court made no attempt to determine whether the transaction between MAI and the acquirers of copies of MAI software constituted a sale.¹⁴⁴ Instead, the court relied exclusively on the fact that MAI labeled the standard agreement under which it transferred its software as a "license agreement," not as a "sales agreement."¹⁴⁵ Yet, because the use of the term "license agreement" is a much more common practice in the industry than the use of the term "sales agreement" or "purchase agreement," the practical effect of the Ninth Circuit's holding was to

136. 17 U.S.C. § 117.

137. *Novell*, 25 F. Supp. 2d at 1229.

138. *See, e.g., id.* at 1230.

139. 991 F.2d 511 (9th Cir. 1993).

140. *See id.* at 517.

141. *See id.* at 518.

142. *See Apple Computer, Inc. v. Formula Int'l, Inc.*, 594 F. Supp. 617, 621 (C.D. Cal. 1984).

143. *MAI Systems*, 991 F.2d at 518 n.5.

144. *See id.* at 517.

145. *Id.*

nullify section 117 except in those relatively rare cases where the parties had not termed the contract a "licensing agreement."¹⁴⁶

The *MAI* decision was not the last word on the application of section 117 to license agreements. In *DSC Communications Corp. v. Pulse Communications, Inc.*,¹⁴⁷ the United States District Court for the Eastern District of Virginia expressly disregarded such labeling.¹⁴⁸ The facts of the case involved a transfer of "POTS-DI" software copies from the plaintiff DSC to a number of Regional Bell Operating Companies ("RBOC").¹⁴⁹ Defendant Pulse and the RBOCs had made copies of plaintiff DSC's POTS-DI software in connection with replacing certain hardware supplied by DSC with hardware supplied by Pulse.¹⁵⁰ Pulse argued that the defendants had the right to make such copies

146. Moreover, because federal law does not distinguish between a "license" and a "sale" (indeed, does not directly govern matters such as sales), the court used state law to preempt federal policy in contradiction to the Supremacy Clause of the Constitution. According to the Supremacy Clause, the Constitution and the laws of federal government are the supreme law of the land. Conflicting state legislation must give way in an area of federal competence, such as the protection of intellectual property. The congressional objective in promulgating section 117 was to ensure that owners of intellectual property could not indirectly tie the market for their software to the market for hardware or repair services by prohibiting otherwise lawful copies to be made. By calling upon a state law distinction (which is in any case fictitious) between a contract for the "sale of a copy of software" and a "software license," the Ninth Circuit completely ignored a consequential constitutional infirmity in its ruling.

However, this was touched on obliquely in *Central Point Software, Inc. v. Global Software & Accessories, Inc.*, 880 F. Supp. 957 (E.D.N.Y. 1995). In that case, a licensee of certain software, prevented by the Computer Software Rental Act from renting his software, sold it to customers at a low fee, then bought it back when the customer finished using it. Upon suit for copyright infringement, the licensee claimed that, under pertinent state law, the sale was a true sale and not a rental or disguised lease. The court refused, however, to examine the state law issue. The court would not let state law determine the outcome of an infringement action brought under a federal statute. *See id.* at 964-65.

147. *DSC Communications Corp. v. Pulse Communications Inc.*, 976 F. Supp. 359 (E.D. Vir. 1997), *aff'd in part, vacated in part, rev'd in part*, 170 F.3d 1354 (Fed. Cir. 1999), *cert. denied*, 518 U.S. 923 (1999).

148. *See id.* at 362-63.

149. DSC sued its competitor, Pulse, on a theory of contributory copyright infringement. DSC manufactures telephone routing hardware and software, particularly digital carrier loop systems ("DCL"). DCLs are composed of a backplane, which holds expansion cards and uses a software operating system to route and convert telephone signals. Pulse manufactured expansion cards for DSC's hardware systems and competed with DSC in the expansion card market. To avoid competition in the expansion card market for its DCLs, DSC had inserted a provisions in its license that forbade its licensees to: (1) use DSC software on hardware created by a party other than DSC, or (2) transfer their copies of software to a third party. When DSC customers purchased Pulse cards and used them in DSC systems, DSC sued Pulse because every time the owner of DSC's operating system uses a Pulse expansion card, the DSC software is loaded into the Pulse card's memory, creating a "copy." *See id.* at 362.

150. *See id.* at 361.

under section 117, which permits copying by the lawful owner of the software copy if such copying constitutes an essential step in the utilization of the copy.¹⁵¹ Plaintiff DSC contended that the defendants did not have any such right because they did not become owners of the POTS-DI software copies. DSC claimed that it merely licensed such copies; no sale had occurred. The district court rejected this conclusion, however, finding:

[T]he existence of a license agreement between DSC and its customers does not preclude a finding that the RBOCs are "owners of a copy" for the purposes of Section 117. . . . It is necessary to determine ownership of the copy, not whether the transaction with DSC involved a license to use the program. . . . In this case, the transaction involves a single payment, giving the buyer an unlimited period in which it has a right to possession, making [the] transaction a sale. The RBOCs make a single payment for the Litespan software and obtain a perpetual license to use and maintain the same. It is clear that Section 117 was intended to encompass the RBOCs as legitimate holders of copies of the DSC POTS-DI software.¹⁵²

On appeal, the United States Court of Appeals for the Federal Circuit found this approach "overly simplistic."¹⁵³ The appeals court disagreed with both the district court and the Ninth Circuit's *MAI* decision and tried instead to develop a more differentiated approach to characterizing software transfers for purposes of federal copyright law.¹⁵⁴ The appellate court first rejected the *MAI* approach, according to which a transfer labeled "license" could never qualify as a sale for purposes of copyright law:

The Ninth Circuit stated that it reached the conclusion that Peak was not an owner because Peak had licensed the software from MAI. . . . That explanation of the court's decision has been criticized for failing to recognize the distinction between ownership of a copyright, which can be licensed, and ownership of copies of the copyrighted software. Plainly, a party who purchases copies of software from the copyright owner can hold a license under a copyright while still being an "owner" of a copy of the copyrighted software for purposes of Section 117. We therefore do not adopt the Ninth Circuit's characterization of all licensees as non-owners. Nonetheless, the *MAI* case is instructive, because the agreement between MAI and Peak, like the agreements at issue in this case, imposed more severe restrictions on Peak's rights with respect to the software than would be imposed on a party who owned copies of software subject only to the rights of the copyright holder under

151. *See id.* at 362-63.

152. *Id.*

153. *DSC Communications Corp. v. Pulse Communications Inc.*, 170 F.3d 1354, 1362 (Fed. Cir. 1999). It should be noted that the court was applying Fourth Circuit law.

154. *See DSC Communications Corp.*, 976 F. Supp. at 360-61.

the Copyright Act. And for that reason, it was proper to hold that Peak was not an "owner" of copies of the copyrighted software for purposes of Section 117.¹⁵⁵

The original draft of section 117 that was presented to Congress provided that it was not an infringement for the "rightful possessor of a copy" of a work to make additional copies of the software.¹⁵⁶ During the legislative proceedings, Congress changed section 117 to exempt the "lawful owner" from liability. Thus, in the court's view, "Congress must have meant to require more than 'rightful possession' to trigger the Section 117 defense."¹⁵⁷ The court then rejected the approach of the district court, according to which a transfer would always qualify as a sale for purposes of copyright law if it involved perpetual rights of the software acquirer against payment of a lump sum. The court stated:

In finding that the RBOCs were owners of copies of the POTS-DI software, the district court relied heavily on its finding that the RBOCs obtained their interests in the copies of the software through a single payment and for an unlimited period of time. It is true that the transfer of rights to the POTS-DI software in each of the agreements did not take the form of a lease, and that the transfer in each case was in exchange for a single payment and was for a term that was either unlimited or nearly so. One commentator has argued that when a copy of a software program is transferred for a single payment and for an unlimited term, the transferee should be considered an "owner" of the copy of the software program regardless of other restrictions on his use of the software That view has not been accepted by other courts, however, and we think it overly simplistic. The concept of ownership of a copy entails a variety of rights and interests. The fact that the right of possession is perpetual, or that the possessor's rights were obtained through a single payment, is certainly relevant to whether the possessor is an owner, but those factors are not necessarily dispositive if the possessor's right to use the software is heavily encumbered by other restrictions that are inconsistent with the status of owner.¹⁵⁸

155. *Id.* at 361 (citation omitted).

156. *See* Copyright Act of 1976, Pub. L. No. 94-553, 90 Stat. 2565 (October 19, 1976).

157. *DSC Communications Corp.*, 170 F.3d at 1360. The Federal Circuit's interpretation of congressional intent is highly speculative. A more likely interpretation of Congress's reason for the change is that the original wording was vague and not a term of art, and that Congress wished to avoid giving use or reproduction rights to lessees or borrowers (both of whom would be rightful possessors) without permission of the owner of the copy. The term "rightful," not being a modern legal term, has a vaguely moral denotation, whereas "lawful" clearly means "in accordance with lawful rights." "Possessor" conveys no implication of legal right to title (a thief, lessee, or bailee using software is a possessor), whereas the concept of "ownership" entails a right permanently to possess. Congress undoubtedly intended to avoid bestowing a right to use the copy to any possessor, but instead to limit that right to the lawful owner.

158. *Id.* at 1362 (citation omitted).

The court further analyzed the transfer agreement under its own test, according to which a software transfer qualifies as a sale pursuant to which the acquirer becomes the owner of the copy for purposes of copyright law if the acquirer obtains rights to the software copy that are comparable to the rights a purchaser obtains under the traditional concepts of sales and ownership of personal property.¹⁵⁹ In the course of this analysis, the court noted that:

[t]he licensing agreements severely limit the rights of the RBOCs with respect to the POTS-DI software in ways that are inconsistent with the rights normally enjoyed by owners of copies of software Each of the DSC-RBOC agreements limits the contracting RBOC's right to transfer copies of the POTS-DI software or to disclose the details of the software to third parties Such a restriction is plainly at odds with the Section 109 right to transfer owned copies of software to third parties. The agreements also prohibit the RBOCs from using the software on hardware other than that provided by DSC. If the RBOCs were "owners of copies" of the software, Section 117 would allow them to use the software on any hardware, regardless of origin. Because the DSC-RBOC agreements substantially limit the rights of the RBOCs compared to the rights they would enjoy as "owners of copies" of the POTS-DI software under the Copyright Act, the contents of the agreements support the characterization of the RBOCs as non-owners of the copies of the POTS-DI software.¹⁶⁰

In applying an objective test and rejecting the Ninth Circuit's approach of relying entirely on the label of a software transfer agreement ("license" or "sale") in determining its character, the Federal Circuit gave a possible answer to the second question posed above—"Under what circumstances does the transfer of the right to make a copy of computer software qualify as a 'sale of a copy' for purposes of the First Sale Doctrine?"—their answer was that a sale of a copy occurs when the terms of the agreement are consistent with the sale of a copy. Based on this general approach, in accordance with the analysis of the district court, the Federal Circuit deemed it relevant whether the acquirer obtained rights to a software for a limited period of time, as in a lease transaction, or perpetually, as in a sales context.¹⁶¹ The Federal Circuit's use of an objective test and distinction between transfers for a limited period of time versus permanent transfers in particular are the best approach to this problem.

However, the Federal Circuit ultimately based its decision on the fact that the transfer agreement prohibited the acquirer from copying

159. *See id.* at 1360–62.

160. *Id.* at 1361–62.

161. *See id.* at 1362.

the software onto different hardware and from transferring the software copy to a second purchaser.¹⁶² This surprising use of tautology by the Federal Circuit turned sections 109(a) and 117 of the Copyright Act from mandatory law back into optional rules to be decided by contract and does not differ too much from the Ninth Circuit approach in *MAI*. Under *MAI*, if the agreement calls itself a license agreement and not a sale agreement, then it is one.¹⁶³ Under *DSC Communications*, if the license prohibits the exercise of the very rights that the First Sale Doctrine and section 117 afford to the software purchaser, then the statutes providing for such rights in the interest of public policy will not apply.¹⁶⁴ In other words, if the copyright owner imposes a contract clause that undermines the policy behind the statutory First Sale Doctrine, then the First Sale Doctrine simply does not apply to the contract.

Contrary to the holdings of the Ninth and Federal Circuits, neither contractual restrictions on statutory rights nor *pro forma* labels should govern whether these statutory protections apply. The use of objective factors by the Federal Circuit was correct: the transfer of perpetual user rights characterize a "sale" of a copy of software. Consequently, in order to determine whether a transfer of a copy occurred for purposes of copyright laws, courts should determine whether the transaction between the copyright owner and the first acquirer of a certain copy involves an assignment of the copyright itself (sale of the copyrights) or a lease of the individual copy (lease of a software copy). If neither is the case, then the transaction seems to be properly characterized as a sale of a software copy, which should trigger the First Sale Doctrine and section 117. In the course of this determination, courts should disregard the copyright holder's interest and attempts to preclude the applicability of aforesaid statutes. Contractual resale prohibitions or restrictions of the rights contained in section 117 should be irrelevant for purposes of analyzing whether a software transfer qualifies as a sale for purposes of the First Sale Doctrine.

Instead, courts should determine whether a license involves either (i) a grant to a transferee of software copies of the additional rights that are not generally implied in a sales context (e.g., the right to create and distribute an unlimited number of additional copies or

162. Some publicists have been beguiled by this tautology as well. See, e.g., Rice, *supra* note 9, at 173 ("Nonsale transactions, in addition, differ from ownership transfer with respect to the transferee's capacity to alienate possession.").

163. See *MAI Sys. Corp. v. Peak Computer, Inc.*, 991 F.2d 511, 517-18 (9th Cir. 1993).

164. See *DSC Communications Corp.*, 170 F.3d at 1361-62.

the right to create derivative works), or (ii) an agreement by the transferee of software copies to use the copyrighted work only to a limited extent in order to obtain price reductions (e.g., a licensee agrees to use the software only in certain fields, on certain designated hardware, in CPU performance categories, or through a defined number of authorized users). To the extent that such additional rights or restrictions are present in a software transfer (assuming, of course, that they are otherwise valid under antitrust or other laws), they may alter the overall "sales character" of the transaction. As a consequence, the First Sale Doctrine should not apply, and the transferee will accordingly not enjoy the rights granted by sections 109 and 117 of the Copyright Act unless such rights are granted contractually. However, it would be circular to conclude merely from the fact that the transferor tried to exclude the rights granted by sections 109 and 117 of the Copyright by contract, that the transaction does not qualify as a sale of a copy and, therefore, the transferee does not enjoy the statutory rights. If courts wish to treat the First Sale Doctrine as a non-mandatory "fallback" provision, which can be derogated from contractually, courts need not expend the time of analyzing objective factors as proposed by the Federal Circuit. Instead, courts could return to the jurisprudence of *MAI* and merely consider the label of the agreement as the decisive factor.

In 1998, as part of the Digital Millennium Copyright Act, Congress narrowly overruled *MAI* by providing in new subsection (c) of section 117:

[I]t is not an infringement for the owner or lessee of a machine to make or authorize the making of a copy of a computer program if such copy is made solely by virtue of the activation of a machine that lawfully contains an authorized copy of the computer program, for purposes only of maintenance or repair of that machine, if—(1) such new copy is used in no other manner and is destroyed immediately after the maintenance or repair is completed; and (2) with respect to any computer program or part thereof that is not necessary for that machine to be activated, such program or part thereof is not accessed or used other than to make such new copy by virtue of the activation of the machine.¹⁶⁵

It remains to be seen whether this narrow legislative change confirms the Federal Circuit's interpretation in *DSC Communications* (which was still based on the pre-1998 version of section 117 even though the case was decided in 1999).¹⁶⁶ Possibly, Congress con-

165. 17 U.S.C. § 117(c) (2000).

166. See Pub. L. No. 105-304, Title III, § 302, 112 Stat. 2887 (1998). Amended section 117 and designated the sentence beginning "Notwithstanding the provisions . . ." as Sub-

strained itself to a narrow change because the lawmakers were undecided and insecure regarding the consequences following any change in this area of the law, as evidenced by the current request for public comment on intellectual property law issues including the First Sale Doctrine.

D. Software Transfers Under the First Sale Doctrine

1. *Drebin* and *Wise*: Precursors to the “Sale of a Copy” Definition

The modern application of the First Sale Doctrine to software began with other, more traditional kinds of media. Thus, although the issue of how to define a “sale of a copy” for purposes of the First Sale Doctrine today arises regularly in software transfers, “sale of a copy” problems actually predate the application of the doctrine to computer software. To understand how the use of software licensing has changed and undermined the First Sale Doctrine, it is helpful to comprehend how courts have treated licenses of other media.

The United States Court of Appeals for the Ninth Circuit attempted to distinguish between a “license” and a “sale of a copy” in two 1977 cases, *United States v. Drebin*¹⁶⁷ and *United States v. Wise*.¹⁶⁸ In both *Drebin* and *Wise*, the defendants were convicted of willful copyright infringement for selling allegedly unauthorized copies of motion pictures.¹⁶⁹ The defendants appealed the convictions, arguing that sales of film prints did not infringe a copyright because the film prints had been previously licensed for distribution and exhibition.¹⁷⁰ After

section (a), then inserted the heading; designated the sentences beginning “Any exact copies . . .” and “Adaptations so prepared . . .” as Subsection (b) and then added subsections (c) and (d). See Mark A. Lemley et al., *Exclusive Rights in Computer Programs*, in *SOFTWARE AND INTERNET LAW 201-05* (Mark A. Lemley et al. eds. 2000).

167. 557 F.2d 1316 (9th Cir. 1977).

168. 550 F.2d 1180 (9th Cir. 1977), *cert. denied*, 434 U.S. 929, *reh'g denied* 434 U.S. 977 (1977). The Ninth Circuit also mentioned this distinction in passing in *Triad Systems Corp. v. Southeastern Express Co.*, 64 F.3d 1330 (9th Cir. 1995), *cert. denied*, 516 U.S. 1145 (1996). *Triad* involved an appeal from the district court's grant of a preliminary injunction against an alleged copyright infringer. The owner (“Triad”) of copyrighted diagnostic software for Triad's own computer system sued an independent service organization (“ISO”) for copyright infringement when the ISO used Triad's software to repair Triad machines. Under the license agreement between Triad and its licensees, the licensees could not duplicate the software or allow it to be sold to or used by third parties. After noting that Triad licensed, rather than sold its software, the court upheld the injunction on the grounds that when the ISO turned on Triad machines, a copy of Triad's operating system was made in the RAM, thereby infringing Triad's copyright. Because Triad never purchased the software, the Doctrine of First Sale issue did not arise. See *id.* at 1333.

169. See *Drebin*, 557 F.2d at 1321; *Wise*, 550 F.2d at 1183.

170. See *Drebin*, 557 F.2d at 1322; *Wise*, 550 F.2d at 1189.

analyzing the agreements, the court found that they were "true licensing agreements" on the grounds that they reserved title to the copyright owner and required return of the film prints. The court therefore concluded that no sale had occurred because the films had been presumably leased.¹⁷¹ However, in *Wise*, which involved a criminal indictment for copyright infringement, the court noted that one license agreement appeared to constitute a sale because title to the film reel changed hands, and the district court had therefore found the defendant not guilty on that count.¹⁷² The court examined the licenses to determine, not whether title to the underlying copyright had passed, but whether title to the particular copy of a film print had passed.¹⁷³ Finding that title had passed on that copy, the court exonerated the defendant from copyright infringement for that sale.¹⁷⁴

The interpretation of the meaning of "sale of a copy" set forth by the Ninth Circuit in *Drebin* and *Wise* follows a long line of First Sale Doctrine cases making a distinction between a "sale" and a "license" based upon whether title to the carrier media had passed. This distinction is rooted exclusively in the federal common law of copyright. As noted above, the Copyright Act does not expressly define the term "license," although section 101 explains that an exclusive license qualifies as a "transfer of copyrights," while a non-exclusive license does not:

A "transfer of copyright ownership" is an assignment, mortgage, exclusive license, or any other conveyance, alienation, or hypothecation of a copyright or of any of the exclusive rights comprised in a copyright, whether or not it is limited in time or place of effect, but not including a non-exclusive license.¹⁷⁵

Indeed, while the Copyright Act uses the term "license" and addresses the concept of non-exclusive licenses in many different sections, section 106, which lists the exclusive rights of a copyright owner, does not explicitly mention the copyright owner's power to grant non-exclusive licenses to the copyrighted work. Rather, the Act grants the exclusive right to "distribute copies . . . of the copyrighted work to the public by *sale or other transfer of ownership*, or by *rental, lease, or lending*."¹⁷⁶ This supports the view that the granting of a non-exclusive license does not constitute an additional, alternative means of com-

171. See *Drebin*, 557 F.2d at 1326; *Wise*, 550 F.2d at 1190-91.

172. See *Wise*, 550 F.2d at 1183 n.2, 1184 n.6.

173. See *id.* at 1191.

174. See *id.* at 1191-92.

175. 17 U.S.C. § 101 (2000).

176. 17 U.S.C. § 106(3) (2000) (emphasis added).

mercialization. Instead, a non-exclusive license accompanies every commercialization by sale, rental, lease, or lending of a copy of the copyrighted work.

The United States Supreme Court has discussed the meaning of a "license" in the patent and copyright context, but the result has been far from satisfactory. Specifically, in several cases, the Court stated that a non-exclusive license amounts to nothing more than "a mere waiver of the right to sue" the licensee for infringement of the licensed rights.¹⁷⁷ This accurately describes the barest possible non-exclusive license; in reality, a license agreement can and usually does cover much more ground.¹⁷⁸ License agreements often grant exclusive rights by use, territory, or customer.¹⁷⁹ More importantly, an exclusive right confers something beyond a right not to be sued;¹⁸⁰ it transfers—temporarily or permanently—some or all of the monopoly rights conferred by the Copyright Act, which necessarily entails an agreement by the licensor itself to refrain from undertaking the licensed activities. Thus, while the essence of a non-exclusive license is an agreement not to sue the licensee for undertaking the licensed activities, the essence of an exclusive license is an agreement not only to refrain from suing, but an agreement not to participate in the licensed activities as well. In any case, neither definition speaks to the issue of what rights accompany a transfer of a copy of an intangible work such as software.

The license and the sale are entirely different beasts. But courts and scholars still often speak of a "license of a copy" of a work. This means that the licensor will not sue the licensee for copyright infringement by virtue of the licensee using the copy in some way. However, there is a separate question as to whether title to something has

177. *General Talking Pictures Corp. v. Western Elec. Co.*, 304 U.S. 546 (1938); *De Forest Co. v. United States*, 273 U.S. 236, 242 (1927). *See* *United States v. Studiengesellschaft Kohle, mbH*, 670 F.2d 1122, 1127 (1981) ("A license is an agreement by the patentee, usually for a consideration, not to sue the licensee of the patent for infringement of the patent.")

178. A non-exclusive license agreement, like an exclusive agreement, may of course confer ancillary rights to service or warranties, requirements for cross-licensing, and all other manner of contractual undertakings.

179. However, some courts, including the Federal Circuit, have extended this assertion to cover all license agreements indiscriminately. *See, e.g., Spindelfabrik Suessen-Schurr Stahlecker & Grill GmbH v. Schubert & Salzer Maschinenfabrik AG*, 829 F.2d 1075, 1081 (Fed. Cir. 1987) ("As a threshold matter, a patent license agreement is in essence nothing more than a promise by the licensor not to sue the licensee.") (citation omitted).

180. *Cf. Shell Oil Co. v. Shering AG*, 1997 WL 86414 (D. Del.) ("[T]he parties agree that the Exclusive License is something more than a mere 'waiver of the right to sue.'") (citations omitted).

passed, i.e., whether a “sale,” or some other kind of transaction involving a good, has occurred. Unless a “license” involves a sale, lease, or “transfer of ownership” of the copy, it is not an activity exclusively reserved to the copyright owner under federal law. Yet, according to the established judicial view, a “true” license agreement is not subject to the First Sale Doctrine if return of the transferred materials is required and title does not appear to pass, while a sale agreement is subject to the First Sale Doctrine if title to the *particular copy* passes.¹⁸¹ Thus, the most common holding at the time, when the carrier media often cost a significant amount (e.g., large motion picture reels and hard cover books), was that the First Sale Doctrine would not apply where the copyright owner expressly reserved title to the copy.¹⁸² However, the policy behind the doctrine seems to require the same results regardless of the type of licensed goods to which it applies.

2. Software Transfers and the First Sale Doctrine

The first case relying upon the distinction between a “license” and a “sale of a copy” of software under section 109(a) came in 1990. In *ISC-Bunker Ramo v. Altech*¹⁸³ a software copy was transferred onto a hard disk drive and could not be used until copied onto a floppy disk.¹⁸⁴ When the copyright owner claimed copyright infringement against a purchaser who had sold the hard drive to a third party without the owner’s consent, the District Court for the Northern District of Illinois rejected a First Sale Doctrine defense raised by the first and second purchasers.¹⁸⁵ The court held, without elaboration, that “ISC did not sell copies of its software to its customers; it only licensed them, making the ‘first sale’ doctrine inapplicable.”¹⁸⁶ If the *ISC-Bunker Ramo* decision sounds familiar, it is because it relies on the same formalistic distinction between “license” and “sale” as the later

181. See *Bourne v. Walt Disney Co.*, 68 F.3d 621 (2d Cir. 1995), *cert. denied*, 517 U.S. 1240 (1996). In *Bourne*, a copyright holder (“Bourne”) claimed that the Walt Disney Co. (“Disney”) infringed Bourne’s copyright on its musical compositions. Disney had a license from Bourne to use Bourne’s music “in synchronism with any and all of the motion pictures which may be made by [Disney].” *Id.* at 623. When Disney used the music in videocassettes and television commercials, Bourne brought an action for infringement, claiming that even if Disney had the right to synchronize the music with its videocassettes, the First Sale Doctrine permits it to distribute the resulting videocassettes as it sees fit. In upholding that argument, the court explicitly rejected Bourne’s contention that a license was not a sale for purposes of the First Sale Doctrine. See *id.* at 631–32.

182. E.g., *United States v. Wells*, 176 F. Supp. 630, 634 (S.D. Tex. 1959).

183. *ISC-Bunker Ramo Corp. v. Altech, Inc.*, 765 F. Supp. 1310 (N.D. Ill. 1990).

184. See *id.* at 1314.

185. See *id.*

186. *Id.*

case *MAI Systems Corp.*,¹⁸⁷ which relied upon the nomenclature employed in the underlying contract.

The Kansas federal district court came to a similar conclusion the same year in *Data Products v. Reppart*.¹⁸⁸ There, one of the defendants was accused of copyright infringement of the plaintiff's software copyright by, among other things, acquiring the corporation that owned the copy and using the software itself.¹⁸⁹ The software license contained a provision to prevent the resale or transfer of the software. The defendants moved for summary judgment on the copyright infringement claims on the theory that the First Sale Doctrine immunized the acquiring corporation from copyright infringement liability.¹⁹⁰ The court denied the motion. The status of one relevant agreement as a software sale agreement or a license agreement, according to the court, was unclear, and should be resolved by the jury.¹⁹¹ The court then noted, however, that a second agreement expressly stated that it was a license agreement and on that basis alone could withstand a motion for summary judgment.¹⁹² As will be seen, this line of reasoning—that a contract to sell a copy of software, if called a “license agreement,” presumptively loses its character as a sale of a copy—exerted significant influence on later judicial opinions.

However, not all courts fell victim to the tautology. In the 1991 case *Step-Saver v. Wyse*,¹⁹³ the United States Court of Appeals for the Third Circuit noted that nontransferable copyright license practices had developed to prevent software purchasers from renting the software commercially.¹⁹⁴ Judge Wisdom, writing for the court, questioned “whether the use of state contract law to avoid the first sale doctrine would be preempted either by the federal copyright statute (statutory preemption) or by the exclusive constitutional grant of authority over copyright issues to the federal government (constitutional preemption).”¹⁹⁵ He then went on to write that since Congress in 1990 had statutorily prohibited commercial software rental by software licensees,¹⁹⁶ the legal distinction between “sales of software

187. See *supra* note 139 and accompanying text.

188. 18 U.S.P.Q.2d 1058, 1990 WL 198610 (D. Kan. 1990).

189. See *id.* at 1060.

190. See *id.* at 1061.

191. See *id.*

192. See *id.*

193. 939 F.2d 91 (3d Cir. 1991).

194. See *id.* at 105.

195. *Id.* at 96 n.7.

196. See Computer Software Rental Amendments Act of 1990, Pub. L. No. 101-650, 104 Stat. 5134 (codified at 17 U.S.C. § 109(b) (2000)).

copies" and "software licenses" had become "largely anachronistic."¹⁹⁷ Even the licensor in that case had agreed that, notwithstanding the "nontransferability" of the license, the licensee "had the right to resell the copies of the . . . program."¹⁹⁸ Unfortunately, the *Wyse* decision did not attract widespread adherence in other jurisdictions. Instead, most courts continued to seek a meaningful distinction between sales of copies of software and software licenses.

The most significant of these cases is *Microsoft Corp. v. Harmony Computers & Electronics*.¹⁹⁹ In that case, Microsoft sued distributors of its software for copyright infringement on the grounds that the distributors held no Microsoft license.²⁰⁰ The distributors did not prove that they purchased software from legitimate Microsoft licensees. The terms of the Microsoft license stated that those particular copies of software could be distributed only when bundled with a personal computer ("OEM licenses"), while the distributors sold the software as "stand alone" products. In their defense, the distributors pointed out that Microsoft had relinquished control over the disposition of the software copies when it first sold the copies to the Microsoft licensees. After holding that this First Sale Doctrine defense was moot because the distributors could not show a "first sale," the court nevertheless repeated in dicta that, because Microsoft called its sale a "license," a sale could not have taken place.²⁰¹

The trial court dicta of *ISC-Bunker Ramo* and *Microsoft* have exerted a palpable influence on later opinions applying the First Sale Doctrine to computer software. However, one diverging case in the trend toward nullifying the First Sale Doctrine came in 1997 from the United States District Court for Utah. In *Novell, Inc. v. Network Trade Center, Inc.*,²⁰² Novell brought an action for copyright infringement and contributory infringement against a software retailer who bought inexpensive, older Novell software, purchased an inexpensive upgrade, and sold the upgrade as a licensed version of the software.²⁰³ This system was less costly than buying and reselling new copies of software. Novell asserted that it retained ownership to all copies of its software and that the shrinkwrap license agreement forbade anyone

197. *Step-Saver Data Sys.*, 939 F.2d at 96 n.7.

198. *Id.*

199. 846 F. Supp. 208, 213 (E.D.N.Y. 1994).

200. *See Microsoft*, 846 F. Supp. at 211.

201. *See id.* at 213.

202. 25 F. Supp. 2d 1218 (D. Utah 1997), *vacated in part on other grounds*, 187 F.R.D. 657 (D. Utah 1999).

203. *See id.* at 1222.

but authorized purchasers to use the software.²⁰⁴ Under this theory, the retailer had infringed the Novell copyright by selling the software contrary to the license terms and it also committed contributory infringement by allowing third parties to copy the software into their memory (RAM) or onto hard disk drives without Novell's permission. The retailer defended by pointing out that, after first selling the software, Novell had forfeited all rights to control further sale.²⁰⁵ Moreover, the copies of the software that end-users must make into their RAM and onto their hard disk drives were necessary for its use and therefore could not constitute infringement pursuant to section 117.

The court first rejected the contention that the terms of Novell's shrinkwrap license agreement governed what constituted infringement.²⁰⁶ After noting that most jurisdictions continued to reject the validity of shrinkwrap licenses, the court concluded that the Novell license terms were unenforceable.²⁰⁷ The court then noted that software sales are evaluated according to the provisions of the state UCC and therefore concluded that if the transfer of a copy of the software was a "sale" for UCC purposes, it must be a sale for First Sale Doctrine purposes.²⁰⁸ Because the First Sale Doctrine prevented Novell from claiming infringement based on an unauthorized resale of its software, and because section 117 authorized the lawful end-users to make necessary copies of the software, the retailer had neither infringed nor contributed to the infringement of the copyright.²⁰⁹ Perceiving that control over its licensing practices would be severely impaired by the ruling, Novell negotiated a settlement with the retailer that included vacatur of the earlier case.²¹⁰ While the court granted vacatur in the interests of the settlement in 1999, it declined to comment about Novell's argument that case law since the 1997 decision (in particular, due to *DSC v. Pulse*²¹¹) had sufficiently changed to justify vacatur in an opinion displaying a thinly veiled skepticism toward Novell's arguments.²¹²

204. *See id.* at 1229.

205. *See id.* at 1229-30.

206. *See id.* at 1230-31.

207. *See id.* at 1230.

208. *See id.* at 1229-30.

209. *See id.* at 1230-31.

210. *See Novell, Inc. v. Network Trade Ctr., Inc.*, 187 F.R.D. 657 (D. Utah 1999).

211. *See supra* text accompanying notes 147-160.

212. *See Novell*, 187 F.R.D. at 659 n.3.

Most recently, the United States District Court for the Northern District of California, a court that should be savvy about software,²¹³ repeated the dicta of *ISC-Bunker Ramo* and *Microsoft* without further analysis. In *Adobe Systems, Inc. v. One Stop Micro, Inc.*,²¹⁴ Adobe, a computer software publisher, accused a software reseller of selling discounted “educational” software to non-educational end-users.²¹⁵ Because the reseller had not signed any contract with Adobe, Adobe brought suit for copyright infringement.²¹⁶ When the reseller asserted a First Sale defense, the court followed the Illinois and New York precedents mechanically, repeating that the First Sale Doctrine only applies to an “actual sale” and not to a license. After noting that it must give effect to the mutual agreement of the parties, the court decided that, in spite of the use of the terms “purchase” and “own” in the Adobe contracts and license agreements, the presence of the word “license” in the agreements, and the statements of Adobe executives that a license agreement was intended, resulted *ipso facto* in the agreement being a license only.²¹⁷ Copyright publicist Raymond Nimmer testified for Adobe, stating that the license restrictions were “not consistent with any claim that the distributor is the owner of the copies,” but at the same time, “the license is the product[,] . . . no software company ever sells its software.”²¹⁸ The view on which Nimmer based his testimony nullifies the public policy behind section 109(a) of the Copyright Act.²¹⁹ Yet, the court accepted Adobe’s arguments and ruled that the reseller had committed copyright infringement.²²⁰

United States courts have widely differing opinions on which criteria to employ when analyzing whether to apply the First Sale Doc-

213. The jurisdiction of the federal District Court for the Northern District of California includes San Francisco, Marin County, and all of Silicon Valley (San Mateo and Santa Clara Counties).

214. 84 F. Supp. 2d 1086 (N.D. Cal. 2000).

215. See *Adobe*, 84 F. Supp. 2d at 1086.

216. See *id.*

217. See *id.* at 1091.

218. *Id.* at 1091–92.

219. Nimmer obscures the necessary differentiation between “computer program,” an intangible good, and a “license,” a set of legal rights. Nimmer’s claim that no company ever sells its software, besides being factually incorrect (for example, development companies assign all rights—i.e., sell—their software to purchasers all the time), conflates the concept of “sale of a copy” with the sale of the underlying copyright rights themselves. The license is not the product, it is the right to use the product. The product is the intangible data set that makes up a computer program. In determining whether a copy was sold, the question is not whether there was a license. There must be a license, expressly granted by the copyright holder or implied by sections 109 and 117, in order for anything to change hands legally, for any length of time whatsoever. See *id.*

220. See *id.* at 1094.

trine to a software transfer. The traditional view, set forth and applied in *Drebin* and *Wise*, requires courts to analyze whether actual title to the copy of the intellectual property passes to the transferee and need not be returned. The concept opposing a "sale" in these cases may be labeled a "license," but is in reality a "lease" of the copy. By contrast, the prevailing view, advanced in the federal district and circuit court cases,²²¹ concluded that any transfer is a "license" of software, and hence not a sale of a copy. These holdings require the use of the word "license" *pro forma* in the agreement, and for the licensor to reject claims of an intended sale to successfully prohibit end-users from exercising the very rights that would arise under section 117 if it applied. Finally, in *Novell*, the court based its decision on whether the transfer of software was a sale for UCC purposes.²²²

One commentator has argued that courts should instead distinguish between transactions that are "in substance" a "true license" versus a "sale."²²³ In this view, a license granted to an end-user who already possesses copies of a computer program to make a certain number of additional copies of the program is a true license, presumably because no carrier media is sold in such a scenario. Similarly, "when the software's transfer is combined with a large service or maintenance component," the transaction should be considered a license.²²⁴ This view essentially relies upon the transfer of title to a carrier media, such as a CD or DVD. An opposing view is that, because the carrier media is essentially epiphenomenal, software is not a "good" that can be "sold," but rather an intangible that must be licensed.²²⁵ While the premise of this approach is correct, the conclusion begs the very question it seeks to address.

Melville Nimmer advanced another theory with some similar elements; namely, that a software license becomes a software sale due to

221. See *ISC-Bunker Ramo v. Altech, Inc.*, 765 F. Supp. 1310, 1314 (N.D. Ill. 1990); *Data Products v. Reppart*, 18 U.S.P.Q.2d 1058, 1601 (D. Kan. 1990); *Microsoft Corp. v. Harmony Computers & Electronics*, 846 F. Supp. 208, 213 (E.D.N.Y. 1994); *Adobe Sys.*, 84 F. Supp. 2d at 1092; see also *MAI Sys. Corp. v. Peak Computer*, 991 F.2d 511, 518 (9th Cir. 1993); *DSC Communications Corp. v. Pulse Communications Inc.*, 170 F.3d 1354, 1361 (Fed. Cir. 1999).

222. See *Novell*, 25 F.Supp. 2d at 1230.

223. See Thomas Lee Hazen, *Contract Principles as a Guide for Protecting Intellectual Property Rights in Computer Software: The Limits of Copyright Protection, The Concept of Derivative Works, and the Proper Limits of Licensing Arrangements*, 20 U.C. DAVIS L. REV. 105, 150 (1986).

224. *Id.* at 150-51.

225. See Lorin Brennan, *Why Article 2 Cannot Apply to Software Transactions*, 38 DUQ. L. REV. 459, 535-40 (2000).

the sale of the actual medium.²²⁶ Although this position makes some sense with respect to the application of the UCC, which was designed for sales of tangible goods, it seems quite odd to apply it to intellectual property law, which was designed for sales of intangibles. The medium on which software is conveyed (except in embedded systems and pre-loaded hard drives) is usually only a negligible fraction of the cost of the software itself. To try to characterize licensing as a sale by merging it with the sale of the medium misses the mark. The purchaser, or “licensee,” of a novel or software program does not buy for the paper or CD-ROM; he buys for the intangible writing or programming contained therein and the conceptually separate *sine qua non*, the licensed rights accompanying the sale. As the Second Circuit Court of Appeals stated, a book is useless without the legal right to use it.²²⁷ This is true *a fortiori* for software, the value of which vastly exceeds the value of the transfer media. The medium itself is purely incidental to the transfer of intangible data and the rights to use it.

Nonetheless, it is now an almost universal practice in the software industry to specify in the license that the sale of a copy of software “is not a sale, it is a license,” and that the only object sold to the consumer is the underlying media. By distinguishing between the sale of the media and the license of the software, software publishers try to circumvent the First Sale Doctrine and to prevent purchasers of software and of hardware bundled with OEM software or so-called “full upgrade versions” of programs, from reselling that software. At least one commentator has argued that copyright owners should have this right; that the mandatory application of the First Sale Doctrine has a “devastating” effect on software publishers because it prevents them from gaining the economic benefits of price discrimination, which in turn inhibits efficient distribution of software.²²⁸ However, this argument misstates the economic effect of the First Sale Doctrine. It has been observed that the First Sale Doctrine “interfere[s] with the producer’s ability to achieve the perfect pricing curve,” and therefore denies to some producers economic monopoly rents on their

226. See Melville Nimmer et al., NIMMER ON COPYRIGHT § 8.08[B][1] Mathew Bender, Inc. (1997). This view may have been based on a common practice in the motion picture industry of using a reel use license that purportedly conveyed title to the media (the reel) while claiming that title to the intangible copy of the film on the reel remained with the copyright owner. Cf. Rice, *supra* note 9, at 169.

227. See Grappo v. Alitalia Linee Aeree Italiane, 56 F.3d 427, 432 (2d Cir. 1995).

228. See Daniel B. Ravicher, *Facilitating Collaborative Software Development: The Enforceability of Mass-Market Public Software Licenses*, 5 VA. J.L. & TECH. 11, 34–43 (2000).

software²²⁹ (to be distinguished from legal monopoly rents, which the software publishers maintain). Yet, the First Sale Doctrine does not prevent all price discrimination; it merely prevents a copyright owner from monopolizing the aftermarket for used copies of the copyrighted work. Software authors and publishers are free to capture as much consumer surplus as they can on the *first* sale of their copies.²³⁰ And even if the First Sale Doctrine did foreclose price discrimination, it is unclear that whatever benefit the price discrimination conferred on the software market would not be counterbalanced by the elimination or circumscription of the market for used software.²³¹

229. Boyle, *supra* note 36, at 2019, 2028.

230. As for using other means of capturing consumer surplus, it is important to note that most courts in the United States and Europe treat mass market software as goods for most purposes, and competition laws generally disfavor price discrimination in connection with the sale or transfer of goods. Section 2 of the Clayton Act, also known as the Robinson-Patman Price Discrimination Act ("RPA") forbids price discrimination in the sale of like commodities where such discrimination would have an anticompetitive effect in a market. 15 U.S.C. § 13(a) (2000). As discussed above, courts have treated software transfers as sales of goods under the UCC if the sale of goods dominates over the provision of services. The RPA treats the terms "commodity" and "good" as interchangeable, and as might be predicted, courts have tended to apply a UCC-type analysis to RPA claims involving issues where goods and services are both provided. *See, e.g.,* May Dep't Store v. Graphic Process Co., 637 F.2d 1211, 1215-16 (9th Cir. 1980). However, in most circuits, the issue of whether the RPA applies to sales of software has not been definitively decided. We see no convincing policy argument to justify allowing software publishers to discriminate while sellers of other hi-tech goods cannot. Though the case was "not for publication" and the court provided no other relevant analysis, the court in *Storis, Inc. v. GERS Retail Systems, Inc.*, 1995 U.S. Dist. LEXIS 7614, *10 (D. N.J. 1995) held that plaintiff *Storis*, in the business of developing, marketing and manufacturing computer software that aids retail stores in the U.S., had alleged sufficient allegations in its complaint to withstand a motion to dismiss on grounds of failure to state a claim for predatory pricing in violation of the Robinson-Patman Act. The complaint alleged that GERS (in the same line of business) committed price discrimination between *Storis* customers and all other customers, with the intent of injuring *Storis* through GERS' software. *See also* John J. Voorhees, Jr., Note, *Price Discrimination and Software Licensing: Does the Robinson-Patman Act Fail to Accommodate Modern Technology?*, 69 WASH. U. L. Q. 317 (1991).

231. Whether an antitrust policy disfavoring price discrimination is wise is an issue beyond the scope of this Article, but is worth touching on in the software context. Judge Frank Easterbrook, writing for an unanimous Seventh Circuit Court of Appeals in *ProCD, Inc. v. Zeidenberg*, 86 F.3d 1447 (7th Cir. 1996), presented his best argument as to why price discrimination benefits both software publishers and software consumers. *Id.* at 1449-50. His argument turns on the fact that price discrimination allows publishers to offer software to some sectors of the public at prices that would not be efficient in a market with uniform prices. In other words, under some circumstances, price discrimination allows publishers to charge more to consumers that want the software very much and can afford higher prices, and charge less to consumers that want the software less or who may not be able to afford high prices. This may sometimes result in an overall increase in quantity sold by the price discriminating manufacturer, but this does not necessarily lower average price overall. For price discrimination to be profitable to a software publisher, such discrimination

Similarly, the service or maintenance component should have nothing to do with the characterization of the agreement. Service and maintenance are commonly sold bundled with hardware and other tangible goods that are not “licensed,” and warranties are almost universally used in the software industry. Moreover, tying the purchase of maintenance and repair services to the purchase of software may, in some circumstances, violate antitrust laws, and such an approach would encourage software publishers to tie in service and maintenance in order to avoid the application of the First Sale Doctrine. It would not be wise policy, as section 1 of the Sherman Act²³² attests, to encourage businesses to limit public choice through tying arrangements.

Every sale of software is accompanied by a license of some form. Unfortunately, not a single United States court has recognized, in a published or reported decision, that a sale of a copy of software must necessarily be accompanied by an express or implied license agreement. Therefore, the proper issue for analysis is not whether a “sale of a copy” of software or a “license” of the software has occurred, but whether the terms of the license constitute the transaction as a “sale of a copy” or a “lease of a copy” of software. In Part IV, this article describes how courts in the European Community have approached the First Sale Doctrine from precisely this perspective.

must be an industry practice established by collusion of some kind, or else the publisher must have economic monopoly power. For if equivalent substitute software were available from another publisher, then those consumers facing higher prices charged by the price discriminator would turn to its competitor, leaving the price discriminator to sell only to those who will pay a price lower than the equilibrium competitive price. Because economic monopoly power or cartelization are alternative preconditions to effective price discrimination, and because both such market structures are generally inefficient, the merits of allowing price discrimination in the software industry seem dubious, notwithstanding its many supporters. See, e.g., William W. Fisher III, *Property and Contract on the Internet*, 73 CHL-KENT L. REV. 1203, 1234–40 (1998); Ravicher, *supra* note 228, at 34–43. In addition, price discrimination encourages companies in the inefficient market to micromanage the use of their products. As one commentator put the question, “Do we really want to commit ourselves to a regime that will offer companies major assistance in the form of state power, assistance that will yield them big bucks, but only if they monitor their customers superlatively well?” Boyle, *supra* note 36, at 2034. It is also worth noting that, in the real software market, publishers have clearly not lacked incentives to continue innovation and invention even while lacking the right to monopolize the aftermarket in their software. One commentator has argued that the constraints on price discrimination of are a virtue of the system because they balance incentives with distribution near marginal cost (the competitive equilibrium). See, e.g., *id.* at 2030.

232. 15 U.S.C. §§ 1–2 (2000).

III. Public Policy and the Resale of Software

United States courts considering the First Sale defense for computer software transfers often focus their attention on determining whether the presence of a license agreement negates the application of the First Sale Doctrine by distinguishing a "sale of a copy" of the software from a "license" of the software.²³³ A better starting point for the analysis is to take the license for granted, and to determine whether an agreement conveys a copy of software by "sale" or "lease," as courts traditionally have done for other transfers of copies of intellectual property, such as movie reels, books, or phonograph records. One United States court came close to this position in dicta,²³⁴ but none have positively repudiated the well established "sale versus license" precedent on the merits.

The tautological approach of relying upon the agreement's own label to determine its legal status severely undermines the public policy that motivated Congress to include the First Sale Doctrine in the 1909 and 1976 Copyright Acts. The First Sale Doctrine "restates and confirms" the judicially created principle that "where the copyright owner has transferred ownership of a particular copy . . . of a work, the person to whom the copy . . . is transferred is entitled to dispose of it by sale, rental, or any other means."²³⁵ If a licensor could negate the First Sale Doctrine's applicability by *pro forma* methods, then the Doctrine would never, or almost never, apply to any transfer of computer software because almost every sale of a copy of software is accompanied by an explicit "License Agreement." Such license terms threaten to undermine the congressionally determined balance between granting the copyright owner adequate reward to continue creation, while

233. It is interesting to note that this approach would be viable when analyzing whether the First Sale Doctrine applies to a manufacturing or a publishing license as discussed above. See *supra* note 44. When a copyright owner conveys such a license, he may convey a copy of the software (to be destroyed upon termination of the license), but the purpose of the agreement is neither to sell nor to lease any particular copy. The license agreement is designed to transfer certain production rights independently of any copy. In this case, the proper opposition is between a "sale of a copy" and a "license to publish."

234. See *Step-Saver Data Sys., Inc. v. Wyse*, 939 F.2d 91, 96 n.7 (3d. Cir. 1991). In *Step-Saver*, Judge Wisdom noted that, since Congress had prohibited commercial software rental by software licensees statutorily in 1990, Computer Software Rental Amendments Act of 1990, Pub. L. No. 101-650, 104 Stat. 5134 (codified at 17 U.S.C. § 109(b) (2000)), the legal distinction between contracts for sales of software copies and software licenses had become "largely anachronistic." *Step-Saver*, 939 F.2d at 96 n.7. Even the licensor in that case had agreed that, notwithstanding the "nontransferability" of the license, the licensee "had the right to resell the copies of the . . . program." *Id.*

235. H.R. Rep. No. 94-1476, at 5693 (1976).

encouraging public dissemination of the work in accordance with market forces. As the United States Supreme Court has reiterated many times through diverse formulations:

The limited scope of the copyright holder's statutory monopoly . . . reflects a balance of competing claims upon the public interest: Creative work is to be encouraged and rewarded, but private motivation must ultimately serve the cause of promoting broad public availability of literature, music, and other arts. The immediate effect of our copyright law is to secure a fair return for an "author's" creative labor. But the ultimate aim is, by this incentive, to stimulate artistic creativity for the general public good.²³⁶

Section 109(a) of the 1976 Act ensures that the copyright owner reaps its reward at the first sale and does not attempt to distort the market using licensing terms backed up by a threat of an action for infringement. Courts have conceded that they would not be likely to nullify a statutory purpose through a far-fetched interpretation of its meaning.²³⁷ However, this is exactly what has happened since 1990 to the application of the First Sale Doctrine in United States courts. If a court did conclude that a license agreement was subject to the First Sale Doctrine, the subsequent sale of software would not constitute copyright infringement, regardless of the provisions of the license agreement.²³⁸

To avoid undermining the congressional policy behind the First Sale Doctrine, courts must recognize the reality that every legal transfer of software is accompanied by a license of some kind. The proper analysis begins with the terms of the license. In the *Drebin* and *Wise* decisions, the court undertook just such an analysis for film reels, but the analysis in those cases was flawed in two ways. The first is merely a semantic error. The court juxtaposed the concept of a permanent "sale of a copy" against a temporary "license." The proper term for a temporary transfer of a copy of intellectual property is a "lease" of the copy; a "license" is the grant of rights to use the intellectual property rights to the copy and can be either temporary or perpetual. The second flaw is that the sole factor considered by the *Drebin* and *Wise*

236. *Twentieth Century Music Corp. v. Aiken*, 422 U.S. 151, 156 (1975). See *Fogerty v. Fantasy, Inc.*, 510 U.S. 517, 526-27 (1994); *Feist Pubs., Inc. v. Rural Tel. Serv. Co.*, 499 U.S. 340, 349-50 (1991); *Sony Corp. of Am. v. Universal Studios, Inc.*, 464 U.S. 417, 429 (1984).

237. See generally *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 859-66 (1984) (discussing the need for courts to interpret accurately the intent of legislators and defer to their policymaking choices).

238. *United States v. Wise*, 550 F.2d 1180, 1187 & n.9 (9th Cir. 1989), cert. denied, 434 U.S. 929, reh'g denied, 434 U.S. 977 (1977); *American Int'l Pictures v. Foreman*, 576 F.2d 661, 664 (5th Cir. 1978).

courts in determining whether a sale of a copy had occurred was whether *title* to the copy had passed. The court was certainly correct in concluding that ownership is of preponderant importance to First Sale Doctrine analysis. However, by concentrating on the passage of title, the court opens the door to easy circumvention of the First Sale Doctrine by the licensor. The licensor need merely specify in the license that it retains all title to the copy and perhaps require the licensee to return the copy after a set period of time.²³⁹ Of course, the useful life of software rarely surpasses five or six years, so such a license requirement would be purely symbolic.

A better alternative would be to focus on the substance of the transfer of intellectual property. A copy of software is usually different from other chattels in that “title” to the copy is not strictly germane. After all, title to the particular carrier medium upon which the software was transferred is irrelevant—any particular copy of software can be transferred to a variety of carrier media, and the value of the carrier medium is usually *de minimis*. What matters to the licensee is whether he has lawful possession of the software. Unlike other chattels, to have lawful possession during the commercially valuable life of the software *is to have title*. A lease, in contrast, merely means having lawful possession for less than the commercially valuable life of the software. Specifically, for a lease to occur (and thus, for the First Sale Doctrine not to apply), possession of the copy (regardless of the presence or absence of the carrier media) should only be granted by license for a duration that is significantly shorter than the commercially valuable life of the copy.²⁴⁰

This may seem an unorthodox policy, but, upon reflection, its merit should become self-evident. At the end of its brief useful life, software leaves nothing of value—it has no resale value by definition, cannot be recycled because it is intangible, and generally it becomes technologically moribund. For example, consider a licensed copy of an operating system. Assume that operating systems of this type undergo a major revision on average every twenty-four months. Assume

239. One commentator noted ten years ago that the requirements of a software lease must be strictly met, as counsel for software firms would not take long to capitalize on the ability to insert resale restrictions in what superficially appears to be a lease. *See Rice, supra* note 9, at 175.

240. We focus on “possession” rather than title because title to a copy of intellectual property can be manipulated quite easily by contract, but possession of a copy is a prerequisite to deriving any benefit from its use. Thus, what counts in a software transfer is possession of the copy and a right to use it. “Title” to any particular copy presumably rests with the possessor regardless of the wording of the license agreement.

further that a properly conducted economic analysis shows that businesses of the licensee's type replace their operating systems every thirty-six months. For the license of an operating system of this type to fulfill the first "lease" factor, the license period must last significantly less than thirty-six months.

Of course, this calculation must be determined as a factual matter for each kind of software, but it is not difficult to discover. The first factor that can assist in this analysis is the form of consideration used. A lease of a chattel is accompanied by a payment corresponding to the duration of use; this applies equally to software.²⁴¹ For example, video stores that lease copies of video games typically charge a per diem rate. By contrast, a sale is almost always accompanied by a one-time payment of a fixed price for the software. The second requirement that must be fulfilled for a software transfer to be a "lease" is that the consideration for use of the software must correspond directly to the duration of its use.²⁴²

A. Federal Preemption of State Contractual Remedies

Although the issue of when the First Sale defense should apply to transfers of software copies has been addressed, another important question remains. If the First Sale Doctrine expresses Congress's public policy against restraints on alienation of copies of computer programs, may the copyright owner use the terms of the license to impose a contractual restraint on resale of a copy? Would not any state law granting the licensor the ability to restrain alienation in this manner contradict a federal public policy within a domain regulated by Congress under its constitutional powers, and therefore be void? The legislative history of section 109(a) discloses that Congress did not necessarily intend to preempt copyright owners from imposing some restrictions on resale of the items under state law. On the contrary, the legislative report intimates that section 109(a) "does not mean that conditions on future disposition of copy . . . imposed by contract between their buyer and seller, would be unenforceable between the

241. See Rice, *supra* note 9, at 175. The U.C.C. § 2A-103(1)(j) defines a "lease" as a "transfer of the right to possession and use of goods for a term in return for a consideration," but there is no requirement that the consideration be measured according to the duration of possession or use.

242. One potential problem with this requirement is that there are possible arrangements in which the sale or lease of a copy is not accompanied by any monetary remuneration, e.g., a trade of one software program for another. However, these arrangements are extremely rare, and in these cases, it should be possible to rely upon the duration of the transfer alone.

parties as a breach of contract, but it does mean that they could not be enforced by an action for infringement of copyright."²⁴³ Yet, such a result seems to undermine the purpose of section 109(a).

This issue has been touched upon by two courts already. In the first, *Brode v. Tax Management, Inc.*,²⁴⁴ the plaintiff, the author of the third and fourth editions of a treatise on tax law, claimed that the treatise publisher committed breach of contract and copyright infringement by failing to pull all copies of the treatise from circulation after the publisher informed the author that he would not be commissioned for the fifth edition.²⁴⁵ The district court rightly accepted the publisher's First Sale Doctrine defense against the infringement allegations, noting that the publisher had been the lawful owner of the copies, as were the copy purchasers, and it could not pull the copies from circulation after a sale had been made.²⁴⁶ On the breach of contract claim, the court expressed doubt that the contract imposed any obligation on the publisher to pull the copies. However, the court noted, even if the contract had imposed such a duty on the publisher, the publisher could not be required to comply with the contractual provision. "The portfolios belonged to the subscribers and under the 'first sale' doctrine of copyright, those subscribers had total control of the copies."²⁴⁷ Thus, the court implies that the First Sale Doctrine protects the lawful owner of a copy who sells the copy not only against a claim of infringement, but also against a claim of breach of contract by virtue of the sale.

The other, more widely cited case came from the United States Court of Appeals for the Third Circuit. In the 1991 case *Step-Saver Data Systems, Inc. v. Wyse*,²⁴⁸ Judge Wisdom, writing for the court, noted that nontransferable copyright license practices had developed to prevent software purchasers from renting the software commercially.²⁴⁹ The court questioned "whether the use of state contract law to avoid the First Sale Doctrine would be preempted either by the federal copyright statute (statutory preemption) or by the exclusive constitutional grant of authority over copyright issues to the federal government (constitutional preemption)."²⁵⁰ The issue was not before the court,

243. H.R. REP. NO. 94-1476, at 5693 (1976).

244. 14 U.S.P.Q.2d 1195, 1990 WL 25691 (N.D. Ill. 1990).

245. *See id.* at *5.

246. *See id.*

247. *Id.* at *11.

248. 939 F.2d 91 (3d Cir. 1991).

249. *See id.* at 96 n.7.

250. *Id.*

so Judge Wisdom never had occasion to resolve it. Nonetheless, *Step-Saver*, like *Brode*, stands for the proposition that it would be contrary to federal policy to allow licensors to use state contract law to impose breach of contract penalties for conduct (specifically, the resale of copies of a copyrighted work) that is explicitly approved in the federal Copyright Act.

Finally, as discussed above, in *DSC Communications v. Pulse Communications*,²⁵¹ both the district court and the appellate court generally respected sections 109 and 117 of the Copyright Act as nonderogatable because both courts refused to halt their analyses after determining the parties' intent, and instead tried to analyze the character of the transaction objectively.

As a general matter, federal preemption can negate state law in two ways. First, a federal law can expressly conflict by its terms of a state law, in which case the contrary terms of the state law must succumb to those of the federal. Alternatively, a federal court may nullify a state law on the grounds that, although the federal statute does not speak directly to the matter governed by the state law, application of that state law would undermine the public policy embodied in the federal law, either because Congress intended the federal law entirely to preempt any other lawmaking on the subject of the federal statute, or because the state law is contrary to the thrust of the policy expressed by the federal statute. In such cases, federal courts engage in "interstitial lawmaking"²⁵² to fill in the gaps in the statute according to Congress's implied intent.

In the absence of a manifestation of such intent, however, courts may only negate state law where "necessary to protect unique federal interests"²⁵³ or a "distinctive national policy."²⁵⁴ It is for this reason that courts have consistently held that, unless state law conflicts with a federal statute or policy, "construction of [a] license agreement is solely a matter of state law."²⁵⁵ In the particular case of the common law of contracts enforceable in states, it is well established that the

251. 170 F.3d 1354 (Fed. Cir. 1999).

252. *United States v. Little Lake Misere Land Co.*, 412 U.S. 580, 593 (1973).

253. *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398, 426 (1964).

254. *Barsch v. Metro Goldwyn Mayer, Inc.*, 391 F.2d 150, 152 (2d Cir. 1968), *cert. denied*, 393 U.S. 826 (1968).

255. *Lear, Inc. v. Adkins*, 395 U.S. 653, 661-62 (1969). *See also McCoy v. Mitsubishi Cutlery, Inc.*, 67 F.3d 917, 920 (Fed. Cir. 1995) ("Whether express or implied, a license is a contract 'governed by ordinary principles of state contract law.'"); *Power Lift, Inc. v. Weatherford Nipple-Up Sys., Inc.*, 871 F.2d 1082, 1085-86 (Fed. Cir. 1989) ("[A] license agreement is a contract governed by ordinary principles of state contract law.").

state law of contract is not displaced merely because an agreement relates to intellectual property.²⁵⁶ The question, then, is whether applying the state common law of contracts (or the state commercial law) to allow a licensor to restrain the resale of a copy of software would violate unique federal interests or a distinctive national policy.

The First Sale Doctrine does not explicitly address contract terms limiting resale rights; no provision of the 1976 Copyright Act forbids copyright owners from imposing restraints on resale of copies of software. Instead, section 109(a) states that under federal law, the owner of a copy is "entitled" to sell that copy without needing to obtain the permission of the licensor.²⁵⁷ There are two logical reasons why Congress might adopt section 109(a) while allowing a state law action for breach of contract based on a clause prohibiting resale of a copy to proceed. First, Congress may have wished to allow the copyright owner to profit from after-market sales of its software without being able to prevent the sales absolutely through the high statutory damages, injunctions, and criminal penalties provided for in the Copyright Act. Under this theory, Congress intended to deprive the licensor of the deterrent elements of the Copyright Act while leaving him the economic right to profit from each copy of his work sold. This would prevent the licensor from impeding an "efficient breach" by the licensee, and would thereby help encourage an economically efficient allocation of private capital for the greater perceived benefit of the United States economy.²⁵⁸

The weakness in this argument is that the elimination of copyright does not remove all market deterrents to licensees breaching their contracts with the licensors for reasons of efficiency. First, licensees may wish to avoid breaching the contract and thereby angering the licensor, which could result in deprivation of crucial updates and future software sales by the licensor. The licensee may well rely upon a continuing supply of updated, patched, or more advanced software

256. See *Aronson v. Quick Point Pencil Co.*, 440 U.S. 257 (1979).

257. See 17 U.S.C. § 109(a) (2000).

258. The theory of efficient breach basically posits that, when an allocation of private capital pursuant to a contract is less efficient than an alternative allocation in breach of contract, breach should not be discouraged through punitive measures of any kind. On the concept of efficient breach, see David W. Barnes, *The Anatomy of Contract Damages and Efficient Breach Theory*, 6 S. CAL. INTERDISCIPLINARY L.J. 397 (1998); Richard Crasswell, *Contract Remedies, Renegotiation and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629 (1988). It is interesting to note that the concept of efficient breach is not a brainchild of the current legal fixation on economics, but rather a product of the law and social science orientation of the Legal Realists such as Oliver Wendell Holmes and Karl Llewellyn. See, e.g., Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897).

from the licensor. A copyright owner in the United States may unilaterally refuse to license his software to anyone for almost any reason, regardless of any perceived harm to consumers.²⁵⁹

Also, a more general deterrent is the problem of assessing damages to the licensor for breach. In the rare case that the licensor has used a contractual tool to deter the resale of software, such as imposing liquidated damages for the lost sale of the software, these damages are very likely to strongly favor the licensor.²⁶⁰ But the more common scenario is that the licensor would claim that its damages for the resale are equal to the profit it would have derived from selling an additional copy of the software for each copy resold by the licensee. Such damages would inevitably wipe out any profit accruing to the first purchaser. This is so for two reasons. First, software, like any commodity, is more valuable new than used. This is true *a fortiori* for software, because its value depends on the currency of the technology that the software employs. Second, the marginal cost of producing a copy of software is near zero, and the marginal revenue generated by selling an additional copy of software is likely to be significant (or, at least, so a court will generally assume). Combining these two factors—a high profit to the copyright owner for each sale and a lower resale value for the software—it is apparent that an “efficient breach” of a resale provision will occur only when the marginal cost of the copyright owner producing an additional copy of software exceeds the difference between the sale price and the resale price.

In other words, for the lawful owner of a copy of software to profit from a resale in breach of contract, not only must the software hold its value well (or resale must take place very quickly after the initial sale), but the cost of producing an additional copy of the software must be extraordinarily high. These two conditions are likely

259. See *Image Tech. Servs., Inc. v. Eastman Kodak Co.*, 125 F.3d 1195, 1218 (9th Cir. 1997), *cert. denied*, No. 97-1298, 1998 WL 54320 (1998) (holding that there is a presumption that anti-competitive conduct by a licensor has a legitimate business justification); *Data Gen. Corp. v. Grumman Sys. Support Corp.*, 36 F.3d 1147, 1187 (1st Cir. 1994) (“[A]n author’s desire to exclude others from use of its copyrighted work is a presumptively valid business justification for any immediate harm to consumers.”).

260. Although such liquidated damages provisions may be enforceable as non-punitive in state court, they may be dubious from an economic perspective. Typically, such a provision would impose liquidated damages equal to the profit that the licensor would have received but for the sale to the third party by the licensee. However, in the case of used software, the resale value may be significantly lower than the value of new software. In such a case, the licensor may not have been able to make the sale, because the third party might only have purchased at the lower, “used software” price. The licensor may recover in court liquidated damages much higher than its actual damages.

to occur only in the rarest of circumstances. Moreover, they do not account for the deterrent effect of the costs of litigation that often accompany a breach of contract. Given these market realities, this theory does not seem to offer a convincing reason why a state law permitting a breach of contract action for resale of a copy of software would not undermine the federal public policy embodied in the First Sale Doctrine.

Alternatively, Congress may merely have wished to immunize second-tier purchasers from any cause of action for copyright infringement, while leaving the first tier purchaser liable to the licensor. In this view, if the first-tier purchaser breaches his contract, he will suffer the consequences, but a good faith second-tier purchaser will not be deprived of the benefit of the software copy that he purchased. For example, Congress may have intended to allow a copyright owner to sell OEM versions of his software, without expensive manuals or eye-catching packaging at a much lower price than retail versions of the software, and contractually to forbid the distributor from selling it as a retail version, undercutting the retail profits. This encourages potential hardware purchasers to complete the contemplated purchase because the hardware comes bundled with discounted software, to the benefit of both the purchaser and the sellers, who increase their sales volume without sacrificing profits.

However, this reasoning seems even less convincing than that of the first argument. In the first place, the First Sale Doctrine, as currently written, would not achieve that policy result, because it fails to protect second purchasers from a state law action for tortious interference with a contract. If selling a lawfully owned copy of a copyrighted work were a breach of contract, then the original seller would have a potential action for tortious interference against any second purchaser of the copy, who will often be on notice regarding the license terms due to a copy of the license agreement that pops up during the installation process. Second, even if section 109(a) achieved the policy, it does so through an unnecessarily circuitous method. Had Congress merely wished to exempt second purchasers from liability, why immunize the first purchaser from copyright infringement instead of simply providing that purchasing a copy of a copyrighted work from a lawful owner, in violation of a license agreement, does not constitute infringement or contributory infringement? This is a much more direct route to the same result, without the presumably unwanted side-effect of protecting a lawful owner of a copy who resells in violation of a license agreement. In short, neither theory offers a satisfactory pol-

icy justification for permitting state contract law to undermine the operation of the First Sale Doctrine.

The public policy underlying section 109(a) appears to be that of the courts that developed the common law doctrine of copyright, patent, and trademark exhaustion. The concern was one of competition law and consumer protection—the copyright owner should expect to obtain adequate remuneration upon the first sale of a copy and price the copies accordingly. As one court stated, “the ultimate question under the First Sale Doctrine is whether or not there has been such a disposition of the copyrighted article that it may fairly be said that the copyright proprietor has received his reward for its use.”²⁶¹ Thereafter, the copy is the property of the purchaser, and any restraints on alienation imposed by the seller serve no purpose except to restrain competition to the detriment of consumers in general and the purchaser in particular.²⁶² Such restraints distort the aftermarket for the copyrighted goods and possibly other ancillary markets.²⁶³ It may be recalled that the Supreme Court case upon which the First Sale Doctrine is based, *Bobbs-Merrill Co.*, had specifically negated a contractual provision controlling resale terms.²⁶⁴ In other words, allowing a state law breach of contract claim would undermine the federal public policy of treating chattels that embody intellectual property—including what might be called “digital chattels”—just as any other chattel, and with the same hostility to restraints on alienation. It also encourages market distorting activity by copyright owners seeking to reap multiple rents from a single sale of a copy of the protected work.

Finally, the statutory language of section 109(a) itself appears to preempt any contrary state law. That section provides that the purchaser of a copy is “entitled” to resell the copy without the copyright owner’s permission. The term “entitlement” legally conveys an affirmative right.²⁶⁵ It would violate the principle of federal preemption to

261. *Burke & Van Heusen, Inc. v. Arrow Drug, Inc.*, 233 F. Supp. 881, 884 (E.D. Pa. 1964). *See also* *United States v. Masonite Corp.*, 316 U.S. 265, 278 (1942); *Platt & Munk Co. v. Republic Graphics, Inc.*, 315 F.2d 847, 857 (2d Cir. 1963); *Allison v. Vintage Sports Plaques*, 136 F.3d 1443, 1448–49 (11th Cir. 1998).

262. *See also* *Rice*, *supra* note 9, at 185 (“The vehicle in this instance is a contract, usually an unnegotiated standard form agreement. It is one which does far more than fine-tune the legislated reward to fit special circumstances. It substantially broadens the scope and extends the reach of monopolistic exclusion.”).

263. *See* *United States v. Masonite Corp.*, 316 U.S. 265, 278 (1942).

264. *See supra* notes 68–71 and accompanying text.

265. *See* *Black’s Law Dictionary* 532 (7th ed. 1999) (“Entitlement. Right to benefits, income or property which may not be abridged without due process.”); *WEBSTER’S ENCYCLOPEDIA UNABRIDGED DICTIONARY OF THE ENGLISH LANGUAGE* 476 (1994) (“Entitle. . . . to

allow state law to authorize a licensor to take away a federal entitlement or right absent an express statutory exception. Notwithstanding the reference in the legislative history of section 109(a) to the continuing possibility of a state law action for breach of contract for resale of a copy of software, such an assertion of state law would undermine the federal public policy of the First Sale Doctrine, and should therefore be considered void and unenforceable. Accordingly, where no breach of contract claim is possible against the lawful owner of a copy, the copyright owner would be unable to bring a credible claim of tortious interference with a contract against a third party transferee. Tortious interference has been raised in litigation against a party purchasing a copy of software that allegedly violated a resale restriction, and at least some courts have chosen not to dismiss the argument out of hand for failure to state a valid claim.²⁶⁶ Based on the view of the First Sale Doctrine as a mandatory public policy principle proposed in this article, this would be a mistake, as a party cannot tortiously interfere with an invalid provision of a contract. The first required element of a tortious interference claim is the existence of a valid contractual provision;²⁶⁷ if a resale restraint is invalid under the First Sale Doctrine, a party inducing breach of the restraint commits no tort.

B. Technological Anti-Circumvention Measures

The threat of an action for breach of contract is no longer the only means at the disposal of a copyright owner to extend his market power beyond that contemplated in the 1976 Copyright Act. Ingenious copyright owners have in many cases developed technological means to prevent any transgression of the license terms. Such "anti-circumvention measures" could theoretically prevent the lawful owner of a copy of a copyrighted work, such as a software disc or a copy downloaded from the Internet, from transferring that copy to another party after having installed it on a computer in order to use it. For example, code built into the software could, upon first installation on a computer hard disk drive, disable the software from allowing any

give (a person or thing) a title, right, or claim to something; furnish with grounds for laying claim . . .").

266. *See, e.g.,* Apple Computer, Inc. v. MicroTeam, No. C98-20164 PVT (N.D. Cal. 2000). The defendant, the second purchaser of computer software, failed to defend itself and the plaintiff publisher was granted default judgment in spite of its failure to present any evidence that the defendant had tortiously interfered with the provision. The court failed to address the invalidity of the resale restraint under the First Sale Doctrine.

267. *See* Kenty v. Transamerica Premium Ins. Co., 650 N.E.2d 863 (Ohio 1995); RESTATEMENT (SECOND) OF TORTS § 766 (1979).

further installations on any other computer hard disk drive. Four large hardware manufacturers (IBM, Intel Corp., Matsushita Electric, and Toshiba), cooperating as a group called the 4C Entity, would block certain types of files from being transferred to portable devices such as Zip drives or flash cards.²⁶⁸ Thus, rather than relying on any legal right to prevent the sale of software copies, the licensor could use practical measures to defeat such a sale even in the face of an affirmative legal right on the part of the owner of the copy.

The Digital Millennium Copyright Act was drafted in part to implement the World Intellectual Property Organization's ("WIPO") Performances and Phonograms Treaty,²⁶⁹ to which the United States is a signatory. Article 18 of the Treaty requires signatories to provide "adequate legal protection and effective legal remedies against the circumvention of effective technological measures" used by copyright holders of "phonograms" if such circumvention is not permitted by law.²⁷⁰ Section 1201(a)(1)(A) of the United States Copyright Act (the DMCA) seems to go further, providing that "no person shall circumvent a technological measure that effectively controls access to a work protected under this title."²⁷¹ This appears to include more than just phonograms and appears superficially to allow copyright owners to do technologically what the First Sale Doctrine forbids them to do contractually.

In this case, appearances are deceiving. It is a well established principle of statutory interpretation that when two statutes appear to conflict, as DMCA section 1201(a)(1)(A) and 1976 Copyright Act section 109(a) do, they must, if possible, be reconciled so as to give effect to each.²⁷² The Performances and Phonograms Treaty, upon which the DMCA is based, requires only that the law protect against circumvention that is not "permitted by law."²⁷³ In the case of a technological measure that obstructs the lawful owner of a copy from exercising a statutory entitlement, such as that conferred by the First Sale Doctrine, the only reasonable reading of section 1201(a)(1)(A) would be that copyright owners are free to use technological means to prevent

268. See John Borland, *Hardwiring Copyrights*, CNET NEWS, Mar. 23, 2001, at <http://cnet.com/news/0-1005-5211420-0.html>.

269. See WIPO Performances and Phonograms Treaty, Dec. 20, 1996, at <http://www.wipo.org/eng/diplconf/distrib/95dc.htm>.

270. *Id.*

271. 17 U.S.C. § 1201(a)(1)(A) (2000).

272. See *Musselman Hub-Brake Co. v. Comm'r of Int. Revenue Service*, 139 F.2d 65, 67 (6th Cir. 1943); *D.C. Fed. of Civic Ass'n v. Airis*, 275 F. Supp. 533, 538 (D.D.C. 1967).

273. WIPO Performances and Phonograms Treaty, *supra* note 269, at *7.

unlawful copying or other forms of copyright infringement,²⁷⁴ but not to undermine statutory rights of others granted by the 1976 Copyright Act.

Congress made clear its intent that section 1201(a)(1)(A), as determined by the Copyright Office,

[Does]not apply to persons who are users of a copyrighted work which is in a particular class of works if such persons are, or are likely to be in the succeeding 3-year period, adversely affected by virtue of such prohibition in their ability to make noninfringing uses of that particular class of works²⁷⁵

Unfortunately, the Copyright Office limited these “particular classes of works” to two very narrow kinds of works: compilations of lists of Web sites blocked by filtering software applications, and literary works (including computer programs) protected by access control mechanisms that fail to permit access due to malfunction, damage, or obsolescence.²⁷⁶ Several commentators on the proposed regulations, including the Assistant Secretary of Commerce for Communications and Information, endorsed an exemption for “works embodied in copies which have been lawfully acquired by users who subsequently seek to make noninfringing uses thereof.”²⁷⁷ Such language would have clarified that lawful owners of copies could use circumvention techniques to transfer those copies to others regardless of any technological impediments erected by the copyright owner. Unfortunately, the Copyright Office rejected such a suggested exemption based on the perceived difficulty of defining a “class of works” that would encompass such diverse uses.²⁷⁸ In the opinion of the Office, such an exemption would cover a “class of users” making a particular “class of use,” which was not within the Office’s mandate to exempt “particular classes of works.” Moreover, because the House of Representatives had considered and ultimately rejected a provision in the DMCA protecting persons who had “gained initial lawful access” to a work (incidentally, a “class of users” and not a “class of works”),²⁷⁹ the Copyright Office concluded that Congress did not intend to confer upon it the power to exempt such persons from the anti-circumvention measures.²⁸⁰

274. See *Universal City Studios v. Reimerdes*, 111 F. Supp. 2d 294, 317–18 (S.D.N.Y. 2000).

275. H.R. REP. NO. 105-551, pt. 2, at 36 (1998).

276. See 65 Fed. Reg. 64,556, 64,562 (2000) (codified at 17 C.F.R. § 201.40 (2000)).

277. *Id.* at 64,561.

278. See *id.* at 64,562.

279. H.R. 2281 EH (1999).

280. See 65 Fed. Reg. at 64,572, 64,573.

Whatever the merits of the Office's first objection, its second is a *non sequitur*. There are many reasons that the House could have deleted the exemption for persons with "initial lawful access;"²⁸¹ it does not necessarily follow that Congress deleted the provision intending to prevent the Office from promulgating a similar exemption. If Congress had wished to make such a limitation on the Office's rulemaking power, it could have done so explicitly. More likely, the drafters believed that the Office was in a better position to judge whether such an exemption should be granted, due to its proximity to and familiarity with copyright issues.

While the authors believe the Copyright Office, in ignoring these suggestions, missed an opportunity to clarify the interaction between DMCA section 1201(a)(1)(A) and Copyright Act section 109(a), the authors do not believe that the Office's failure to promulgate a specific exemption derogates from the duty for licensors and courts to avoid using technological means to circumnavigate the First Sale Doctrine. Even in the absence of a specific exemption, any circumvention of such technological impediments should be considered a lawful, protected activity if the circumvention were undertaken in pursuit of a statutory entitlement to transfer the software copy.²⁸²

Yet, merely affirming the copy owner's legal right to circumvent technological restraints on resale of the copy does not resolve the prior question of whether the copyright owner is entitled to impose the restraint. As discussed above,²⁸³ most courts apply the state commercial code to sales of software copies and even "licenses" of software as they define them, and all but one of the States has enacted a version of the Uniform Commercial Code ("UCC"). The UCC provides for several types of warranties to be included by default in any contract for the sale of goods. One such warranty, the warranty of title, provides that the "title conveyed shall be good."²⁸⁴ Because one essential attribute of title to property, as discussed earlier, is the right of alienability, a sale of a copy of software that is technologically designed to obstruct resale could arguably be considered a sale of "technologically disabled title" given that the right of alienability is an

281. For example, expiration of a valid software license would remove any legal justification for continuing access to a copyrighted work. Congress may not have wished to imply continued authorized after such a license expired.

282. Of course, this would affect only the very few with the time, skills, and motivation to hack the security measures. See James R. Davis, *On Self-Enforcing Contracts, The Right to Hack, and Willfully Ignorant Agents*, 13 BERKELEY TECH. L.J. 1145, 1147 (1998).

283. See *supra* Part III.B.

284. U.C.C. § 2-312(1)(c) (2000).

essential attribute of title to property. If the purchaser's ownership of the software copy is incomplete due to a latent technological obstruction, the purchaser can assert that the warranty of good title has been breached. Of course, a software manufacturer may successfully insist that the legal concept of "good title" should not be confused with actual possibilities of accessing, copying, and transferring copies of a computer program.

Moreover, the implied warranty of merchantability imposes a requirement that goods be "fit for the ordinary purposes for which such goods are used."²⁸⁵ If the ordinary purposes for which copies of software are used include being sold, then an argument can be made that software incorporating a built-in technological device to prevent resale is defective and thus traduces the implied warranty of merchantability. The Magnuson-Moss Consumer Product Warranty Act provides that warranties included with products sold to consumers may not exclude the implied warranty of merchantability.²⁸⁶ Software, like most products, derives part of its value from the fact that it can be resold or otherwise alienated from its lawful owner. A product that lacks the essential feature of alienability is not "merchantable" because it has a latent attribute that substantially reduces its value. Of course, it is relevant in this regard whether the purchaser is aware of and accepts the restriction. If not, computer software with a technological obstruction to resale may be a breach of the implied warranty of merchantability as well.

In both cases, the end-user would rely on a combination of state law commercial rights and federal statutory rights under section 109(a). But these commercial remedies typically would only apply to consumers, as business-to-business software sales can be accompanied by a repudiation of both the warranty of title and implied warranty of merchantability. However, the First Sale Doctrine may provide an even stronger argument against the legality of such technological obstructions. The use of a technological measure to undermine the ability of a lawful owner of a copy to transfer that copy to another party would violate section 109(a). DMCA section 1201(a)(1)(A) does not explicitly authorize copyright owners to impose technological restraints on the resale of copies of the protected works, and section

285. U.C.C. § 2-314(2)(c) (2000).

286. See 15 U.S.C. § 2308 (2000). Although there does not seem to be any precedent on point yet, most scholars seem to believe that the Act should be applied to software. See also Cem Kaner, *Uniform Computer Information Transaction Act: Software Engineering and UCITA*, 18 J. MARSHALL J. COMPUTER & INFO. L. 435, 460 (1999).

109(a) requires a sale of a copy to include resale rights. Therefore, a sale must include resale rights, and the licensor may not undermine those rights technologically any more than he may do so contractually.²⁸⁷ In the absence of an affirmative statutory right, which has not been incorporated into the 1976 Act by the DMCA or otherwise, such restraints violate the lawful owner's entitlement freely to alienate the copy.

IV. Applicability of the First Sale Doctrine to Software Transfers Under European Community Law

Turning the focus of this analysis to Europe, statutory provisions and litigation scenarios similar to those under United States law are discovered. Even some of the software products and plaintiffs are the same. Yet, while the European Court of Justice has not yet ruled on the matter, European courts, and in particular those of Germany, have come to very different conclusions with respect to the applicability of the First Sale Doctrine to software transfers.

A. Applicable Statutory Provisions

1. European Community Law and National Laws

The law on copyrights and on contracts is not yet completely harmonized within the European Community.²⁸⁸ Therefore, in all Member states of the European Community, software license agreements are governed both by national contract law, which differs from Member state to Member state, and by the European Community ("EC") law, as implemented into national law. As in the United States and most other countries worldwide, copyright law is territorial (i.e., the copyright law of the country where protection is sought applies).²⁸⁹

287. Any action for infringement by virtue of the use of anti-circumvention measures could thus be defended with a claim of copyright misuse, for an attempt by the copyright owner to extend his statutory monopoly beyond—indeed, contrary to—the terms of the 1976 Copyright Act, is void and unenforceable. *See generally* Aaron Xavier Fellmeth, *Copyright Misuse and the Limits of the Copyright Monopoly*, 6 J. INTELL. PROP. L. 1 (1998).

288. This article has focused on the European Community, because while the European Union ("EU") provides a common "roof" for the different forms of cooperation of its Member states, it is still the European Community ("EC") that passes the relevant laws and undertakes nearly all other relevant legal actions. *See* Helmut Lecheler, *EINFÜHRUNG IN DAS EUROPARECHT*, [Introduction to European Law] 27–33 (2000); Rudolf Streinz, *EUROPARECHT* [European Law] 38–46 (4th ed. 1999).

289. *See* *The Bridgeman Art Library Ltd. v. Corel Corp.*, 36 F. Supp. 2d 191 (S.D.N.Y. 1999); PAUL E. GELLER & MELVILLE B. NIMMER, *INT'L COPYRIGHT LAW AND PRACTICE* § 3[1][a][i] (looseleaf, last updated Oct. 2000).

Therefore, the national law of the Member state where a copyright owner seeks protection or enforcement primarily applies. With regard to contracts law, the national conflict of laws principles govern. However, as EC law is paramount and its purposes and policies may not be undermined by national laws, the relevance of national laws is restricted to aspects and situations that are not yet governed by EC law.²⁹⁰ Thus, German statutory and case law serves as an example to the extent it is relevant for a comparative analysis.

2. The European Community Software Directive and German Copyright Law

The most important legal rules with regard to the licensing of computer software in the European Community common market are provided by EC law, most notably the Council Directive 91/250/EEC of 14 May 1991 on the legal protection of computer programs (the "EC Software Directive").²⁹¹ Sections 69c and 69d[1] of the German Copyright Act²⁹² basically reiterate the German language version of Articles 4 and 5[1] of the EC Software Directive.

Article 4[c] of the EC Software Directive contains the EC version of the First Sale Doctrine. It provides that the copyright owner has the exclusive right to undertake or authorize:

[A]ny form of distribution to the public, including the rental, of the original computer program or of copies thereof. The first sale in the Community of a copy of a program by the Copyright holder or with his consent shall exhaust the distribution right within the Community of that copy, with the exception of the right to control further rental of the program or a copy thereof.²⁹³

All Member states of the EU have implemented this provision in one form or another.²⁹⁴

Similar to section 109 of the 1976 United States Copyright Act, the EC Software Directive does not further define the term "sale" or address the question whether the copyright owner may contractually prohibit a purchaser of a software copy from reselling such copy. In

290. See Grad/Finanzmt Traunstein, 97/70, 1970 ECJ OFFICIAL CASE COLLECTION 825, 837 (1970); Streinz, *supra* note 288, at 141-44.

291. See 1991 O.J. (L 122) 42-46.

292. See Gesetz über Urheberrecht und verwandte Schutzrechte (Urheberrechtsgesetz) [Code on author's rights and related proprietary rights], Fed. Gazette I, 1273 as amended (Sept. 9, 1965), translated at <http://www.ipr-helpdesk.org>.

293. EC Software Directive, Article 4(c).

294. See EC Commission, *Report from the Commission to the Council, The European Parliament and the Economic and Social Committee on the Implementation and Effects of Directive 91/250/EEC on the Legal Protection of Computer Programs* 11 (Apr. 4, 2000).

the United States, as in the EC, the effectiveness of such contractual resale prohibitions is not expressly governed by copyright laws, but rather by general contracts law and competition laws. Just as in United States courts, the German federal court of last instance for civil law matters, the *Bundesgerichtshof*,²⁹⁵ understands the First Sale Doctrine as a limitation of the copyright owner's exclusive rights in the interest of free dealing in goods, which a copyright owner has permitted to enter the stream of commerce.²⁹⁶ Once an author of a copyrighted work has benefited from its exclusive rights to its intellectual property by selling a copy of its work, the public interest in a free marketplace and in the absence of hidden restrictions overcomes the author's interests in controlling the further commercialization of copies of its copyrighted work.²⁹⁷

Articles 4[a] and 5[1] of the Software Directive address the rights of an acquirer of a software copy with respect to uploading and reproducing such copy in the course of its normal use—rights that are addressed in section 117 of the 1976 United States Copyright Act. Article 4[a] of the EC Software Directive provides that the copyright owner shall have the exclusive right to undertake or authorize “the perma-

295. For purposes of the First Sale Doctrine as well as contract and copyright law in general, the authority of the *Bundesgerichtshof* in Germany can be compared to the authority of the United States Supreme Court, even though the German constitution does not provide for one single supreme court as such. Instead, according to Article 95 of the German constitution (“Grundgesetz”), there have to be several federal courts of last instance in the areas of civil and criminal law (“*Bundesgerichtshof*”), administrative law (“*Bundesverwaltungsgericht*”), social security law (“*Bundessozialgericht*”), labor law (“*Bundesarbeitsgericht*”), and tax law (“*Bundesfinanzhof*”). Additionally, according to Article 93 of the German constitution, a federal constitutional court (“*Bundesverfassungsgericht*”) has jurisdiction over a number of enumerated constitutional disputes including complaints of individuals who have already exercised all reasonable rights of complaints and appeals in front of the other courts. In recent years, the German federal constitutional court has continued to expand its own jurisdiction in many areas of political public interest by finding constitutional questions even in core areas of civil and criminal laws, (e.g., by inventing so-called “protection duties” according to which the other courts and even the legislature has to protect certain political interests in accordance with the case law of the constitutional court.). See *LOTHAR DETERMANN, NEUE, GEFÄHRVERDÄCHTIGE TECHNOLOGIEN ALS RECHTSPROBLEM* [New Potentially Dangerous Technologies as Legal Problem] 158–76, 200–08 (1996); *LOTHAR DETERMANN, KOMMUNIKATIONSFREIHEIT IM INTERNET* [Freedom of Communications on the Internet] 274–83 (1999). However, it seems currently unlikely that the German federal constitutional court would hear such technical issues as cases dealing with the First Sale Doctrine as it applies to software transfers. Therefore, the *Bundesgerichtshof* probably has the final say on this issue as far as German law is concerned.

296. See *Bundesgerichtshof, Computer und Recht* [The Computer and Law] 651, 652 (2000) [hereinafter CR]; see also *BUNDESGERICHTSHOF, WETTBEWERB IN RECHT UND PRAXIS* [Competition Law and Practice] 1407, 1409 (2000) [hereinafter WRP].

297. See CR, *supra* note 296, at 651, 653; WRP, *supra* note 296, at 1407, 1409.

ment or temporary reproduction of a computer program by any means and in any form, in part or in whole. Insofar as loading, displaying, running, transmission or storage of the computer program necessitate such reproduction, such acts shall be subject to authorization by the rightholder”²⁹⁸

Article 5[1] of the EC Software Directive provides: “In the absence of specific contractual provisions, the acts referred to in Article 4 (a) . . . shall not require authorization by the rightholder where they are necessary for the use of the computer program by the lawful acquirer in accordance with its intended purpose, including error correction.”²⁹⁹

While the EC version of the First Sale Doctrine seems similar to the United States version, the provision addressing the right to upload a lawfully acquired software copy differs notably from its United States parallel, section 117 of the 1976 United States Copyright Act. First, the EC Software Directive refers to the lawful acquirer, not the lawful owner of a software copy. Second, the EC Software Directive grants the right to create and upload the software copy for purposes of intended use and repair only “in the absence of specific contractual provisions.”³⁰⁰ This reservation may be read to allow a copyright owner to exclude the rights granted in a license agreement. However, the recitals of the EC Software Directive clarify that a “core portion” of user rights may not be excluded contractually:

Whereas the exclusive rights of the author to prevent the unauthorized reproduction of his work have to be subject to a limited exception in the case of a computer program to allow the reproduction technically necessary for the use of that program by the lawful acquirer;

Whereas this means that the acts of loading and running necessary for the use of a copy of a program which has been lawfully acquired, and the act of correction of its errors, may not be prohibited by contract; whereas, in the absence of specific contractual provisions, including when a copy of the program has been sold, any other act necessary for the use of the copy of a program may be performed in accordance with its intended purpose by a lawful acquirer of that copy³⁰¹

The recitals of a directive are legally binding for the Member states because the recitals clarify which results the Member states have

298. EC Software Directive Arts. 4, 5, as implemented in German Copyright Act §§ 69c, 69d.

299. *Id.*

300. *Id.*

301. *Id.*

to achieve in implementing a directive. According to Article 249(3) of the Treaty of Rome establishing the European Community, “[a] directive shall be binding, as to the result to be achieved, upon each Member state to which it is addressed, but shall leave to the national authorities the choice of form and methods.”³⁰² Thus, if a copyright owner sells a software copy, according to the EC Software Directive, the copyright owner cannot contractually exclude a first or second purchaser’s right to create copies as required to upload and run the software copy. Despite the somewhat misleading language of Articles 4 and 5 of the Software Directive, EC law intends to grant any lawful acquirer of a software copy, irrespective of any contractual agreements between the acquirer and the copyright owner, the same rights that are granted in section 117 of the Copyright Act.³⁰³

The German legislature adopted the misleading language of Articles 4 and 5 of the Software Directive word for word in section 69d Nr. 1 of the Copyright Act. The legislation explained that a copyright owner cannot validly exclude a lawful acquirer’s right to upload a software copy into the RAM of a computer.³⁰⁴ As a consequence, courts and commentators treat the right to upload legally acquired software as a “core user right,” which cannot be contractually excluded.³⁰⁵ One German court even held that a software user who uploads a lawfully installed copy from the hard drive of a computer into its RAM does not create a copy for purposes of the German Copyright Act or the EC Software Directive.³⁰⁶ The court based its decision on the fact that Article 4[a] of the EC Software Directive provides that the copyright owner’s permission (i.e., license) is required for upload-

302. Treaty of Rome, March 25, 1958, Article 249(3). See generally THOMAS OPPERMAN, *EUROPARECHT* 209-214 (2d ed. 1999); Streinz, *supra* note 288, at 141-44.

303. See Ulrich Loewenheim, *Special Provisions Applying to Computer Programs*, in GERHARD SCHRICKER, *URheberRECHT* [Copyright Law] §§ 69d(12)-(14), at 1111-12 (2d ed. 1999); JOCHEN SCHNEIDER, *HANDBUCH DES EDV-RECHTS* [Handbook of Electronic Data Processing] 387, 395 (2d ed. 1999); Kai Vinck, *Special Provisions Applying to Computer Programs*, in *URheberRECHT* [Copyright Law] 439-40 (Wilhelm Nordemann et al. eds., 8th ed. 1994); Matthias Brandi-Dohrn, *Softwareschutz nach dem neuen deutschen Urhebergesetz* [Software Protection According to the New German Copyright Law], in *BETRIEBS-BERATER* [Corporate Counsel] 658, 659 (1994) [hereinafter BB]; Hans-Werner Moritz & Stefan Hütig, *Fortbildung des Computerrechts von 1998 bis heute* [Development of the Computer Law From 1998 Until Today], in 12 *SUPPLEMENT TO COMPUTER AND LAW* 2 (2000); MICHAEL LEHMANN, *RECHTSSCHUTZ UND VERWERTUNG VON COMPUTERPROGRAMMEN* [Legal Protection and Commercialization of Computer Programs] § 1A[13] (2d ed. 1993).

304. *AMTLICHE BEGRÜNDUNG* [Official Reasons for the Enactment of the Changes to the German Copyright Act], *BT-DRUCKSACHE* [Off. Gazette of the Fed. Parliament] 12/4022 (IV/270), at 12.

305. See Loewenheim, *supra* note 303, §§ 69d(12)-(14), at 1111-12.

306. 1999 LG Mannheim, CR, 360-62.

ing only “[i]nsofar as loading, displaying, running, transmission or storage of the computer program necessitate[s] . . . [a] reproduction.”³⁰⁷ From this language the court concluded that the EC and German legislatures must have assumed that certain acts of loading, displaying, and running do not necessitate a reproduction because they do not involve the creation of a sufficiently permanent copy.³⁰⁸ However, neither the EC Software Directive nor the German Copyright Act clearly defines how permanent a copy must be to cause copyright infringement. Most German commentators assume that by uploading a copy into the RAM of a computer the software user creates a copy for purposes of the German Copyright Act and the EC Software Directive,³⁰⁹ a view that is shared by courts and commentators in the United States.³¹⁰

The German legislature also adopted the codification of the First Sale Doctrine in the EC Software Directive word for word in section 69c Nr. 3 of the German Copyright Act, which applies exclusively to software. The generally applicable version of the First Sale Doctrine of German copyright law is laid out in article 17(2) of the German Copyright Act, which provides that “[i]f the original work or copies thereof have been put into circulation in the territory of the European Union . . . with the consent of the holder of the distribution right, their further distribution shall be permissible with the exception of rental.”³¹¹

3. German Contracts Law: Civil Law and the Standard Contracts Terms Act

Like United States law on contracts, the German Civil Code³¹² respects the freedom of individuals to enter into any agreements and contractual promises, provided that such agreements do not violate the German Federal Penal Code, other mandatory federal and state

307. EC Software Directive, Article 4(a).

308. *See id.* at 361.

309. *See* LEHMANN, *supra* note 303, § I.A[13]; Moritz & Hütig, *supra* note 303, at 5; Loewenheim, *supra* note 303, § 69c(9), at 1095; JOCHEN SCHNEIDER, *supra* note 303, at 387.

310. *See* MAI Sys. Corp. v. Peak Computer, Inc., 991 F.2d 511, 518 (9th Cir. 1993); Mark A. Lemley et al., *Exclusive Rights in Computer Programs*, in *SOFTWARE AND INTERNET LAW 195–96* (Mark A. Lemley, Peter S. Menell, Robert P. Merges, Pamela Samuelson, eds. 2000).

311. F.R.G. Copyright Act § 17(2).

312. *See* Bürgerliches Gesetzbuch (“BGB”), v.18.8.1896 (Reichsgesetzblatt s.195). Federal Gazette (“RGBl.”) at 195. Civil and criminal laws are subject to (concurrent) federal legislative jurisdiction.

statutes, including the above mentioned mandatory principles of the German Copyright Act, or certain principles of public policy.³¹³

The German Civil Code provides clearly defined sets of rules for certain types of contracts, which were common at the time of the enactment of the German Civil Code in 1896: sections 433 *et seq.* define contractual obligations of the parties to a sales contract; sections 535 *et seq.* lay out the rules for lease agreements; sections 611 *et seq.* cover services provided on a time and materials basis ("services agreements"); while sections 631 *et seq.* cover contracts wherein one party promises to produce a work and the other party pays if the work meets the acceptance criteria ("works agreements"). Additionally, the German Commercial Code³¹⁴ contains special rules that apply only to merchants.

Most of the individual provisions in these sets of rules may be derogated from. However, in accordance with German legislative intent, in Germany contracting parties traditionally refer to the statutory concepts of sales, lease, services, or work contracts and specify in their written contracts only the variables of a transaction (such as price, goods sold or leased, work to be created, etc.), and possibly certain derogations from the statutes (e.g., a disclaimer of certain warranties, a limitation of liability). As a result, German contracts are generally much shorter than agreements drafted in the United States, which often contain lengthy lists of definitions as well as reiterations, clarifications, and derogations from statutory and common law rules.³¹⁵

Yet with regard to derogations from statutory concepts, the reality of the business world today—in Germany as in the United States—seems to be that more often than not, one party presents to the other a contract of adhesion, the terms of which the other party accepts unchanged or not at all. In an attempt to correct a perceived unfairness created by unequal bargaining powers, German courts established a line of "content control" case law based on section 138 of the German Civil Code.³¹⁶ Subsection one of this mandatory provision declares void any contract or other legal instrument that violates public policy, and German courts have found a number of standard contract clauses, such as "overbroad" limitations of liability and warranty dis-

313. See BGB (HGB) §§ 134, 138 v.10.5.1897 (Reichsgesetzblatt s.219).

314. See Handelsgesetzbuch May 10, 1897, Reichsgesetzblatt [Federal Gazette] 1897 at 219, as amended.

315. See MATHIAS REIMANN, EINFÜHRUNG IN DAS US-AMERIKANISCHE PRIVATRECHT 22 (1997).

316. See MANFRED WOLF, AGB-GESETZ KOMMENTAR 15–16 (Manfred Wolf et al. eds., 4th ed. 1999).

claimers, to violate public policy. The German federal legislature approved, codified, and tightened this case law in 1976 with the Standard Contracts Terms Act.³¹⁷ This Act generally declares boilerplate terms void to the extent they are unfair. German courts consider a contractual clause a “standard term” if there are any indications that the drafter intended to use the clause again in other contracts.³¹⁸ The drafter has to show that a clause was seriously negotiated with the other party in order to avoid applicability of the Standard Contract Terms Act (“the Act”). Unless a clause has actually been changed pursuant to negotiations, drafters are often unable to prove that “serious negotiations” took place.³¹⁹

The Standard Contract Terms Act lists certain terms that are generally void, for example, contractual penalties of any kind, limitations of liability that apply to gross negligent or intentional conduct, or an exclusion of the buyer’s right to a refund in case of nonconforming goods.³²⁰ The Act also lists certain terms that are *normally void*, unless there is a specific justification for them. On this list are clauses such as the drafter’s right to terminate for convenience and any factual acknowledgements of the other party (e.g., that a copy of the terms has been received, that the parties would not have entered into the agreement if certain terms were invalid, or that the agreement has been negotiated).³²¹ Additionally, as a catch-all provision, section 9 of the Act allows courts to invalidate any standard term that (i) puts the

317. See Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen (AGB-Gesetz), v.9.12.1976 (BGBl. I. S. 3317).

318. According to AGBG § 1, a clause is deemed pre-formulated if: (i) it is drafted to be used in several contracts, even when used for the first time. See Helmut Heinrichs, *AGBG*, in OTTO PALANDT, 1 BGB, AGBG para. 6 (56th ed. 1997) (deducing that the AGBG applies if clause is drafted for three to five contracts); 1992 BUNDESGERICHTSHOF, NEUE JURISTISCHE WOCHENSCHRIFT [New Weekly Law Journal] 2759; 1981, 2344, 2345 [hereinafter NJW] (establishing that the first use is sufficient); 1988 BUNDESGERICHTSHOF, NJW 410 (establishing that a clause “stored” mentally is sufficient); and (ii) it is presented by one party to the other (and not suggested by an independent third party or jointly conceived); and (iii) it has not been negotiated. According to the Bundesgerichtshof, a clause is negotiated only if the party presenting the clause has seriously offered to modify it according to the interests of the other party. See 1998 BUNDESGERICHTSHOF, NJW 410; 1987 NJW 410 at 211.

319. A clause is generally presumed to have been negotiated if such clause is in fact changed during negotiations, or if another clause is changed instead as a compromise (1988 BUNDESGERICHTSHOF, NJW 410–11). A clause does generally not qualify as “negotiated” under II AGBG § 1, if the party presenting the clause merely explains it and convinces the other party to accept the clause unchanged (1992 BUNDESGERICHTSHOF, NJW 2759, 2760).

320. See Standard Contract Terms Act § 11.

321. See *id.* § 10.

non-drafting party at an unreasonable disadvantage, (ii) derogates significantly from the statutory fall-back provisions (e.g., in the German Civil Code), or (iii) puts the material purposes of the contract at risk by unreasonably limiting either the drafting party's obligations, or the non-drafting party's rights.³²²

Section 9, also applies to agreements between merchants while the specific lists of invalid clauses apply only to contracts with consumers.³²³ However, in determining what is unreasonable in a contract between merchants under Section 9 of the Standard Contract Terms Act, German courts usually seek recourse to the blacklists applicable in a consumer context.³²⁴ If a clause is blacklisted for consumer contracts, German courts will often find the clause unreasonable even in a purely commercial context.³²⁵

If a German court determines that a boilerplate contract term is unfair for purposes of the Standard Contract Terms Act, the court will strike the entire clause.³²⁶ German courts will not interpret a clause restrictively in order to uphold it as courts in the United States normally do. On the contrary, in order to encourage narrow drafting of standard contract terms, German courts apply the following test: Would the challenged clause be unfair if its wording were interpreted as broadly as possible in the interest of the drafting party? If so, it will be stricken, even if a narrower interpretation would have been reasonably possible and ensured that the clause would have been reasonably fair. For example, let us assume a plaintiff sues a defendant for breach of a contract governed by the defendant's standard terms. If the defendant's standard terms contain a limitation of liability clause, according to which the defendant's liability shall under no circumstances exceed the value of the contract and the defendant shall never be liable for consequential damages, a German court would read this clause to mean that the defendant shall not even be liable for consequential damages or in excess of the contract value in cases of intentional misconduct.³²⁷ Such a far-reaching limitation of

322. *See id.* § 9.

323. According to Standard Contract Terms Act § 24(1), sections 10 and 11 do not apply if the non-drafting party acts for its business or professional practice.

324. *See* Norbert Horn, *Section 9 of the Standard Contract Terms Act*, in *AGB-GESETZ KOMMENTAR* 1901-13 (4th ed. 1999).

325. *See, e.g.*, BGH, 96, 182 (191-92).

326. *See* 1993 BGH, NJW, 1135; Helmut Heinrichs: PALANDT, *BÜRGERLICHES GESETZBUCH* [Commentary on the German Civil Code], 56th ed. at 2391 (1997).

327. *See* Walter Lindacher, *Section 9 of the Standard Contract Terms Act*, in *AGB-GESETZ KOMMENTAR* 250-52 (4th ed. 1999).

liability would qualify as unfair under the Standard Contracts Term Act.³²⁸ Consequently, the German court would strike the entire limitation of liability clause. As a consequence, the defendant would be fully liable even if the actual case before the court only involved ordinary negligence, or no fault of the defendant at all. In order to draft a standard limitation of liability clause to pass the strict scrutiny of the Standard Contract Terms Act, a drafter must expressly exclude all scenarios under which a limitation would be unfair, such as willful breach, gross negligence of managerial employees, strict product liability, and violations of so-called cardinal contractual duties.³²⁹

With the Standard Contracts Terms Act, Germany exceeds the minimum standard set by the EC Directive on Unfair Terms in Consumer Contracts,³³⁰ which only applies in a consumer context.³³¹ If a contract is formed pursuant to solicitation in Germany or with a consumer residing in Germany at the time of contract formation, the German Standard Contracts Terms Act even applies to agreements that are governed by foreign law.³³² However, the Act does not apply if an agreement is governed by foreign law, one party resides outside Germany, and the non-drafting party is a merchant.³³³

4. Restraints on Alienation Under European Community and German Laws

German law displays the same antipathy to general restraints on alienation as the common law of the United States. Section 137 of the German Civil Code provides that the ability to eliminate generally disposable rights cannot be excluded in a contract effective *erga omnes*.³³⁴ However, section 137 of the German Civil Code does not affect the validity of a contractual promise between parties in privity to refrain from eliminating a generally disposable right. Thus, if a seller and a first purchaser agree in a car sales agreement that the first purchaser shall be prohibited from reselling the car, the first purchaser would nevertheless be able to transfer title of the car to a second purchaser.

328. WOLF, *supra* note 316, at 1270. Any limitation to the contract value is normally regarded unfair.

329. See Lindacher, *supra* note 327, at 242-53.

330. See Council Directive 93/13/EEC, 2000 O.J. (L 095), (21/04/EEC1993, at 29-34).

331. See Helmut Heinrichs, *Standard Contract Terms Act*, in OTTO PALANDT, 1 BGB, AGBG 2378 (56th ed. 1997).

332. See Standard Contracts Terms Act §§ 12, 24a.

333. See Lindacher, *supra* note 327, at 1416.

334. See Romina Polley, *Verwendungsbeschränkungen in Softwareüberlassungsverträgen*, 1999 CR 345, 347.

The second purchaser would acquire title and the first purchaser would possibly violate the sales contract with the original seller.³³⁵

However, a contractual resale prohibition in a pre-formulated standard sales agreement would be invalid under the German Standard Contract Terms Act as an unfair derogation from the German civil code according to which a purchaser can normally use the purchased good without restraint.³³⁶ An individually negotiated contractual resale prohibition could be invalid under unfair competition laws.³³⁷ Both EC and German antitrust laws are generally stricter with respect to vertical restraints of trade than United States antitrust laws. Under Article 81 of the EC Treaty, contractual resale prohibitions between undertakings are considered illegal restraints of trade.³³⁸

335. See generally Heinrichs, *supra* note 331, at 117.

336. See Standard Contract Terms Act §§ 9(II), 433, 903 Civil Code; 1998 OLG Bremen, Betriebs-Berater (BB), at 4, 5.

337. See Michael Lehmann, *Aktuelle kartell- und wettbewerbsrechtliche Probleme der Lizenzierung von urheberrechtlich geschützten Computerprogrammen* [Current antitrust and competition law problems related to the licensing of copyrightable computer programs], 1985 BB 1209, 1210; XVI LEHMANN, *supra* note 303, at 802, 814; Polley, *supra* note 334, at 351-52; SCHNEIDER, *supra* note 303, at 469-70; Hanns Ullrich & Karheinz Konrad, *Competition Laws, in DER INTERNATIONALE SOFTWAREVERTRAG* [The International Software Agreement] 332-35 (Hans Ulrich & Eberhard Körner eds. 1995).

338. The Rome Treaty establishing the European Community of 1958, as amended, ("EC Treaty") provides in TITLE IV (ex Title V), "COMMON RULES ON COMPETITION, TAXATION AND APPROXIMATION OF LAWS," Chapter 1, "Rules on competition," section 1, "Rules applying to undertakings," Article 81 (ex Article 85):

(1.) The following shall be prohibited as incompatible with the common market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member states and which have as their object or effect the prevention, restriction or distortion of competition within the common market, and in particular those which: (a) directly or indirectly fix purchase or selling prices or any other trading conditions; (b) limit or control production, markets, technical development, or investment; (c) share markets or sources of supply; (d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage; (e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts. (2.) Any agreements or decisions prohibited pursuant to this Article shall be automatically void.

EC Regulation 17/62 additionally provides for hefty fines in case of certain violations. See Gerhard Dannecker, *Commentary on Regulation 17, in EG-WETTBEWERBSRECHT* [EC Competition Law] 1780 (Ulrich Immenga & Ernst-Joachim Mestmächer eds. 1997). It is not entirely clear whether resale prohibitions can be covered by the new general block exemption regulation 2790/1999, O.J. L336, 29/12/1999, at 21-25: While the regulation generally exempts vertical restraints imposed by undertakings of 30% or less market share, according to Article 4(b) the regulation does not apply to agreements that restrict "the customers to whom the buyer may sell the contract goods or services." Arguably, a contractual resale prohibition is the farthest reaching customer restriction possible. The block exemption

Under section 16 of the German Act Against Restraints of Trade, contractual resale prohibitions are not illegal *per se*, but any resale restrictions can be prohibited by the German Federal Cartel Office.³³⁹

B. German Court Decisions on Software Transfers Under EC and German Laws³⁴⁰

1. Sale, Lease, or License Agreement?

Similar to the UCC cases in the United States discussed above, German courts have had to decide whether software transfers qualify as sales, leases, or “true” licenses in connection with disputes related to supposedly defective or otherwise nonconforming software. Under United States law in similar cases the question typically is whether the UCC rules on contract formation and implied warranties apply. Under German contracts law, courts normally have to decide for purposes of applying the German Standard Contracts Terms Act, whether the drafter has attempted to derogate unreasonably from the statutory provisions on sales or lease agreements.

Most notably, the rules on sales contracts in the German Civil Code provide for a six month warranty period.³⁴¹ This warranty period commences when the purchaser receives possession of the sold goods.³⁴² During the warranty period, a purchaser can demand, at its discretion, an abatement of the purchase price, or a refund of the purchase price against return of the goods, if such goods were defective when the purchaser received them.³⁴³ The seller may reserve the right to repair or replace defective goods in order to avoid an abate-

regulation for technology transfer agreements, regulation 240/96, O.J. L31, 9/2/1996, at 2-13, does not seem to exempt resale prohibitions.

339. Section 16 of the German Gesetz gegen Wettbewerbsbeschränkungen [Act Against Restraints of Trade], last amended and re-published Aug. 26, 1998, Fed. Gazette I at 2546 provides: “The Cartel Office may declare void and prohibit agreements regarding goods or services between undertakings, which restrict the freedom of one party . . . to sell the goods to third parties.” According to section 17 of the German Act Against Restraints of Trade in *patent* license agreements, any restraints are illegal unless justified and covered by the statutory patent rights of the patent holder. However, this provision would normally not apply to a software transfer because such transfers would usually qualify as sales under German law.

340. In Germany, court decisions are traditionally published without any reference to the identity of plaintiff and defendant. Only in some instances have the authors of this article been able to identify the software manufacturer due to the name of software products that were mentioned in the published court decisions.

341. See F.R.G. CIV. CODE §§ 459, 477 (2000).

342. See *id.*

343. See F.R.G. CIV. CODE §§ 459-65.

ment or refund of the purchase price.³⁴⁴ However, according to the German Standard Contract Terms Act, the purchaser must retain the right to a refund in case repair or replacement is unreasonable under the circumstances.³⁴⁵ In a consumer context, the consumer must also retain the right to an abatement of the purchase price which is especially burdensome in the software context given the fact that no computer program is completely error-free.³⁴⁶ Also, if a seller, in its standard sales contract, reserved the right to terminate the contract and demand a return of the goods sold, such termination clause (often found in standard agreements accompanying software transfers in the United States) would substantially derogate from the concept of sales in the German Civil Code to the disadvantage of a purchaser, and therefore be invalid under the Standard Contract Terms Act.³⁴⁷

A right to terminate for breach would, however, be typical in a lease context.³⁴⁸ If a software manufacturer wanted to reserve the right to terminate and demand a return of its software, it could enter into lease agreements with German customers. However, according to section 536 of the German Civil Code, a lessor must maintain the leased good in suitable condition for the entire term of the contract. If a leased good is or becomes defective, the lessor must repair or replace it.³⁴⁹ If the lessor fails to do so, the lessee may abate its rent, or demand specific performance or damages in court.³⁵⁰ Under the German Standard Contract Terms Act, a lessor is typically not able to exclude these basic remedies in a pre-formulated, non-negotiated contract.³⁵¹ Thus, in a lease context, a software manufacturer would have to warrant the conformity and functionality of its software not only for a six month warranty period applicable to sales, but for the entire lease period, not unlike landlords, who must maintain residential apartments both under the German Civil Code and most United States state laws. In practice, few software manufacturers are willing to do so. Additionally, many software consumers prefer to acquire computer programs permanently, and most software manufacturers prefer an up front lump sum payment to monthly rent payments. Lump sum payments allow a manufacturer to be able to recognize revenue, which

344. See F.R.G. CIV. CODE § 476.

345. See Standard Contract Terms Act § 11(10)(b).

346. See WOLF, *supra* note 316, at 941.

347. See *id.* at 942-43.

348. See *id.* at 936, 943.

349. See F.R.G. CIV. CODE § 536 (2000).

350. See F.R.G. CIV. CODE §§ 936-38 (2000).

351. WOLF, *supra* note 316, at 941.

often affects the stock price of a publicly traded company, at least in the United States.

Given the aforesaid disadvantages of the established concepts of sales and leases under German contracts law for sellers, software manufacturers targeting the German market felt a similar incentive as United States market players to label software transfers something different. This incentive likely existed because the large players in the German market were initially mostly United States companies (and still are to a considerable extent), and because the concept of a license was as undefined in German law as it is in United States law. A literal translation of the United States "software license agreement" became the industry standard label for standard agreements accompanying software transfers: *Softwarelizenzvertrag*.

As one might expect from a statute first enacted in 1896, the German Civil Code does not contain any specific rules on license agreements. When the first software license agreements were presented to German courts, the courts could have treated this new phenomenon as a contract *sui generis* and determined, on a case by case basis, what standard clauses are fair and unfair in a software license agreement for purposes of the German Standard Contract Terms Act.³⁵² In section 7 of the Act, the legislature asked the courts specifically to prevent any circumvention attempts: "This Act applies also if its provisions are avoided by alternative structures."³⁵³

Also, despite the fact that software has been expressly recognized in section 2 of the German Copyright Act as a category of copyrightable works since 1985,³⁵⁴ prior to the implementation of the EC Software Directive into German law in 1993, German courts had required a very high level of originality before they would afford copyright protection for software.³⁵⁵ Many programs that would have easily

352. See Claus D. Müller-Hengsenberg, *Die Bedeutung des Kaufrechts für die Computersoftware* [The Relevance of the Law on Sales for Computer Software], 2000 NJW 3545; Andreas Witte, *Urheberrechtliche Gestaltung des Vertriebs von Standardsoftware*, 1999 CR 65; Polley, *supra* note 334; SCHNEIDER, *supra* note 303, at 609–55.

353. F.R.G. Standard Contract Terms Act § 7 (2000).

354. See Loewenheim, *supra* note 303, at 1064 Vor §§ 69a–ff., Nr. 1. This is required by the Agreement on Trade-Related Aspects of Intellectual Property Rights ("TRIPS") annexed to the 1994 World Trade Organization Agreement and the World Intellectual Property Organization ("WIPO") Copyright Treaty, both of which Germany and most of the rest of Western Europe have ratified.

355. The leading cases are from 1985 and 1991: 1985 BGH, GRUR, 1041 (known as the collection program case—"Inkasso-Programm") and 1991 BGH, NJW, 1231 (known as the operating system case—"Betriebssystem"). See Loewenheim, *supra* note 303, at 1064, Vor §§ 69a ff., Nr. 2; SCHNEIDER, *supra* note 303, at 343–46.

qualified as copyrightable in the United States were not found to be so in Germany. Consequently, German courts tended to treat software like any other goods and held early on that the traditional rules on sales, leases, and works contracts apply at least by way of analogy to most types of software transfers.³⁵⁶

Thus, in 1981, in one of the first software-related cases, the *Bundesgerichtshof* reviewed a software license agreement under the Civil Code rules on commercial leases because, according to the license agreement, the licensee was entitled to use a copy of the computer program for a limited time period of five years.³⁵⁷ Commentators concluded from this holding that any transfer with a time limit beyond the useful life of the software product, or subject to a right to terminate, qualifies as a lease.³⁵⁸ This, in turn, means that the software provider has to maintain the software during the entire time of use, even in the absence of a support contract and additional consideration.

In 1987, the *Bundesgerichtshof* published a thoroughly reasoned decision holding that a permanent transfer of a software copy, without significant user restrictions and for a one-time payment, generally qualifies as a sales contract for purposes of the implied warranties in the German Civil Code.³⁵⁹ The acquirer must have proven that the software contained "bugs" that rendered the software unusable for its intended purpose. Because the transfer agreement was not expressly labeled as a sales contract (more likely it was labeled as an end-user software license agreement), the court considered applying the respective laws of lease, license, and sales. The court decided that the transfer could not qualify as a lease because according to the agreement the acquirer was entitled to keep the software copy perpetually.³⁶⁰ Therefore, the court found it was intended that the acquirer should become the owner of the software copy and the implied warranties in the sales section of the German Civil Code were to apply.³⁶¹ With respect to the acquirer's warranty claims, the court deemed it necessary to decide whether the agreement also contained elements of a license agreement because, if it did, the right to use the software was necessarily transferred with the software copy and the warranty claims did not concern a defect in rights, but a defect in the product

356. See Müller-Hengsenberg, *supra* note 352, at 3545-47.

357. 1981 BGH, NJW 2684 ("Programmsperre I").

358. See Schneider, *supra* note 303, at 665-66, 672-74.

359. See 1988 BGH, NJW 406; SCHNEIDER, *supra* note 303, at 643-45.

360. See 1998 BGH 406, 407.

361. See *id.* at 408.

(i.e., the software copy that was stored on a disk).³⁶² The court decided that the right to use did not transfer.³⁶³

In a significant 1989 case before the *Bundesgerichtshof*, a software vendor brought a claim for payment of monies due for an online software transfer.³⁶⁴ According to the agreement between the parties, the acquirer was to keep the software copy perpetually against payment of thirty-six monthly installments in the amount of DM 500 each.³⁶⁵ The court deemed the payment and delivery modalities irrelevant and found that at the heart of the transaction was a perpetual exchange of a software copy against a lump sum price.³⁶⁶ Because the vendor delivered the software copy to the acquirer for perpetual use against payment of a pre-defined sum, the court qualified the transaction as a sale and applied consumer protection laws pertaining to installment sales of tangible goods by way of analogy.³⁶⁷

Following this line of cases treating software licenses as sales of goods, the *Bundesgerichtshof*, in 1993, emphasized that a software copy could generally be treated as a tangible good for warranty issues and applied the rules on "works contracts" to a situation where a software developer had delivered allegedly malfunctioning programs for perpetual use by the acquiring company against payment of a lump sum.³⁶⁸

As a consequence, many lower courts qualified software transfers as sales without much discussion. For example, in 1994, the Court of Appeals in Frankfurt am Main, held that a central processing unit ("CPU") clause in a standard software license agreement is generally invalid under the Standard Contract Terms Act because under the German Civil Code provisions on sales, a purchaser can use purchased goods at its discretion without any restrictions from the seller.³⁶⁹ According to a CPU clause, an acquirer of a software copy may install and operate such copy only on a certain specified CPU, which may be described (1) by size and performance, or (2) by serial number and location.³⁷⁰ With the second version of a CPU clause (designated

362. See *id.* at 408-09.

363. See *id.* at 408.

364. 1990 BGH, NJW 320.

365. See *id.* at 320.

366. See *id.* at 321.

367. See *id.* at 321-22.

368. See 1993 BGH, NJW 2436; SCHNEIDER, *supra* note 303, at 644.

369. See 1995 OLG Frankfurt, Betriebs-Berater Beilage 2, 23.3, at 4.

370. See Hans-Werner Moritz, *Leistungsstörungen bei Hardware und Software* [non-performance or defective performance regarding hardware and software], in *COMPUTER-RECHTS-HANDBUCH* [Handbook of Computer Law] § 41 Comms. 61-66 (looseleaf

hardware, specified by serial number and location), manufacturers may aim to control the exact hardware product that will run their software.³⁷¹ With the first version of a CPU clause (designated performance category of CPU specified by size and performance criteria), manufacturers usually try to justify differentiated license fees in proportion to the benefits a user receives from using the software product. A common argument is that due to CPU clauses, manufacturers are able to capture consumer surplus by charging smaller companies with less effective hardware lower prices for software products, which, in the absence of CPU-related pricing, the manufacturer would have to price so high that smaller companies could not afford the software.³⁷²

In the case before the Court of Appeals in Frankfurt am Main, a company had acquired two software copies in 1980 at a fee related to the CPU on which the acquiring company installed the software. When the company upgraded its hardware in 1987 and re-installed the two software copies on a new system with a CPU of higher performance, the software manufacturer demanded an upgrade fee of DM 22,334.20 based on the CPU clause in the original contract. While the district court decided in favor of the software manufacturer, the court of appeals invalidated the CPU clause as incompatible with general principles of sales law and dismissed the case.³⁷³ Again, the purchaser's dominion over software paid for with a single fee was upheld.³⁷⁴

In 1999, the same court invalidated a CPU clause in a situation where it qualified the software transfer agreement as a "true" license agreement.³⁷⁵ The Court of Appeals in Frankfurt am Main stated that the legal analysis of its 1994 decision, discussed above, did not apply because the 1994 decision approached it from a sales context.³⁷⁶ It found that the software transfer addressed in the 1999 decision, in contrast, did not qualify as a sale because in the software license agreement the software manufacturer reserved title to the software copy and granted a time-limited, non-transferable right to use the software

collection, last updated Mar. 1999); Polley, *supra* note 334, at 346; SCHNEIDER, *supra* note 303, at 350-52.

371. To ensure that the software product functions appropriately, to accompany efforts to bundle software and hardware products, or to prevent transfers to other countries.

372. See Zahrnt, Case Note, in *Betriebs-Berater Beilage* 2, 23.31995, at 5.

373. 1995 OLG Frankfurt, *Betriebs-Berater Beilage* 2, 23.3, at 4.

374. *Id.* See also BGB §§ 433, 903.

375. See 2000 OLG Frankfurt, CR, 146, 149.

376. See 2000 OLG Frankfurt CR.

copies in question. The licensee assumed an obligation to install updates and delete prior versions, both parties had a right to terminate for convenience, and the licensor assumed the obligation to support and maintain the software copy.³⁷⁷

The court did not further discuss the character of the consideration, which might have supported a qualification of the transfer as a sale. It is not clear from the factual description given in the court decision how exactly the licensee paid for the software copy in question. However, when the licensor attempted to enforce the CPU clause by demanding additional fees for his consent to the hardware upgrade, the licensor demanded an "initial license fee" of DM 278,000 up front and a "yearly update fee" of DM 41,700.³⁷⁸ If the payment structure in the original software license agreement had been similar, based on prior case law the court could have interpreted the update fees as services fees under a separate agreement and qualified the transfer of the original software copy against a one-time initial license fee as a sale. The court could then have invalidated any preformulated contractual restrictions that failed to comply with civil law principles of sales.

However, apparently the court wanted to take the opportunity to clarify which circumstances would make pre-formulated CPU clauses unfair under the Standard Contract Terms Act, regardless of whether the software transfer agreement qualifies as a sale, lease, or license agreement. Thus, in a rather lengthy obiter dictum, the court acknowledged the interests of software manufacturers and users to agree on differentiated license fees depending upon the commercial benefits that the software user is able to achieve due to the performance capacity of the user's hardware.³⁷⁹ Therefore, the court held that individually negotiated CPU clauses should normally be enforceable and even boilerplate CPU clauses should be enforceable if they are limited to situations where a software user transfers the software copy to a higher performance CPU. However, the court found that boilerplate CPU clauses are unfair and invalid under the Standard Contract Terms Act if, according to the relevant clause, the licensor is entitled to an upgrade fee in case of any transfer, even if the licensee transfers the software copy to a different CPU with the same performance capacity.³⁸⁰

377. See OLG Frankfurt CR, at 149-50.

378. See *id.* at 146.

379. See 2000 OLG Frankfurt, CR, at 150-51.

380. See 2000 OLG Frankfurt, CR, at 151-52.

German courts also condemn any attempts at circumvention. For example, the Court of Appeals in Koblenz held that a software manufacturer could not validly terminate a software maintenance and support agreement in order to force the acquirer of the software copy to pay an "upgrade fee" in connection with the transfer of the software copy to a new hardware system.³⁸¹ Similar to the aforementioned facts before the Frankfurt Court, the software manufacturer before the Koblenz Court had transferred its software containing a license restricted to a designated hardware system.³⁸² According to the terms of the end-user license agreement between the parties, the acquirer had to obtain the software manufacturer's consent before the acquirer was permitted to transfer the software copy to a different hardware system, at which point the manufacturer was entitled to an upgrade fee.³⁸³ The court deemed this clause unfair and invalid under the German Standard Contract Terms Act because the perpetual transfer of a software copy for a lump sum payment qualified as a sale and a purchaser is generally entitled to use or alienate his own goods at will under the German laws on sales.³⁸⁴ Although the separate maintenance and support agreement provided for both parties' right to terminate for convenience every twelve months, the court assumed a violation of the implied covenant of fair dealing if the manufacturer tried to enforce an "upgrade fee" clause in the software license agreement if the upgrade clause was invalid under the laws pertaining to sales.³⁸⁵

Because repairs are also permitted for purchased goods, the *Bundesgerichtshof* recently held that an acquirer of a software copy may create and transfer to a third party an additional copy for repair purposes.³⁸⁶ With regard to the copyright implications of this decision, the court referred to section 69c Nr. 2 of the German Copyright Act,³⁸⁷ and Article 4 Nr. 2 and Article 5 of the EC Software Directive. Under these laws, the lawful acquirer of a software copy may create additional copies without the copyright owner's consent "where they are necessary for the use of the computer program by the lawful ac-

381. See 1993 OLG Koblenz, NJW, 3144.

382. See *id.* at 3144-45.

383. See *id.*

384. See 1993 OLG Koblenz, NJW, at 3145.

385. See *id.* at 3146.

386. See 2000 BGH, CR, 656.

387. See F.R.G. Copyright Act § 69(c).

quirer in accordance with its intended purpose, including for error correction.”³⁸⁸

As these cases demonstrate, German courts have created a distinction between sales and leases of software, irrespective of the formal trappings of the license agreement accompanying the transfer of the software copy. While the content of German commercial law clearly differs from its United States counterpart, the policies that underlie the laws of the two countries—protecting legitimate purchaser expectations and avoiding market distorting activity—are identical. German courts, like United States courts, have concluded that a permanent transfer of a copy of software constitutes a sale of goods for the purposes of commercial law, regardless of the presence of a license agreement.

2. Application of the First Sale Doctrine to Software Transfers

As in the United States, EC software manufacturers and users have in many cases taken opposing positions as to whether the First Sale Doctrine applies specifically in connection with disputes about software resale prohibitions and restrictions on distribution. This section analyzes the cases addressing the “sale of a copy” question in the context of the EC and German law version of the First Sale Doctrine.

a. Attempted Enforcement of Resale Prohibitions

In a 1998 case before the Court of Appeals in Bremen,³⁸⁹ a software manufacturer had transferred a software copy to an end-user for a one-time payment under a software license agreement, according to which the right to use the software copy was nontransferable.³⁹⁰ In order to effectively enforce the transfer restriction, the software manufacturer incorporated an expiration mechanism into the software copy.³⁹¹ From time to time, the software manufacturer prolonged the expiration date in connection with software maintenance and support services. The first acquirer of the software was not aware of this mechanism and after a while resold the software copy to a second purchaser. The second purchaser became aware of the expiration mechanism in connection with an attempted resale to a third pur-

388. Section 69c Nr.2 of the German Copyright Act, implementing Article 4 Nr.2, Article 5 of the EC Software Directive.

389. See 1998 OLG Bremen, Betriebs-Berater (BB), 4 (4-7).

390. See *id.*

391. See *id.*

chaser and demanded that the mechanism be removed.³⁹² The manufacturer dismissed the request and demanded that either the second or third purchaser pay the regular license fee.³⁹³ The manufacturer then applied for an injunction prohibiting the resale of the software copy. The second purchaser counterclaimed to remove the expiration mechanism based on a number of theories, including tort, arguing that the expiration mechanism qualified as a criminal destruction of data.³⁹⁴ The software manufacturer asserted in its defense that no data would have been destroyed if the first acquirer of the software had complied with the transfer prohibition and the copyright laws.³⁹⁵ It further argued the transfer prohibition was enforceable because the transfer agreement constituted a license agreement and not a sales agreement.³⁹⁶

The Court of Appeals in Bremen sided with the second purchaser, and found that the transfer constituted a sale, because the software was transferred perpetually against a lump sum payment.³⁹⁷ The court deemed the fact that the transfer agreement was labeled a "license agreement" entirely irrelevant and held that the First Sale Doctrine applied to the transfer from the manufacturer to the first purchaser, the contractual resale prohibition was invalid under the German Standard Contract Terms Act, and the transfer from the first purchaser to the second purchaser constituted neither a breach of contract nor a copyright infringement.³⁹⁸ Thus, the software manufacturer's distribution rights had become exhausted under the First Sale Doctrine.

Similarly, the Düsseldorf Court of Appeals held that a software manufacturer committed a severe breach of trust by secretly installing a dongle³⁹⁹ in a software copy before selling it to an end-user because

392. *See id.*

393. *See id.*

394. According to sections 303a and 303b of the German Penal Code, a person who substantially interferes with the data processing of a business by illegally deleting data can be sentenced to five years imprisonment.

395. *See* 1998 OLG Bremen, Betriebs-Berater (BB).

396. *See* OLG BB, at 5.

397. *See id.*

398. *Id.* at 6.

399. A dongle, or "hardware key," is a copyright protection device that comes with software. The software cannot be used unless the dongle is plugged into the computer's parallel port. The dongle thus hinders software piracy because each program is tied to a unique number encoded onto the dongle. *See* ALAN FREEDMAN, THE COMPUTER DESKTOP ENCYCLOPEDIA 369 (1996). A software dongle performs the same function without the use of hardware, by disabling the software's own installability after the first installation.

it unlawfully limited the end-user's control over the lawfully acquired copy.⁴⁰⁰

b. Attempted Enforcement of Resale Restrictions

(1) Updates Resold as Stand-Alone Products

In 1997, the Munich District Court decided a software manufacturer's lawsuit, which in accordance with industry practices generally distributed identical versions of its software either as full versions, or as updates.⁴⁰¹ While both versions were technically identical, the "update" versions were labeled as such with a sticker on the outside of the packaging material. Consumers who already owned an earlier version of the manufacturer's product were normally able to acquire updated versions for about 25% of the original purchase price.⁴⁰² While most first and second-tier distributors observed this differentiation, at least one second-tier distributor acquired software copies labeled "updates" at the lower update price from a first-tier distributor, removed the label "update," and resold the copies as full versions priced somewhere between the market price for updates and the market price for new versions.⁴⁰³ When the manufacturer brought a lawsuit based on copyright infringement, the Munich District Court held that according to the First Sale Doctrine the manufacturer's distribution rights became exhausted when the manufacturer sold the software copies to the first-tier distributors. Therefore, the first-tier distributors were able to resell such copies without restrictions and consequently, the second-tier distributor did not infringe the manufacturer's copyright. The Munich Court of Appeals affirmed this decision and dismissed the software manufacturer's appeal in 1998.⁴⁰⁴

In 1999, the Court of Appeals in Frankfurt am Main came to the same conclusion with respect to a lawsuit brought by Adobe Systems, Inc.⁴⁰⁵ The court held that once Adobe had sold software copies to a distributor, Adobe's distribution rights became exhausted and the distributor's resale of such software copies to end-users did not constitute copyright infringement.⁴⁰⁶ It was not infringement even if the distributor sold "update versions" as stand-alone products to end-users who

400. See 1993 OLGZ Düsseldorf, Betriebs-Berater Beilage, 13, 10.7, at 6.

401. See 1998 LG München, CR, 141.

402. See *id.*

403. See *id.*

404. See 1998 OLG München, CR, 265.

405. See 1998 OLGZ Frankfurt, CR, 7.

406. See *id.*

had not previously acquired any Adobe software.⁴⁰⁷ However, the court did find a violation of German unfair competition laws because one distributor had printed invalid Adobe registration numbers on the updates, which the distributor sold as full versions.⁴⁰⁸ End-users of the Adobe software copies in question needed a license key from Adobe for each software copy before they could install and use the copy. Adobe gave out such license keys to end-users of its software only against presentation of the Adobe registration number that came with full products. Adobe printed such registration numbers only on the packaging material of full software copies, not of update software copies. End-users that had already acquired Adobe full copies held an Adobe registration number and when they called Adobe to obtain a license key to install an update, Adobe gave out a license key.⁴⁰⁹ End-users that had never acquired a full copy with an registration number but acquired an update version could not obtain a license key from Adobe. When the distributor printed bogus Adobe registration numbers on update versions, the distributor tricked the end-users. This was sufficient for the Frankfurt Court of Appeals to assume a violation of unfair competition laws without further discussing the legality of Adobe's registration system.⁴¹⁰

It is likely that the court assumed that the registration scheme as such was justifiable to the extent that Adobe intended to prevent the use and dissemination of illegally created copies. An acquirer of an update version that was originally created and sold by Adobe or with Adobe's consent would likely have been entitled to a license key from Adobe, even if the end-user had never acquired a full version before. If Adobe denied a license key to an acquirer of a legally distributed update version merely because such acquirer had not bought an Adobe product before, Adobe would be indirectly attempting to enforce illegal resale restrictions. However, an end-user who lacks a proper Adobe registration number issued by Adobe would have to prove in a potentially time consuming procedure that her copy is not an illegal copy before she can obtain the license key from Adobe to use the copy. Because the distributor concealed this potential problem, the distributor violated unfair competition laws. If the distributor had disclosed this problem with the sale of the update versions, the distributor would probably have complied with unfair competition

407. *See id.* at 8, 9.

408. *See id.* at 10.

409. *See id.*

410. *See id.* at 11.

laws and, under German law, Adobe would not have been able to enforce different pricing of technically identical updates and full versions. Arguably, the distributor could even have demanded from Adobe proper registration numbers for the resale of update versions as full products to remove the resale obstacles. However, simply forging the registration numbers in order to avoid potentially invalid distribution restrictions is not an acceptable practice under the strict German unfair competition laws.

(2) Original Equipment Manufacturer Versions Resold as Stand-Alone Products

Software publishers have many means of attempting to capture consumer surplus and multiple rents from their marketing activities. One of the most common means has been considered—differential pricing between “full” and “upgrade” versions of substantively identical software. Another frequently used technique is selling OEM versions⁴¹¹ of the software at a much lower price than stand-alone versions. The only substantive difference between OEM and stand-alone products (other than their license terms) is usually the lack of attractive packaging and sometimes printed materials.⁴¹² Conflicts between publishers and distributors over the practice of reselling copies of OEM versions as if they were stand-alone products has also raised First Sale Doctrine issues in Europe.

In 1995, Microsoft obtained an injunction based on copyright infringement against an independent manufacturer of computer hardware and reseller of hardware and software in Berlin.⁴¹³ Microsoft had granted duplication and distribution licenses to so-called “replicators” in Europe. These replicators were, according to Microsoft’s standard distribution license agreements, permitted to create copies of the Microsoft computer program *Word for Windows* and distribute such copies to authorized second-tier distributors under two labels.⁴¹⁴ Authorized second-tier distributors could acquire *Word* either as a stand-alone product or, for a considerably discounted price, as an OEM version to be transferred only in connection with a new personal com-

411. An OEM version of software, it may be recalled, must, by its license terms, be sold in conjunction with computer hardware. See *supra* note 12.

412. These may be available in electronic format on the software media, such as an Adobe Acrobat file readable from the software CD-ROM.

413. See LG Berlin, 25.8.1995, File Nr. 5 U 8281/95 (unpub.).

414. See *id.*

puter.⁴¹⁵ By having the OEM versions transferred at a discount, Microsoft intended to give an incentive to hardware manufacturers (OEMs) to install Microsoft products on as many new personal computers as possible to get consumers accustomed to the Microsoft products and increase market share. Technically, the two versions of *Word* were identical. The accompanying user manuals were also practically identical. The only noticeable difference between the stand-alone version and the OEM version of *Word* concerned the packaging materials.⁴¹⁶ The OEM versions were packaged in rather plain materials displaying a notice that the OEM versions were only for distribution with a new personal computer. The Berlin retailer had purchased a large number of OEM versions of *Word* from an authorized second-tier distributor, whose identity was apparently not disclosed in the proceedings.⁴¹⁷ The retailer then resold these OEM versions as stand-alone products at a lower price than other retailers who had acquired stand-alone versions at higher wholesale prices through the Microsoft channels.⁴¹⁸

In court, the retailer argued that Microsoft's exclusive rights under the German Copyright Act became exhausted when Microsoft's replicator, with Microsoft's consent, sold the OEM versions to the authorized second-tier distributor.⁴¹⁹ Thus, the retailer argued, according to the First Sale Doctrine, the authorized second-tier distributor had the right and ability to resell the Microsoft software to the retailer.⁴²⁰ Microsoft, on the other hand, argued that it had never sold any copies of its proprietary software. Instead, according to Microsoft, it had only granted a limited distribution license permitting the sale of its software in conjunction with a new personal computer. Microsoft argued that even if one assumed a first sale, such first sale could only cause an exhaustion of exclusive rights to the extent Microsoft granted such rights to the first acquirer, i.e., the replicator. In other words, under the First Sale Doctrine, a first purchaser might be able to transfer to a second purchaser what the first purchaser acquired from

415. Microsoft's standard distribution agreement contained a clause according to which "[the distributor] shall distribute and license Product(s) only with those Customer Systems listed in Exhibit C for the particular Product(s) [Distributor] shall require its distributors, dealers, and others in its distribution channels to comply with the foregoing." *See id.*

416. *See* LG Berlin, 25.8.1995, File Nr. 5 U 8281/95 (unpub.).

417. German civil procedure law does not recognize the concept of "discovery."

418. *See* LG Berlin, 25.8.1995, File Nr. 5 U 8281/95 (unpub.).

419. *See id.*

420. *See id.*

the copyright owner—but not more. Consequently, according to Microsoft, the anonymous second-tier distributor was unable to transfer to the retailer the right to resell Microsoft products without a new personal computer, because the replicators and the first-tier distributors themselves were never authorized to do so.⁴²¹

In February 1996, the Berlin Court of Appeals sided with Microsoft and affirmed the decision of the Berlin District Court.⁴²² The court of appeals pointed out that according to section 32 of the German Copyright Act⁴²³ any copyright owner may generally limit the scope of a grant of distribution rights.⁴²⁴ Therefore, Microsoft was able to limit the right to distribute its OEM versions to distribution with new personal computers. Because Microsoft never disposed completely, but only to a limited extent, of its exclusive distribution rights the court found that upon occurrence of the first sale, Microsoft's distribution rights were only exhausted to a limited extent.⁴²⁵ Consequently, under the First Sale Doctrine, when a Microsoft replicator transferred a copy of *Word* as an OEM version to a second-tier distributor, Microsoft's exclusive rights to prohibit the distribution of its software copy *as an OEM version* became exhausted. Therefore, the second-tier distributor was permitted to resell the software copy to the retailer *as an OEM version* and the retailer was permitted to resell the software copy to consumers *as an OEM version*. However, according to the Berlin Court of Appeals, because Microsoft never undertook or consented to a sale of its OEM versions as stand-alone products, Microsoft's right as the copyright owner to prohibit the distribution of its OEM versions as stand-alone products did not become exhausted.⁴²⁶ Thus, when the retailer resold the OEM versions as stand-alone products, the retailer infringed Microsoft's distribution rights.

With respect to competition laws, the Berlin Court of Appeals found that Microsoft's restraints were not automatically excused to the extent Microsoft exercised its copyrights.⁴²⁷ However, the court did not find a violation of anti-competition laws. The general prohibition of resale restrictions in the German Act Against Restraints on

421. *See id.*

422. *See* KG, 1996 CR, 531.

423. Section 32 is entitled "Limitation of Rights of Use" and provides: "A right of use may be limited with regard to territory, time, and scope."

424. *See* LG Berlin, 25.8.1995, File Nr. 5 U 8281/95 (unpub.).

425. *See id.*

426. *See id.*

427. *See id.*

Trade⁴²⁸ did not apply in the case before the court, because the conduct in question qualified as bundling under section 18. According to the new section 18, bundling can be prohibited by the German Federal Cartel Office in a specific case, but in the absence of such prohibition, bundling is not per se illegal under German antitrust law.⁴²⁹ In June 1997, the Berlin Court of Appeals issued a permanent injunction which affirmed and repeated its own reasoning used to grant the preliminary injunction in Microsoft's favor.⁴³⁰

This permanent injunction was overturned by the *Bundesgerichtshof* in July 2000.⁴³¹ The *Bundesgerichtshof* agreed with Microsoft and the Berlin Court of Appeals that a copyright owner can impose distribution related restrictions and limitations on its distributors with effect *erga omnes*.⁴³² If a distributor, such as a Microsoft "replicator," violates such restrictions when it creates and sells software copies, then such infringing sale of a software copy will not qualify as a first sale under the First Sale Doctrine. However, if a first distributor observes the copyright owner's restriction and sells software copies in accordance with such restrictions, then the copyright owner's distribution rights are completely exhausted. Thus, because the replicators observed Microsoft's restrictions and sold stand-alone versions and OEM versions at different prices, a first sale for purposes of the First Sale Doctrine occurred. Consequently, even the first-tier distributors which first acquired the software copies from the replicators were, under the First Sale Doctrine, permitted to resell the OEM versions without any restrictions to second purchasers like the retailer that was sued by Microsoft. Also, that retailer was permitted to resell the OEM versions without a restriction.

The *Bundesgerichtshof* compromised between the statutory language of the German Copyright Act and the EC Software Directive. These laws simply provide that the first sale of a copy of a program by the copyright holder or with his consent shall exhaust the distribution right of that copy. Like section 69c of the German Copyright Act, Arti-

428. See Gesetz gegen Wettbewerbsbeschränkungen [Act Against Restraints of Competition] Fed. Gazette I, 2546 (amended Aug. 26, 1998).

429. Wolfgang Kirchhoff, *Koppelungsbindungen* [Tying restrictions] HANDBUCH DES KARTELLRECHTS [Handbook of Antitrust Law] 388-90 (Gerhard Wiedemann ed. 1999). Under Article 81(I)(e), bundling is clearly illegal. However, the Berlin Court of Appeals seemed to negate the applicability of Article 81, 82 EC Treaty because of an assumed lack of European Common Market dimension and therefore, EC jurisdiction.

430. See KG, 1998 CR, 137.

431. See Bundesgerichtshof, 2000 CR, 651.

432. See *id.* at 652.

cle 4(c) of the Software Directive provides that “[t]he first sale . . . shall exhaust the distribution right . . . , with the exception of the right to control further rental of the program or a copy thereof.”⁴³³ These laws do not provide that the distribution rights shall be exhausted only to the extent approved by the copyright owner. The court gave a policy explanation for the different treatment of distribution restrictions on the first and second level.⁴³⁴ In the relationship between the copyright owner and its first-tier distributors, the interests of the copyright owner to control the manner of commercialization of its works is paramount.⁴³⁵ However, on the second level and lower levels of trade, the public interest in simple rules on personal property and an unrestricted stream of commerce outweighs the copyright owner’s interests.⁴³⁶ The First Sale Doctrine is intended to protect the public from invisible restraints on alienation. The *Bundesgerichtshof* added that in a situation where the end-user of a copyrighted work needs the copyright owner’s permission to use such work, the copyright owner would still retain a substantial amount of control.⁴³⁷ However, given the fact that lawful acquirers of copies of *Word* are already permitted by statute to upload the program without Microsoft’s permission, the *Bundesgerichtshof* noted only one option for Microsoft to impose distribution restraints on lower levels of trade. That option imposed a contractual obligation on each acquirer to require any second purchasers to observe the OEM restriction. Since such a scheme was not before the court, the court noted in this regard that Microsoft must observe the limitations imposed by the German Standard Contract Terms Act and anti-competition laws.⁴³⁸

The *Bundesgerichtshof* also dismissed Microsoft’s assertion that the retailer violated unfair competition laws by unlawfully interfering with the contracts between Microsoft and the replicators, with the contracts between the replicators and the first-tier distributors, or with the contracts between the first-tier distributors and the second-tier distributors.⁴³⁹ In the absence of any specific mischief, it does not constitute unfair competition to take advantage of someone else’s breach of contract under German law.⁴⁴⁰

433. Software Directive Article 4(c).

434. See KG, 1996 CR, at 653.

435. See *id.*

436. See *id.*

437. See *id.* at 654.

438. See *id.* at 653.

439. See *id.*

440. See *id.* at 654.

C. Summary

Under the EC Software Directive's First Sale Doctrine, as interpreted by German courts, a copyright owner's distribution rights to a software copy terminate if and when the copyright owner permits a perpetual transfer of the copy against payment of a lump sum. Any contractual resale restrictions are generally unenforceable. Any lawful acquirer is permitted to create an additional copy in order to use or repair the software, e.g., by uploading the software into the RAM of a computer. However, the First Sale Doctrine does not apply if a copyright owner grants a right to use a software copy only for a limited period of time, or to the extent a copyright owner grants additional rights such as commercialization rights or the right to create multiple copies.

Thus, German courts interpreting the EC Software Directive have persuasively discerned the assertion that a license agreement is not a contract *sui generis* and does not, by its very presence, negate the First Sale Doctrine. Rather, the intention behind the Doctrine was to ensure that the expectations of software purchasers were satisfied without threatening to divest *bona fide* lessors of software of their control over the disposition of the leased copy.

Notwithstanding the European foresight on this issue, the issue of technological anti-circumvention measures remains in flux as much in Europe as in the United States. Anti-circumvention measures have recently become a legislative pet project there as well. On February 14, 2001, the European Parliament approved a new directive giving copyright owners the right to implement anti-circumvention measures.⁴⁴¹ While the directive will not pass until the Parliament and Council agree on the final wording, the concern for the copyright owner's right against piracy may also threaten traditional rights of a purchaser in Europe. It will be interesting to learn whether the common problem will be addressed by differing solutions in the same manner as the general application of the First Sale Doctrine.

441. See *EU Copyright Law Nears Approval After Committee OK*, Reuters Newswire (Feb. 5, 2001); Comm'n of the Eur. Union, Communication From the Commission to the European Parliament Pursuant to the Second Subparagraph of Article 251(2) of the EC Treaty Concerning the Common Position of the Council on the Adoption of a Directive of the European Parliament and of the Council on the Harmonization of Certain Aspects of Copyright and Related Rights in the Information Society, at <http://europa.eu.int/eur-lex/en/com>.

V. The Copyright Policy Approach in Application

In concluding, it may be helpful to apply this article's interpretation of the First Sale Doctrine to a variety of common scenarios for illustrative purposes.

In the first scenario, perhaps the most common, a software publisher transfers a copy of its software to an acquirer according to an agreement under the terms of which: (a) the acquirer is entitled to keep a physical software copy permanently; (b) the manufacturer grants to the acquirer a non-exclusive, nontransferable right to install a copy of the software on one computer hard drive (or personal digital assistant memory chip, or household electronic device, etc.) and to upload one copy into the RAM of one computer provided that not more than one copy of the software may ever be in use at the same time;⁴⁴² and (c) the acquirer pays a certain standard license fee, either in form of a lump sum payment or on credit in installments. This transfer should be deemed to constitute a sale for purposes of the First Sale Doctrine because the manufacturer transfers the software copy permanently. Consequently, the nontransferability clause of the agreement should be deemed null and void, and the acquirer may resell or otherwise transfer the software copy to a second acquirer, who would then become the lawful owner of the copy and, as such, have the statutory right⁴⁴³ use the software copy.

In a noteworthy and increasingly common variation on the first scenario, all elements are identical to that scenario except the physicality of the software copy. Instead, the publisher, distributor, or retailer delivers the software copy to the acquirer over the Internet or a network of some kind. In considering this scenario, the Librarian of Congress has asserted that there is no "digital First Sale Doctrine."⁴⁴⁴ Similarly, some commentators argue that a first purchaser of a downloaded software copy cannot legally resell the copy because the purchaser would have to make an additional—illegal—copy for purposes of sending a copy to the second purchaser (unless the first purchaser actually transferred the hard disk drive to the second).⁴⁴⁵

442. Typically, in a standard license agreement, the software manufacturer would state that it grants a non-exclusive, nontransferable license to use the software and to keep one copy for archival purposes.

443. Under sections 109 and 117(a)(1) of the United States 1976 Copyright Act and Articles 4 and 5 of the EC Software Directive as implemented into sections 69c and 69d of the German Copyright Act.

444. 65 Fed. Reg. 35,673, 35,674 (June 5, 2000).

445. See Moritz & Hütig, *supra* note 303, at 4; Loewenheim, *supra* note 303, § 69c Nr. 33, at 1104; Comm. of the Software & Info. Indus. Assoc. ("SIIA") (Aug. 4, 2000), filed with

However if the first purchaser deletes the copy in the course of transmission, no additional copy is made and there is no basis to claim infringement. Even if the transmission itself does not delete the copy, assuming that the first purchaser immediately deletes the software copy that remains on its system after a successful transmission, the creation of the additional copy should be permitted under the statutory rules that allow the duplication of software for purposes of a lawful use and the fair use doctrine.⁴⁴⁶ Neither the first nor the second purchaser derives any commercial or other value from the residual copy of the software on the first purchaser's system if the copy is deleted immediately following the transfer.

Also, the presence or absence of a physical transfer medium is irrelevant to the application of the First Sale Doctrine. The same public policy considerations apply regardless of how the software is delivered to the purchaser; the essence of a software transfer is the transfer of the software copy itself (i.e., the code) and the rights to use the code. The value of the transfer media is nearly always either negligible or incidental to the software purchase. Therefore, the First Sale Doctrine should be applied equally to this digital variation of the aforementioned first scenario.

A second scenario is a license agreement providing for a number of restrictions that may have an indirect impact on the resale of software copies, e.g., a "CPU clause," an "authorized user" requirement, or a "concurrent user" limit. Such license agreements can be identical to the license agreements described in the first scenario, but the software publisher also inserts a clause into the agreement according to which the acquirer may use the software copy only (i) on a designated CPU, (ii) by authorized users (who could be named employees or abstract positions, e.g. head of engineering, vice president product development, etc.), and/or (iii) by a limited number of users at the same time. Such clauses typically attempt to regulate the permitted uses of software copies in order to enable the software manufacturer to price its software in relation to the benefits that the acquirer will likely be able to derive from the software.

Such clauses do not necessarily have to impair the public policy behind the First Sale Doctrine. If the restrictions would "run with the software copies" from a first acquirer to a secondary acquirer, they

the United States. Copyright Office and available at http://www.loc.gov/copyright/reports/studies/dmca/dmca_study.html.

446. See 15 U.S.C. §§ 109(a), 117(a)(1) (2000). See EC Software Directive Arts. 4, 5, as implemented in German Copyright Act §§ 69c, 69d.

would not seem to unduly affect the merchantability of the software copies. Otherwise, the copyright owner would have to rely on contractual schemes and try to obligate first acquirers to obligate secondary acquirers by way of contract as the *Bundesgerichtshof* suggests in the OEM case discussed above. Either way, such restrictions may somewhat reduce the value of the software copy to the first acquirer, which is taken into account by the copyright owner's pricing. Yet, the restrictions do not necessarily have to deprive the first acquirer of the possibility of reselling the software. Therefore, the First Sale Doctrine does not have to apply to this second scenario absent sales characteristics in the transaction.

However, such restrictions could also be designed to circumvent the First Sale Doctrine, for example, by tying the use of a software copy to specifically named employees (as opposed to a certain position), or to a CPU identified by a serial number (as opposed to performance capacity). Obviously, a software purchaser will not necessarily intend to transfer his employees or CPUs with its software copies. Such clauses could therefore violate the First Sale Doctrine and be void.⁴⁴⁷

A third common license model, called a "site license" or "enterprise license" follows the pattern of the first example above, but the license agreement is designed not to sell one copy of the product to be installed on a single computer or other equipment, but to authorize the software installation on a network server, to be deployed over a local area network ("LAN") to a number of host computers operated by a single company or organization. Although a site license usually involves the sale of a single copy of software, the license agreement

447. German courts seem to differ on this point and find that under the German Standard Contract Terms Act, CPU clauses would generally be invalid if contained in a boilerplate clause. If, instead, the software manufacturer individually negotiates the CPU clause with the first acquirer, e.g., by also offering the software copy for a higher fee without the restriction, the clause could be valid and enforceable with respect to the first acquirer. Nevertheless, the second acquirer would not be bound by the restriction, unless it also contractually agrees on such a restriction with the first acquirer.

Although this approach currently lacks any statutory foundation in the United States, it offers advantages that a simplistic rule forbidding CPU clauses lacks. The German approach addresses both the competition and purchaser protection functions of the First Sale Doctrine. By requiring the licensor to offer viable alternatives to the CPU clause, the approach avoids market distorting behavior and actually opens new market options for the software. Equally, by requiring that the clause be negotiated, it protects consumers who typically purchase software, expecting to "own" the copy and hence to retain the power to resell it, without examining license provisions closely. It is therefore recommended that the United States Congress consider adopting an exception to the First Sale Doctrine modeled on the German rule.

may additionally authorize the acquirer to make multiple copies of the software and upload them to a predetermined number of other computers connected to the LAN, or allow access by a predetermined number of other computers to the copy residing on a hard disk drive in the LAN server. In the former case, the purchaser makes multiple copies that reside on the hard disk drives of each host computer; in the latter, host computers connected to the LAN send a request to the server to access the software, and the server uploads copies directly to the host computers' RAM. In either case, the license agreement provides for multiple copies to be made for an equal number of users.⁴⁴⁸

From the first example above, it should be obvious that the First Sale Doctrine authorizes the purchaser of a site license to resell the initial software copy received from the publisher. What is not so obvious is whether the Doctrine also authorizes the purchaser to transfer the right to make additional copies. In this regard, it must be determined whether the pricing model resembles a sale or a "true" license to commercialize intellectual property in a certain way involving the exclusive rights that are not directly affected by the First Sale Doctrine. If the acquirer has to pay a pre-defined, additional lump sum amount for every additional copy that the acquirer creates and uses (e.g., \$150 per extra copy), such an arrangement is economically identical to a sale of such extra copies and should not be treated differently for purposes of the First Sale Doctrine. It cannot be relevant that the copyright owner in this scenario does not ship the additional copies on carrier media without any significant value if all other terms and conditions of the arrangement point to the concept of a traditional sale. Consequently, for purposes of the First Sale Doctrine, a sale occurs when the first acquirer creates the copies with the permission of the copyright owner, and therefore, the first acquirer may resell such copies at its discretion.

If, instead, the copyright owner permits the acquirer to make an unlimited number of copies subject to the limitation that such copies may only be created, stored and used at a certain location or in a certain business unit, then the transaction is substantially different from a sale because the number of sold items is not defined. Balancing the interests of the copyright owner with the interests of free competition and end-user rights, it does not seem reasonable that the acquirer of a site license could always transfer such license to another person or entity. For example, if a copyright owner permits the owner

448. See also Professor Rice's excellent discussion of this issue and comparison to motion picture display licensing, *supra* note 9, at 180.

of a small retail store under a site license to create as many copies of a bookkeeping program as the licensee wants, the copyright owner would be deprived of its chances to efficiently commercialize its copyrighted work. Therefore, if a person acquires a software copy for a one-time payment a software copy, and the perpetual right to make an unspecified number of additional copies, under the First Sale Doctrine such person can resell only the initial copy, not the right to make copies.

Like a site license, a publishing license for copies to be owned and distributed by the publisher can be, but does not have to be functionally equivalent to the sale of a fixed number of copies. If the distributor acquires, by payment of a one-time sum, the perpetual right to create and sell a certain number of copies of the software, then the transaction qualifies as a sale and the First Sale Doctrine applies.⁴⁴⁹ However, if the distributor acquires the right to make copies by promising to pay certain royalties, or monthly lump sum fees for a certain period of time, then the grant of an exclusive right is at the heart of the transaction and the First Sale Doctrine will not apply when the distributor actually creates the copies. However, once the distributor transfers a copy to a reseller or an end-user for a lump-sum fee, such transfer qualifies as a sale and occurs with the copyright holder's consent. Therefore, the First Sale Doctrine applies after such sale of a copy by the distributor occurs.

A slightly different variation on the fourth scenario is the license providing for outsourced publishing services, in which the copyright owner grants a software publisher the right to reproduce a fixed number of copies of the software, all of which are to be owned by the copyright owner. This, too, is a "true license agreement" that is not transferable under the First Sale Doctrine. Under the license agreement, the publisher never owns the copies it creates; the First Sale Doctrine does not apply, because the Doctrine only permits the transfer of copies by their lawful owner.

The sixth scenario is a fixed term lease of a copy of software. Here, a copyright owner transfers a copy of its software to an acquirer according to an agreement under which the acquirer may use the software copy for a (possibly renewable) fixed term against payment of a one-time fee. The fixed term is substantially less than the useful

449. *Cf. Intel Corp. v. ULSI Sys. Tech., Inc.*, 995 F.2d 1566, 1569 (Fed. Cir. 1993) (holding that the patent exhaustion doctrine immunizes a manufacturing license from a claim of patent infringement by virtue of its sales of manufactured chips to another party against the wishes of the licensor).

life of the software. If the agreement is renewable, then after the expiration of the fixed term, the acquirer may renew the agreement for an additional fee. As explained above, under this agreement the lessee never becomes the lawful owner of the copy, and accordingly, the First Sale Doctrine does not apply.⁴⁵⁰ However, if the copyright owner permits the acquirer to use and keep the software copy for a period equal to or exceeding the commercially useful life of the software, e.g., ten years where the software in question has a realistic useful life of seven, this transaction probably constitutes an attempt to avoid the First Sale Doctrine, and should be treated as a sale subject to the Doctrine.

VI. Conclusion

Marshall McLuhan wrote: "The medium is the message. This is merely to say that the personal and social consequences of any medium . . . result from the new scale that is introduced into our affairs by . . . any new technology."⁴⁵¹ The social or legal consequences of the translation of the First Sale Doctrine to a new medium—computer software—threatens to undermine the doctrine that preceded its own application to software. This Article has argued that, in analyzing the licensing of computer software, United States courts have exalted form over substance in approaching the application of the First Sale Doctrine to electronic media such as software. Instead of questioning whether any given license agreement conveys title to a copy of software, as courts traditionally have done for other sales of intellectual property (such as movie reels, books, or phonographs), courts since 1990 have analyzed the First Sale Doctrine as if the proper opposition were between a sale of a copy and a "license" of a copy.⁴⁵² Under these decisions, a "license" was defined as an agreement *sui generis* that can be identified from the label at the top of the agreement or the choice of words used without reference to the substance

450. Under the German Standard Contract Terms Act, any boilerplate clauses would be measured against the German Civil Code provisions on leases.

451. MARSHALL McLUHAN, UNDERSTANDING MEDIA ch. 1 (1964).

452. It is interesting to note that this approach would be viable when analyzing whether the First Sale Doctrine applies to a manufacturing or publishing license. When a copyright owner conveys such a license, he may convey a copy of the software (to be destroyed upon termination of the license), but the purpose of the agreement is neither to sell nor to lease any particular copy. The license agreement is designed to transfer certain production rights independently of any copy. In this case, the proper opposition is between a "sale of a copy" and a "license to publish." The First Sale Doctrine would not apply to a license to publish, but it would apply to the sale of the copies after production.

of the rights transferred, or, in one case, in which the licensor simply evidences an intent to avoid the First Sale Doctrine.

This tautological approach undermines the public policy that motivated Congress to include the First Sale Doctrine in the 1976 Copyright Act. The problem stems from the failure of United States courts to recognize that every transfer of computer software is accompanied by a license of some kind. The proper focus is therefore upon the *terms*, not the existence, of the license agreement. Specifically, United States courts should follow the traditional practice under the First Sale Doctrine for other types of media, of analyzing the terms of the license to determine whether title to the copy has passed to the licensee. In undertaking the same analysis, European courts have focused on whether the terms of the license amount to a sale of a copy of the software or a lease of the copy. United States courts have only done so in the context of section 117 of the Copyright Act, and even in that case the courts' analysis failed to comprehend the true nature of a "license agreement." Yet, German courts and the Federal Circuit⁴⁵³ do agree in applying the protective measures to purchasers of sales-like transfers of software copies, the former under section 117 of the Copyright Act, and the latter under comparable provisions of the EC Software Directive and the First Sale Doctrine. German courts assume a sale occurs when a perpetual transfer of a software copy is exchanged for a lump sum payment. The United States Court of Appeals for the Federal Circuit deems a perpetual transfer and a lump sum payment strong indications that a sale occurred, although it would apparently not qualify a transfer as a sale if the acquirer's rights to the software copy are significantly restricted under the transfer agreement. As discussed above, it would be circular to negate a sale whenever a copyright owner attempts to contractually exclude further transfers because it is the very function of the First Sale Doctrine to provide for transferability in certain situations despite the interests and wishes of the copyright owner. Nevertheless, there are other contractual restrictions that prevent qualifying a transaction as a sale—most importantly a time limit on the right to use the software. If the copyright owner makes software copies available only for a limited period of time, German courts assume a lease and do not apply the First Sale Doctrine. This approach captures the essential element of the proper analysis of the First Sale Doctrine which is looking to the substance of the license to determine whether actual possession of a copy

453. See *supra* note 153 and accompanying text.

of the software remains with the licensee for a period of time significantly shorter than the commercially valuable duration of the software.

The problems with allowing copyright owners to exempt the First Sale Doctrine from computer software are manifold. Such a policy undermines the Copyright Act's delicate balance between granting authors (and here, programmers) adequate incentive to continue creating, while making the fruits of their creation accessible in the socially optimum amount. By allowing copyright owners to eschew application of the First Sale Doctrine by using *pro forma* license terms, courts have undermined the alienability of software copies and allowed copyright owners to skew market forces and reap rewards unnecessary to encourage their continued creation of intellectual property. Moreover, because the use of profitable techniques in one media typically spread to other media, the continued collusion of courts in undermining the First Sale Doctrine threatens to render the entire doctrine, as applied for 150 years to all types of copyrightable intellectual property, legally nugatory.

Finally, the statutory language of section 109(a) does not support the view that copyright owners are entitled to impose contractual or technological restraints on resale of software copies under state law. Although the application of state law is seemingly supported by the legislative history of the 1976 Copyright Act, the clear wording of federal law creates an "entitlement" in the copy owner to resell the copy that should trump any contrary state commercial or contract law under federal preemption principles. Such preemption is necessary to protect the federal public policy of granting a legal monopoly that is limited to rewarding copyright owners only as much as necessary to encourage continued creation of protectable works.

Addendum

After completion, yet prior to publication of this Article, the United States Copyright Office published its final report pursuant to its request for public comments regarding DMCA section 104, mentioned in Part I of this Article. The Office rejected public calls for a “digital first sale doctrine.” The rejection was apparently motivated by the massive online copyright infringement to which the *Napster*⁴⁵⁴ case brought widespread attention.⁴⁵⁵ While the factual issues of that or similar cases cannot be discussed here, the authors believe that a digital version of the First Sale Doctrine is not necessary because section 109, as interpreted in this Article, adequately applies to online as well as offline scenarios. The same rules govern purely electronic transfers of software copies because the coincidental exchange of a tangible carrier medium is irrelevant economically, and distinguishing between the two contexts is inconsistent with the public policy objectives underlying the First Sale Doctrine.

Close upon the heels of the Copyright Office report, the United States District Court for the Central District of California issued a decision strongly supporting the application of the First Sale Doctrine to computer software and espousing many of the views taken in this Article.⁴⁵⁶ Should the court’s decision command respect at the appellate level, the First Sale Doctrine may have a future in the Cyber Age after all.

454. *A&M Records, Inc. v. Napster, Inc.*, 239 F.3d 1004 (9th Cir. 2001).

455. See U.S. Copyright Office, Digital Millennium Copyright Act of 1998, § 104, at <http://loc.gov/copyright/reports/sec-104-report-vol-1.pdf>, at 97–101 (last visited Sept. 3, 2001).

456. See *Softman Prods. Co., LLC v. Adobe Systems Inc.*, No. CV 00-04161 (C.D. Cal. Oct. 22, 2001) (order denying preliminary injunction).

