The Software Industry Wakes Up To A Brave New World

July 11, 2012
Attorney Articles

In a surprising decision early in July, in the case of *UsedSoft GmbH v. Oracle International*, the highest court in Europe, at the stroke of the pen, has re-written the basic rules of the game relating to the distribution of software in the European Union.

In a word, the European Court of Justice ("ECJ") held that licensed copies of software can be bought and sold on the open market without the consent of the licensor - even where the licence is stated to be personal to the original purchaser and non-assignable - provided that licence fees were paid upfront and that the licence was granted to the licensee in perpetuity.

The decision focuses on downloaded software, but the ECJ emphasised that it applies regardless of the method by which the copy is sold. Licensed end-users will be free to sell their copies as 'second-hand software' whether the copy was originally downloaded online, purchased on physical media or installed on the licensee's machine by the vendor.

The decision will affect a very significant part (possibly the majority) of software licences granted in Europe. Licences which are subject to annual or periodical fees will not be affected, nor licences that are granted for limited periods of time. However, software is commonly sold against the payment of one-off fees with the grant of a perpetual user right. Many software vendors today prefer to earn recurring income from maintenance and consultancy services, rather than from licence fees. All perpetual licences would appear to be affected by the decision.

The impact on the market

The newly formulated rule - based on the application of the 'exhaustion of rights' principle - will apply to all types of software products. The greatest impact will probably be felt at the 'retail software' level - everyday software used by individuals and businesses - common desktop/tablet applications, financial tools, games, media players, development tools, mobile apps and so forth. It is easy to see the development of a second-hand market for such products. But it will also be relevant to a wide range of pure business software. Software for business processing, project management and stock management, for instance, and of course Oracle's own databases, could also be traded in the 'second-hand market' and even some individually tailored products - as long as there is a buyer for the product in question.

Software vendors will need to re-think their business models and re-draft their contractual terms. Many will seek work-around solutions. However, artificial legal

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obstacles to the right of re-sale recognised by the ECJ may not always have the desired legal effect (just as the non-assignability of the licences did not help Oracle in the case at hand). Great care will be required in formulating new legal and business strategies for the distribution of software. Some vendors may move away from a model of perpetual licences and up-front fees, in favour of limited term, renewable licences. Some may prefer to supply their software as a service rather than through the distribution of licensed copies. The ECJ decision is fairly clear that SaaS business models will not be affected by the exhaustion rule, which could give a certain boost to the cloud industry.

The economic effects of the decision are difficult to predict. It is likely that a market for ‘second-hand software’ will quickly develop and it is easy to imagine the market awash with cheap, second hand, older versions, as well as many copies of current new versions reaching the market from obscure sources. An opportunity emerges not only for online marketplaces to specialise in second-hand software but also for intermediaries (like UsedSoft) to enter the business of buying and selling copies of software to exploit price differentiations between markets.

But the effects will be felt wider and deeper. Economists will struggle with the question how the rule (and the emergence of a second-hand market) will impact the price of ‘new’ software and whether the application of the exhaustion rule will benefit the users of software overall (beyond the availability of legitimate 'second hand copies'). If the rule prompts the industry to shun the practice of selling software with perpetual licences, this may spell bad news to customers who became accustomed to purchasing software with the payment of one-off fees.

A new challenge in the fight against piracy

Fighting piracy will inevitably become much more challenging. The ECJ recognised the risk but pointed out that software vendors are free to use licence keys and other technology measures to track and control the use of their products and to ensure that a licence sold to one customer does not mushroom overnight into thousands of illegal copies distributed on the open market. True, the distribution of unlicensed copies is already common, but there is a real risk it will become much more prevalent in the presence of a legitimate marketplace for ‘second-hand software’. The emergence of such markets will inevitably make it easier to distribute unlicensed copies. Unless adequate technology control measures are introduced, it will be impossible for purchasers to know whether or not copies offered for sale are legitimate.

One possible problem, which was considered by the Court, is that many sellers of licensed copies might continue to use copies of the software held on their computers after selling their legitimate copies (and of course, some may sell further copies illegally). The exhaustion rule, as formulated by the Court, requires the seller of the ‘second-hand copy’ to make his own copy unusable. It will only be possible to monitor compliance with the requirement if the copy is digitally protected. Further, according to the decision, if a seller sells a licensed copy without destroying his own copy, the purchaser will hold a legitimate copy and the seller will be the infringer. This means that purchasers will feel fairly confident that they will not be at risk of infringement when buying second-hand software (although a purchaser will still be holding an infringing copy if it is bought from an unlicensed seller, or from a seller who already sold his legitimate copy).

The exhaustion rule applies only to copies of software originally sold in the EU. In principle, the rule does not allow the resale of copies that were first purchased

outside the EU. But again, without effective digital control measures, it will be very difficult for software vendors to ensure that second-hand licensed copies of their products sold on the secondary market in the EU do not originate from outside the EU. Purchasers of second hand copies too will have little ways of knowing whether a copy offered for sale was originally licensed in the EU.

It remains to be seen whether the industry will take steps to try to help the market differentiate between licensed and unlicensed copies and to mark copies of software according to the first place of distribution.

Uncertain legal implications

When is a copy sold in the EU?

The decision in the UsedSoft case throws up some very fundamental legal questions.

One was alluded to above - what constitutes a copy sold in the EU? If an end-user in the EU downloads a copy of a software product from the internet (where the vendor and the server on which the software resides could be located anywhere in the world), what is the location of the sale? Further, if a copy is purchaser outside the EU but the licence is granted perpetually on a worldwide basis, is that sufficient to trigger the exhaustion rule (the vendor having consented to the use of the copy in the EU)? Similar questions have been considered extensively by the European court in the past when applying the exhaustion of rights rule to physical products. The application of the rule to ephemeral copies of software, however, will require a re-examination of the issue.

What is the effect of the sale of a 'second-hand copy' on the EULA?

Another key legal question is the effect of the sale of a second-hand copy on the software licence itself.

The Court's decision focuses on the idea that a copy of a software product sold to an end-user (under a perpetual licence) is then "owned" by the purchaser. That "ownership" - the Court emphasised - is a unique concept of EU law, not necessarily "ownership" in the conventional sense under national laws of Member States. That notional "ownership" underlies the application of the exhaustion (or re-sale) rule. If one purchases a copy of the software and owns it, one is entitled to sell it onwards without having to obtain the original seller's permission.

But the right to use a copy of the software is granted by contract. The exhaustion of rights rule has never before been applied to a right that exists under contract (only to physical goods). The Court paid very little attention to the significance of the end-user licence agreement (the "EULA") and the decision does not explain the fate of that contract upon the sale of the second-hand copy. Does the EULA expire upon the sale of the second hand copy? Would the contract continue to apply as between the licensor and the original licensee (insofar as it remains relevant)? Or will the rights and obligations pass on to the buyer of the second hand copy?

The EULA typically includes important terms and conditions. It can impose conditions on the use of the software and various requirements on the licensee, it usually includes warranties and indemnities given by the vendor (and in some cases by the end-user too) as well as provisions on liability limitation, dispute

resolution and so on. Software vendors may wish to include new provisions in their licence agreements in order to address issues arising from the exhaustion principle, but will these terms have any effect after a sale is concluded?

The question is not a simple one. On the one hand, the basis of the exhaustion rule is that the intellectual property rights are exhausted in relation to a copy, once it is put on the market by the IP owner (the software vendor). It follows (presumably) that a licence from the vendor is no longer required for the use of that copy. Further, it is difficult to see how the exhaustion rule can give effect to a transfer of contractual rights and obligations from seller to buyer (particularly if the contract is stated to be non-assignable). On the other hand, is it possible then that an end-user who accepted certain terms under an EULA can free himself from the contract simply by selling his copy? Is it possible that the purchaser might acquire better rights than those of the seller (that is, the right to use a copy of the software with no strings attached and subject to no terms and conditions)?

What will be the case, for instance, if the licence allows the user to run the software only in a particular location or only to be accessed by named individuals? Would these restriction go away on sale? Would they continue to bind the purchaser? Or possibly, could it be argued that a licence that contains such restrictions (even if it is granted in perpetuity) is not subject to the exhaustion rule, because the licensee does not truly “own” a copy?

Numerous legal and practical consequences hang on the point concerning the fate of the EULA upon the sale of a ‘second-hand copy’. No doubt, the industry and its legal advisers will grapple with these issues for some time to come and questions will come before the European courts. But it is likely to take many years before the legal complications stemming from the decision in *Oracle v UsedSoft* will be settled. Until then (unless legislation intervenes) the trade in ‘second-hand software’ will remain shrouded in uncertainty.