The Exhaustion Theory Is Not Yet Exhausted

Part 2

By Erik Verbraeken

Three years ago, I wrote in this magazine an article "Recent Developments in the U.S. and the EU: The Exhaustion Theory Is Not Yet Exhausted" (les Nouvelles, September 2009). A recent decision of the European Court of Justice in the ***Oracle vs. UsedSoft case (http://curia.europa.eu/juris/document/document.jsf?text=&docid=124564&doclang=en&mode=req)*** *has brought new food for thought to the discussion of the boundaries of the perimeter of the exhaustion theory with respect to the commercialization (importation) of products that are subject to intellectual property rights; the interest of the UsedSoft decision is that this time, the case focuses on the implications of the exhaustion doctrine with respect to copyright and software, the combination of which has not yet been an area of attention for the European Court of Justice. The purpose of this paper is to extract several key rulings of the Court's decision in order to determine the scope of the judgment for software vendors on the one hand, and on the other hand, to pin down the issues that remain open-ended and which may thus be a source for future litigation in this area.*

1. The *Oracle vs. UsedSoft* Case

UsedSoft is a German company which trades in used software licences. The business model developed by this company consisted in purchasing obsolete software licences from enterprises and other institutions, whether as a result of system changes, staff reductions, cuts in business segments, insolvencies, *etc.* As part of its commercial offer, UsedSoft proposed 'used' software licenses for computer programs that were developed and sold by Oracle. These programs were normally made available for download on the Internet. Hence, UsedSoft customers downloaded the resold software directly from Oracle's Web site after acquiring a 'used' licence (*i.e.* the activation key for accessing the downloaded file) via UsedSoft.

Oracle sought an injunction from the German courts to cease this practice, putting forward the limited rights that were granted to purchasers of its software over the Internet, *i.e.* "a non-exclusive, non-transferable user right, exclusively for your internal business purposes and for an unlimited period"; downloading of copies of computer programs from the Internet should therefore not be regarded as a "first sale" that result in the exhaustion of the distribution rights that form part of the copyright in that article, but as mere licenses (rentals) for which the Court has held in previous jurisprudence that such arrangements do not exhaust the copyright in the (licensed/rented) article itself.

■ Erik Verbraeken,
Johnson Controls,
Building Efficiency
Business Unit,
Director of Legal Operations,
Paris, France
E-mail: erik.verbraeken@jci.com

The Bundesgerichtshof decided to stay the proceedings and refer the case to the European Court of Justice for a preliminary ruling on the question whether the right to distribute a copy of a computer program should be considered exhausted when the acquirer has made the copy with the rightholder's consent by downloading the program from the Internet onto a data carrier.

On July 3, 2012, the Court rendered its judgment, retaining the exhaustion of right for software resale. The following key rulings merit further evaluation. One should keep in mind that part of the judgment is motivated by the wording of the Directive n° 2009/24 on the legal protection of computer programs, in particular Article 4(2) thereof which sets forth that "The first sale in the European Union of a copy of a program by the rightholder or with his consent shall exhaust the distribution right within the European Union of that copy, with the exception of the right to control further rental of the program or a copy thereof."

2. "The right of distribution of a copy of a computer program is exhausted if the copyright holder who has authorised, even free of charge, the downloading of that copy from the Internet onto a data carrier has also conferred, in return for payment of a fee intended to enable him to obtain a remuneration corresponding to the economic value of the copy of the work of which he is the proprietor, a right to use that copy for an unlimited period."

It has come as no surprise that the right of exhaustion would apply to the distribution of a physical copy of the data carrier through which the software was originally released to the public, since this conclusion would be fully in line with previous case law of the Court of Justice, in particular the *MV Membran vs. GEMA* decision which held that the copyright owner "may (not) rely on the exclusive exploitation right conferred by copyright to prevent or restrict the importation of sound recordings which have been lawfully marketed in another Member State by the owner himself or with his consent."

However, the interest of the decision lies mainly in the extension of the exhaustion doctrine to downloading operations of the same software. Contrary to the position of the Attorney General, who considered such an operation as an illegitimate reproduction of the software through the downloading thereof from the Oracle webserver, even if the purchaser had regularly acquired the corresponding activation key, the Court referred to the digital reality of today's software marketing by holding that "from an economic point of view, the sale of a computer program on CD-ROM or DVD and the sale of a program by downloading from the Internet are similar. The on-line transmission method is the functional equivalent of the supply of a material medium." The second acquirer and any subsequent acquirer must be considered as 'lawful acquirers' within the meaning of Article 5(1) of Directive 2009/24, enabling the new acquirer, in the event of a resale of the copy of the computer program by the first acquirer, to download onto his computer the copy sold to him by the first acquirer. Such a download must be regarded as a reproduction of a computer program that is necessary to enable the new acquirer to use the program in accordance with its intended purpose under Article 5(1) of Directive 2009/24.

The quoted paragraph uses two qualifications that temper the unlimited application of the exhaustion rule to software sales, and that raises at the same time a new specter of questions whenever software vendors will commence to adapt their commercial strategy in order to deviate from those exhaustion criteria.

The first qualification is that the first download has been authorized in return for payment of a fee intended to enable him to obtain a remuneration corresponding to the economic value of the copy of the work. Consequently, exhaustion will only occur if the copyright proprietor received an adequate price. It may be interesting to compare this holding of the Court to the suggested wording of the Advocate General, whose point of departure in deciding whether the download should be considered as a "first sale" triggering exhaustion was not the appropriate remuneration of the software, but the price formula used by the supplier: "That right of use bears the hallmarks of rental where it has been conferred temporarily in return for the payment of a periodic fee (…). On the other hand, it appears to me to bear the hallmarks of sale where the customer secures permanent acquisition of the right to use the copy of the computer program (…) in return for a lump sum payment."

Both formulas have significant drawbacks. The decision of the Court implies that a software vendor can escape the exhaustion of his copyright on the software product if he can establish that the transaction was made on terms that did not enable him to obtain a remuneration corresponding to the economic value of the product. This would at least allow to ring-fence and shield off one type of license arrangements for which Oracle claimed that their unlimited distribution, following a first acquisition, would be at odds with the purpose of this particular license, *i.e.* those licenses offered at a reduced price to make it easier for the programs to be used by financially fragile user groups such as training institutions.

Another typical price formula used in the software industry that does not allow the software vendor to obtain an upfront remuneration corresponding to the economic value of the copy are the so-called runtime licenses, where the determination of the applicable license fee is coupled to such variable factors as, *e.g.*, number of users, annual revenues derived from the software, effective annual runtime, *etc.* Since the "return on investment" will be spread over time, it would be incompatible with this business model to allow for exhaustion of copyright if the same software could subsequently be sold with no strings attached to third parties. Finally, although it seems unlikely, a software vendor may decide to charge different rates for software downloads compared to hardcopy purchases, arguing that a download from the Internet is priced at a rate that does not adequately reflect the economic value of the product. In accordance with its reasoning before the Court, it could thus hold that the inferior remuneration for the download is sought not simply for the program download, but is paid on the basis of the licensing agreement in return for the right of use conferred by that agreement; contrary to a hardcopy sales transaction where the superior remuneration corresponds to an effective transfer of ownership coupled to a further right of distribution.

However, setting the dividing line at the benchmark of "periodic fee" against "lump sum payment" or "flat fee" as suggested by the Attorney General will be a recipe for "exhaustion evasion" as well. Under this formula, it would then be rather easy to escape the burden of the exhaustion rule simply by converting all "one shot" lump sum license agreements into annual fee license agreements. Since from an economic perspective, the definition of a lump sum in the software industry is often the capitalized counterpart of a periodical fee over the expected lifetime of the software, it will not be a radical step for a software vendor to change its price policy if this would avoid the application of the exhaustion rule. It will then be a business evaluation whether this advantage of a periodical fee (to protect your product from being traded on second-hand markets) outweighs the disadvantages of such a policy (increased administrative cost, risk of unpaid invoices, risk of bankruptcy).

It should also be noted that the Court links the application of the exhaustion rule to the payment of a fee. Does this imply that free copies of the software are not submitted to the effects of the exhaustion theory? An argument in favor of such a conclusion is that free copies of the software are often distributed for specific use purposes, in particular non-commercial use purposes. Consequently, a software vendor would wish to avoid copies that have been licensed out for free at universities or research centers subsequently find their way to the second-hand market where the products will be offered at a handsome price. Otherwise, from a practical perspective, if the "trade" in the software remains limited to the same non-commercial environment (*e.g.* a university hands out a copy of the software to a research center in order to help the latter with the performance of a research project), this will probably trigger, in the absence of a true commercial prejudice, little if any litigation, whatever the legitimacy of such a claim on the legal side.

The second qualification is that the right to use the copy of the software must have been granted for an unlimited period. Term licenses are therefore not subject to the exhaustion rule, so it seems. The rationale for this distinction comes from the distinction between "sale" (subject to exhaustion") and "rental" (not subject to exhaustion), as confirmed by the Court in the *Warner Bros. vs. Christiansen* case. However, from an operational perspective the use of this criterion for the determination whether the exhaustion principle applies or not opens the door widely to circumventing practices where software houses may henceforth simply structure their software license as a long-term rental arrangement. Because software products have a short average lifespan of only five years (Atkinson, A. A., Kaplan, R. S. and S. M. Young. Management Accounting, 2004), it is probably sufficient to propose the software under a ten-year license to run with the hare and hunt with the hounds: the ten year license can be offered under a flat fee in order to equal the economic conditions of a perpetual license (for all practical purposes, a ten-year rental comes down to a perpetual license, since the client will in all likelihood need to upgrade to a subsequent version of the software in order to benefit from continued maintenance services) and the effects of exhaustion can be avoided through the limited term of the agreement. Even if from a contractual perspective, the client does not wish to be exposed to a possible restitution of the software after ten years (*i.e.* if he wants a perpetual license), a lease option for an extra $1 at the end of the term can be offered, knowing that although in that case the exhaustion rule will creep back in, there is very little chance that a purchaser will be found for this "antique" software without further maintenance support (after all, who today would buy a Microsoft Windows 98 package?). With this qualification, the Court seems to undermine its own observation that "if the term 'sale' within the meaning of Article 4(2) of Directive 2009/24 were not given a broad interpretation (…) the effectiveness of that provision would be undermined, since suppliers would merely have to call the contract a 'licence' rather than a 'sale' in order to circumvent the rule of exhaustion and divest it of all scope."

So, is there a perfect solution? In contrast to other copyrighted material, like books, sound recordings and movies, software rapidly loses value over time. Where for books, sound recordings and movies, the distinction "sale" *vs*. "rental" makes perfect sense, because there is loss of value (at least emotional) in the restitution of the product at the end of the rental term, which may drive an interested third party towards a purchase; this is not the case for software,where over time, the commercial value of the product will suffer an important downfall. So, if the exhaustion theory should not apply for the rental of works because, as the Court held in *Warner Bros,* of the existence of a specific market for the hiring-out of such recordings, as distinct from their sale, this holds true for products that can be re-introduced upon the rental market upon their restitution (books, sound recordings, movies), but not necessarily for software products that after their restitution are probable ripe for the garbage can (apart from short-term rentals that correspond to particular time-constrained needs). In this perspective, the particular nature of software makes it rather awkward to define a precise dividing line between exhausted and non-exhausted intellectual property rights. A possible way out of this impasse would be to provide for full exhaustion of every form of distribution of software, whether through a sale, a rental or otherwise; this solution would only be effective if the exhaustion goes hand in hand with a novation of contract terms, which will be addressed in point 3 hereafter. Moreover, providing for such a radical conclusion would also necessitate the modification of the existing legislation, since today rentals are explicitly excluded from the scope of exhaustion.

3. "The exhaustion of the distribution right under Article 4(2) of Directive 2009/24 extends to the copy of the computer program sold as corrected and updated by the copyright holder."

One of the issues raised by Oracle was that, even if the download of a computer program should be considered a first sale, then the exhaustion theory should only apply to the original copy that was downloaded, excluding the subsequent patches and updates that may have been brought by Oracle to said original copy as a result of the maintenance services that it provided to the client; in fact, recital 29 of Directive 2001/29 provides literally that "the question of exhaustion does not arise in the case of services and online services in particular." Expectedly, the Court denies such reasoning: through what seems a derivative application of the accession theory, it holds that "the functionalities corrected, altered or added on the basis of such an agreement form an integral part of the copy originally downloaded and can be used by the acquirer of the copy for an unlimited period, even in the event that the acquirer subsequently decides not to renew the maintenance agreement."

The logic of this position lies not only in the economic rationale of such extension, since otherwise, in the same way as the rule of exhaustion would be diverted from its full effect by naming the agreement a "licence" rather than a "sale," the same rule would be severely eroded if accessory services brought to the original product would allow the latter to escape from the mazes of the exhaustion theory. Could the seller of an engine avoid the exhaustion rule only because the car dealer carries out an oil change on said engine, or otherwise maintains the latter during the annual control services? Could the importer of a fire security device be prevented from further selling the same device because upon importation, he has to equip the tool with particular adaptations in order to comply with local legislation?

It is also from an IP perspective that one may seriously question the impact of maintenance services on the application of the exhaustion doctrine. Copyright protection can only be invoked against works that qualify as "original," *i.e.* there has been sufficient skill and labour expended in their creation—or sometimes, significant investment of resources. For much of the maintenance services provided by a software supplier, both qualifications would probably lack—the distribution of patches is the result of error correction services for which it would be difficult to claim originality, the supply of updates concerns most of the times minor improvements released by the software company, for which likewise it would be difficult to claim copyright protection. Thus, even if theoretically the modification of the original product through the contribution of maintenance services could shelter the said product from being subject to exhaustion, from a practical perspective, this would only happen if the modifications brought to the product are themselves of copyrightable quality.

4. "If the licence acquired by the first acquirer relates to a greater number of users than he needs, the acquirer is not authorised by the effect of the exhaustion of the distribution right under Article 4(2) of Directive 2009/24 to divide the licence and resell only the user right for the computer program concerned corresponding to a number of users determined by him."

In the present case, Oracle offers group licences for the software at issue for a minimum of 25 users each. An undertaking requiring licences for 27 users thus has to acquire two licences. Theoretically, this leaves available an unused portion of 23 single user licenses, which the purchaser could propose to the marketplace if he himself has no further in-house need for those licences.

Through the above ruling, the Court closes the door to a possible trade in unused individual license rights. This is an important caveat that may significantly reduce the operational consequences of this decision. Software license agreements come in many forms: limited licenses containing restrictions on the number of copies available, whether through a designated number of computers (a.k.a. node-locked licenses or CPU licenses), or a designated number of users operating a program at any given time (a.k.a. floating license), or a number of geographical locations (a.k.a. site license). The licensed software may also be offered as an unlimited license, the benefit of which extends to the full company site (a.k.a. corporate license). Finally, the software may be offered through a volume purchase arrangement, with substantial discounts according to the number of licenses purchased.

The ruling of the Court only sets forth that a multi-user license cannot be subject to piecemeal chopping where licensees keep the number of licences they want and then simply resell the surplus of licences they have available under the licence agreement. However, this "out-of-the-blue" conclusion, for which the Court does not give any further background explanation, may be seriously questioned. The essential function of a copyright has been defined by the Court as the possibility to ensure a reward for the creative effort (Magill). If a package license (or volume license) is then offered to a licensee, it may reasonably be considered that the software vendor has realized an appropriate benefit or, in the words of the Court, "a remuneration corresponding to the economic value of the copy of the work of which he is the proprietor." To use the analogy of the *Merck vs. Stephar case*, "it is for the proprietor of the (copyright—EV) to decide, in the light of all the circumstances, under what conditions he will market his product, including the possibility of marketing it (under a volume purchase arrangement—EV). If he decides to do so he must then accept the consequences of his choice as regards to the free movement of the product within the Common Market."

One may object that the reduced price has been paid in consideration of the purchase of the full package, and that consequently, the purchaser may not "denature" the purchase by breaking down the full package in individual pieces in order to bring these individual pieces one-by-one back on the market. But again, one may wonder: why not? If this is the conclusion to be drawn from the judgment of the Court, the consequences in the related IP areas may be troublesome, for this would become an unexpected side effect of the *UsedSoft* decision with major consequences on parallel trade opportunities. Because commercial purchase orders often extend to large volumes of goods, could IP rightholders henceforth forbid further trade by asserting that the "downstream" volume brought to the market by the trader is inferior to the "upstream" volume that the original manufacturer sold to the first acquirer? Trade volume discounts are of all times, and if the consequence of the above holding of the court is that a package deal cannot be cut in individual units for further trade purposes, IP litigators will be offered a brand new field of legal defense arguments to extrapolate this reasoning to patent and trademark infringement cases.

Second, the Court's decision does not give any guidance about the fate of individualized licenses. If the license format is a "per CPU" format, where the license is granted only for a specific computer upon which the software is to be compiled or installed and executed, and which is designated by licensee in the license form, are those restrictive terms exhausted by the first sale of the software, and can the licensor still oppose these restrictions against future purchasers? Likewise, if a floating license is coupled to a site license, can this software be disconnected from one site and transferred to another site, provided the number of concurrent users does not change?

Third, the decision of the Court may lead to a modification of the landscape of license models, where software companies may prefer to structure their license agreements as package agreements, or altogether abandon the "physical" world of software selling and donwloading in order to enter the "virtual" world of cloud licensing (software as a service).

5. "An original acquirer who resells a tangible or intangible copy of a computer program for which the copyright holder's right of distribution is exhausted in accordance with Article 4(2) of Directive 2009/24 must, in order to avoid infringing the exclusive right of reproduction of a computer program which belongs to its author, laid down in Article 4(1)(a) of Directive 2009/24, make his own copy unusable at the time of its resale."

This statement of the court, while in line with the "transfer of property" implications of a single-user license (but questionable with respect to multi-user licenses, see above Section 4), raises the issue of monitoring and proof. Although the burden of proof is attributed to the seller/first purchaser of the software, the question may be raised whether the copyright owner may still have an alternative course of action against the second purchaser on the basis of contributory infringement. If software sales, for exhaustion purposes, are communicating vases, then there seems to be no exhaustion if the first purchaser did not erase its own copy from its IT network, which would then imply that the second purchaser remains an infringing party, whether directly (in the absence of exhaustion) or indirectly through contributory infringement for lack of surveillance. How should this proof then be delivered? Is a written confirmation of destruction of the software copy sufficient, or would a notarised certificate or its equivalent be required? What about "chain acquisitions"—do all subsequent acquirers have to prove that all previous owners have correctly erased their copies from their machines?

6. "It must be observed that the downloading of a copy of a computer program and the conclusion of a user licence agreement for that copy form an indivisible whole. (…). The operations mentioned in paragraph 44 above, examined as a whole, involve the transfer of the right of ownership of the copy of the computer program in question."

Transfer of the right of ownership to the computer program does not instruct about the fate of the use conditions that were attached to the software program under the original license. Most license agreements contain restrictive covenants with respect to scope of use, confidentiality, reverse engineering and decompilation, and transferability. The question is upon transfer of ownership: do these restrictive conditions automatically transfer upon the purchaser? This would not be the obvious conclusion since under the doctrine of privity, a contract cannot confer rights or impose obligations arising under it on any person or agent except the parties to it. The application of the exhaustion theory thus has the undesirable side-effect that the purchaser acquires all of the use rights for the software (since downloading a copy of a computer program is pointless if the copy cannot be used by its possessor, according to the Court), but none of the corresponding obligations because the contract is a personal relationship affecting only the parties to it.

An equitable solution would be to have an exhaustion of rights be coupled to a novation of obligations. Unfortunately, it would take three to tango in such a situation: a novation is valid only with the consent of all parties to the original agreement. As the Court held itself in the *Peak Holding vs. Axolin* decision, "any stipulation, in the act of sale effecting the first putting on the market in the EEA, of territorial restrictions on the right to resell the goods concerns only the relations between the parties to that act. It cannot preclude the exhaustion provided for by the Directive." Automatic novation would therefore require legislative action to bring about such automatic transfer of obligations to the acquiring party—unless a national court could hook upon a rule of interpretation that as being the accessory of the user rights to the goods that were transferred, the obligations should likewise be considered as transferred. ■