A Thorogood Special Briefing

Chapter 1
Understanding Software Licence Agreements

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Chapter 1
Understanding software licence agreements

What is a software licence agreement?

At the core of software and software contracts is the legal concept of copyright. Copyright (as it applies to software) is the right for the owner or licensed proprietor to prevent anyone from copying their software without paying something for it. Since the use of software requires copying to occur, then any user of software must have permission to use and thereby copy such software.

A software licence agreement authorises someone to do something with software which would otherwise be an infringement of copyright. The party granting this authorisation is known as the 'licensor' while the party receiving the authorisation is known as the 'licensee'.

The licensor may own all rights to the software, or may have the permission of the owner to enter into licence agreements with others. The licensee may be:

- a user of the software;
- a distributor of the software;
- a publisher of the software;
- a website owner or host;
- a party who modifies, translates or adds codes to the software;
- a party who makes copies of the software for its owner or a distributor;
- an original equipment manufacturer;
- a value added reseller;
- a joint venture partner;
- an independent maintenance company;
- a facilities management company;
- a technology escrow agent;

- an independent training company; or
- an independent sales representative or agent.

In general, if the software in question is protected by patent, copyright, or trade secret law, the licence agreement allows the licensee to deal with the software as specified in the licence grant provision of the agreement without infringing the licensor's copyright or patent rights, and/or without misappropriating the licensor's trade secrets. The agreement addresses other topics as well, such as payment and warranties. Sometimes maintenance and training will be addressed in the licence agreement and sometimes they will be covered by separate agreements. Whatever its other terms might be, the agreement will virtually always specify the rights conveyed to the licensee and the restrictions imposed on the licensee regarding the licensed software.

An agreement that licenses one or more copies of software is different from an agreement that sells one or more copies. When copies of software are sold, the purchaser 'takes title' to the copies. One analogy is the purchase of a book at a bookshop. The purchaser can do many things with the purchased book, for example, he can resell the copy, lend it to a friend or give it away. However, the purchaser cannot reprint the book, and cannot sell or make copies if the item is protected by an intellectual property law such as copyright. Such a reproduction and distribution would constitute copyright infringement if the purchaser did not have the permission of the copyright owner to reproduce the item and sell it commercially. Thus, when goods that are protected by copyright are purchased, title to the copy purchased does not give the purchaser complete freedom to do whatever he or she desires with the copy. There is an invisible, legal string attached to such goods that makes certain actions involving the purchased copy illegal.

In contrast, when copies of software are licensed, the licensee often does not obtain title to the licensed copy. Instead, the licensee obtains possession of one or more copies of licensed software and gains certain specified rights to deal with the licensed copy or copies under the terms of the software licence agreement. There are exceptions to the general rule about the licensee not taking title to a licensed copy of software which are explained later. For this introduction, it is sufficient to note the general key difference between a software sale agreement and a software licence agreement: the former passes title while the latter does not. In addition, because licence agreements often contain limitations on the licensee's ability to deal with licensed software, the legal string mentioned above is usually stronger when affixed to licensed copies than it is on purchased copies of software.

One related point is important to our introductory discussion. There is a major difference between purchasing the intellectual property rights in software, on the one hand, and purchasing or licensing a copy of software, on the other. If the software is protected by copyright, to continue our book analogy, then the difference is between purchasing the copyright for the book and purchasing a copy of the book. In other words, the copyright owner can sell, and you can buy, copies of an item protected by copyright, but that purchase does not make you the copyright owner. Owning a copy of a book or software is not the same as owning the copyright for the book or software. Copyright is an asset of its owner and can be disposed of in the same manner as other assets, for example, when you sell assets of a company or sell all shares or stock in a company.

To further continue the book analogy, if there is copyright in a book written by one author, then the writing on the pages is the expression of the idea or creativity behind the book but there is also copyright in the creativity or style if it can be expressed in writing. To this end the printed pages are like object code while the creativity, style and idea are like source code.

You should be aware that there is a difference between a software developer, a software publisher and a software distributor:

- A software developer is a party that creates software.
- A software publisher may create software, may acquire it from developers, or may do both. In any event, the publisher will reproduce copies of the software or have them reproduced, will stock inventory of the software, and will promote its distribution. Most publishers distribute software as well.
- A software distributor acquires software from publishers and usually stocks an inventory, but always distributes copies by one or more methods, for instance, sales representatives, mail order, etc.

These differences have close parallels in the book publishing industry. A software publisher acquires its rights to the software in question from the developer, just as a book publisher acquires its rights to books from authors. One difference between book publishers and software publishers is that book authors are rarely employed by the publishers of their books, while it is more common for software developers to be individuals employed by the publishers of their software. It is also common for the developer to be an independent author like a typical book author. However, these independent developers are often corporations rather than individuals. Individual developers are most frequently found in the arena

of home or school use microcomputer software. An independent software distributor is very much like an independent book distributor. Of course, there are exceptions to these general arrangements.

What types of software and databases are distributed under contract and what laws protect them?

Mainframe and minicomputer software

Most mainframe computer and minicomputer software is distributed under a contract, and is also protected by trade secret law. In the United States patent law is used increasingly in lieu of trade secret law, copyright law is infrequently used in conjunction with trade secret law, and more reliance is placed upon copyright law, trade secret law and contract law. In the United Kingdom and the rest of the European Union, patent law is still not the primary source of intellectual property right protection. Contract law provides protection because such software is typically licensed to users.

Microcomputer software

Certain types of microcomputer software are distributed under contracts. Most microcomputer software is protected by copyright law. However, the laws and mechanisms selected to protect microcomputer software will vary, for example, some is licensed and hence protected by contract law if the licence agreement is valid and enforceable, some microcomputer software is sold, like books, without an accompanying user contract, and hence is not protected by contract law.

For example, very expensive or novel microcomputer programs may be protected by trade secret law, or patent law might be used, but copyright protection combined with trade secret protection is common. Usually such software is marketed under a licence agreement signed by the end user.

For typical microcomputer business applications, copyright and trade secret law are often used in combination. Such software is usually marketed under a licence agreement that is not signed by the user. The enforceability of these agreements in the absence of validating legislation is questionable. In the United States some patent protection for parts or all of these programs is evident in the marketplace.

For home, educational or entertainment programs, copyright law is often used in combination with some effort to protect through trade secret and trademark law. Such software is usually marketed by selling copies, not through licensing copies. Such sales can be compared to selling copies of books except that trade secret protection is not available for commercially published books. In addition, there is a significant volume of unprotected 'freeware' or 'public domain' software available through libraries, electronic bulletin boards, trade publications and other sources.

Commercially available software

Trademark and unfair competition law are important to the businesses of software, computer and database providers, for example, to their identity, quality image, and sales; but trademark law and unfair competition law do not directly protect the content or expression of products as do patent, copyright and trade secret law, except perhaps in some misappropriation situations, for example, the misappropriation and publication of news in a database before it is published by the source of the news.

Commercially available databases

Databases generally available to the public for a fee are protected by various bodies of law and contracts depending upon circumstances such as the method of dissemination, the value, user rights, etc. For example:

- If microfiche is the medium, copyright protection often is used exclusively. Often copies of the microfiche and its data content are sold, sometimes the data is licensed under a licence agreement.
- If printed copies or reports are marketed, copyright protection is often used exclusively. If the data is licensed, trade secret and contract protection may be attempted.
- If a computer tape, disk or CD-ROM is the medium, copyright and trade secret protection are often used, especially if the data access code is recorded on the tape, disk or CD-ROM. Usually the data is licensed under the terms of a licence agreement.
- If the data is made available through a closed telecommunications network with a host computer, copyright protection is usually used and the data tends to be licensed. Trade secret protection may be attempted.
- If the data is made available through the internet or online, networks copyright protection is usually used and the data tends to be licensed

under contractual terms and the conditions are often contained in a click-wrap contract. Trade secret protection may be attempted.

EC Directive 96/9 on the Legal Protection of Databases now introduces a new *sui generis* right of protection of 15 years in addition to copyright.

Non-contract protection

Tort law and/or criminal law offer some redress for the theft, disruption or destruction of software or databases under certain circumstances. For example, many jurisdictions have adopted computer virus legislation that makes various types of computer tampering a criminal offence. In the United Kingdom, the Computer Misuse Act 1990 specifically addresses the question of hacking in that three offences exist, namely:

- unauthorised access to computer material;
- unauthorised access with intent to commit or facilitate the commission of further offences; and
- unauthorised modification.

Further civil and criminal law remedies for infringement of copyright in computer programs is available under the Copyright, Designs and Patents Act 1988.

General comments

While the primary focus of this work is software licence agreements in the context of a major acquisition, distribution arrangement, development project, or conversion project, many comments are offered regarding computers and databases accompanied by licensed software. Advice is given in relation to other types of computer contract such as maintenance and support agreements, outsourcing agreements and escrow, and numerous parallels are drawn between software providers on the one hand and computer and database providers on the other. The term 'provider' is preferred in this work because software is available from different types of sources: developers, publishers, distributors, retailers, mail order houses, computer vendors, database publishers, bulletin boards, etc. 'Provider' encompasses all sources. As used in this book, either the type of provider in question will be clear from the context, or the term will have a typical meaning of publisher, distributor, computer vendor that distributes software, etc.

References in this work to a customer's 'technical staff' or 'technical personnel' are meant to encompass members of a company's data processing staff, programming staff, consultants in technical areas, or management information services department, and are intended to include their managers, directors, etc. 'Customer' is used rather than 'user', except on occasion, because customer has a broader meaning. For example, a publisher may be a customer for a software developer, but not a user of the developed software. The context in which 'customer' is used should make its meaning clear. 'Price' as used herein is meant to include purchase price, licence fee, service charge, etc, depending on the context.

Goals and purposes of parties to a software licence agreement

In general

The goals and purposes of the parties to a software licence agreement vary according to a number of factors, but some generalisations can be made. Software providers in western countries tend to be motivated by profit. Software is expensive to develop and distribute. A new microcomputer business application may cost half a million pounds or many times that amount to develop and market. Mainframe programs often cost even more.

Software licensees are not uniform in their goals and purposes. Commercial users of application programs, operating systems, databases and computers generally want results. That is, these users have more or less specific results in mind when they acquire a new application, or switch to a new operating system. The desired results may be processing customer orders faster, inventory control, electronic mail, improved secretarial efficiency, better response times, a more capable system, reduction of current processing costs, etc. These goals are the business and/or technical reasons for licensing commercially used software. Of course, many commercial users also desire maintenance-free software that requires little or no operator training and hope for a good relationship with the software provider, but some problems in these and other areas usually will be tolerated if the more specific major business or technical results are achieved.

In contrast, the traditional position of both software and computer providers is that they provide solutions that the customer is responsible for selecting and operating so as to produce whatever results are required. The goal of the

commercial customer to receive results and the purpose of software, database and computer providers to furnish a solution are inconsistent even though some solutions often provide the desired result. This insight is important to your understanding of software, database and computer transactions.

Licensee-distributors have different goals from licensee-users. A distributor falls into the category of profit-motivated software providers. Like others in this group, the licensee is interested in moving the product out of the door and into the hands of the user. Thus, you can see that the goals and purposes of all licensees are not the same because different types of licensees deal with software in different ways.

Another major goal of parties to a software licence agreement merits attention. Software providers want to minimise potential liability. A liability determination in litigation may lead to bad publicity that damages business. Damage awards can wipe out profits and push a company into bankruptcy. Minimising the risk of legal liability is a goal of the software provider in software licence agreements.

In contrast, a software user wants to quietly enjoy his licensed software free of any concerns about liability arising from its operation. Sophisticated software users ensure that their licence agreement makes the software provider responsible for the most likely risks of legal liability arising from the exercise of the user's licensed rights.

There are other goals and purposes that could be mentioned, but these suffice to illustrate the differences in the parties' outlooks.

In general, the software provider wants to make profit from supplying a solution to the customers' needs (with software being the medium and the object of the solution) and without incurring the burden of ongoing responsibility and liability to the customer. The customer wants to satisfy his needs fully by the software he is obtaining and paying for with the maximum performance and ongoing support from the provider.

Why are software licence agreements required by many software providers?

As we observed earlier, software is an asset. It can be protected by contract provisions, patent law (sometimes), copyright law (often), and trade secret law (fairly often). Assuming the software in question is protected by copyright law, the owner of a copy is allowed to transfer that copy to others without the copyright owner's permission or knowledge. If all the software was sold, the owner of each copy

could deprive the copyright owner of much needed revenue by transferring his copy to another after a period of use. If the software could not be transferred, the second user would have to acquire a copy in the marketplace, thereby improving the copyright owner's profits. The only way the copyright owner can prohibit such a transfer under current law is by means of contract restrictions on a licensee. The desire to maximise revenue leads a copyright owner to licence his software rather than sell copies.

In addition, if object code is distributed rather than source code, the owner can claim trade secret protection for his program. Unfortunately for the owner, trade secret law allows reverse engineering through disassembly or decompilation. The trade secret owner can, subject to certain statutory exceptions in EU Member States, prohibit reverse engineering of distributed copies through restrictions in licence agreements. The desire to prohibit reverse engineering leads the owner to licence his software rather than sell copies.

This desire to prohibit reverse engineering is prompted by the realisation that the ideas discovered from a decompiled or disassembled program can be used by a current or future competitor in a competing product, and can be disseminated to users by trade publications or on bulletin boards, any one of which reduces the owner's revenue flow. The software business is hard enough without giving away your trade secrets.

While there are other reasons, such as minimising legal risks through protective contract provisions, these are two of the main reasons why software licence agreements are required by many software providers.

In the case of *Microsoft Corporation v Commission case T-201/04*, The Court of First Instance rejected the appeal by Microsoft against the European Commissioner's decision in 2004 that Microsoft had abused its dominant position under Article 82 of the Treaty of Rome.

The case originated from a complaint from Sun Microsystems that Microsoft had refused to provide it with interoperability information which Sun required in order to develop its server products so as to operate effectively with Microsoft's Windows PC operating system. After several years of investigation, the Commission adopted a Decision, finding that Microsoft had abused its dominant position in the market place and in particular that Microsoft's refusal to make available interoperability information was anticompetitive. Microsoft, amongst other things was fined 497,192,304 and ordered to cease its anticompetitive practices.

Microsoft's appeal to the Court of First Instance was based on a number of points but in essence Microsoft claimed that the Commission had been incorrect in its assessment of the law relating to interoperability and bundling and furthermore, that the imposition of a fine was illegal.

For the computer industry, the issues surrounding the abuse of dominant position and also that of interoperability data are important.

At a time when many software companies are moving to more open solutions, it is unusual for a major software vendor to totally ring-fence its products and use intellectual property rights as a mechanism to prevent competitors or perceived competitors from interfacing their products.

The right to reverse analyse where interoperability data is necessary is an enshrined right under European law and arises because the European Commission recognised many years ago that dominant technology companies could stifle competition and innovation by ring-fencing their technology and refusing to make interoperability data available to other developers. Microsoft's refusal to make data available to Sun was in itself anticompetitive as confirmed by the Court of First Instance.

The recent court decision requires detailed analysis but in the short term it is suffice to say that the licensing practices of software companies continue to require audit and analysis in order to ensure compliance with EU law.

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Some differences between software sale, lease and licence transactions

Legal concepts and characteristics

As the introduction explained, there are significant differences between software sales and software licences. A software lease is also different from both. It is important that you understand the basic differences and similarities of these transactions.

Legal concept of sale

Nature: a sale conveys title or ownership, which is a property interest. The rights to possess and use the purchased item are part of the ownership rights, as are the rights to resell or otherwise dispose of the purchased item:

- Sell equipment: Title passes to purchaser.
- Sell intellectual property rights: Title to copyright, patent, trademark, or trade secret passes to purchaser.
- Sell a copy of the software: Title to the copy passes to the purchaser, but the seller retains ownership of the intellectual property rights in the copy, for example, patent, copyright, trademark, etc.

Legal concept of lease

Nature: a lease conveys the right to possess and use, but not to resell or otherwise distribute the leased item. No title passes. A lease is primarily a financing arrangement that conveys property interests. Thus it could be argued that a lease is a mixed property law and financing concept:

- **Property lease**: Transfers a leasehold title to property giving the right to occupy the premises upon payment of rent. Title does not pass but an option to purchase the freehold may be included in the lease.
- **Equipment lease**: Conveys a personal property right to possess and use the leased equipment upon payment of rent. Title does not pass but an option to purchase may be included in the transaction.
- **Software lease**: Conveys a personal property right to possess and use the leased software upon payment of rent. Title does not pass as a part of the lease transaction. If the software is protected by copyright and trade secret law, the lessee should also have an express or implied intellectual property right licence to possess and use the intellectual property or protected technology in the software. The lessee often obtains this licence directly from the intellectual property right licensor who may or may not be the lessor as well. Independent, third-party software lessors are increasingly noticeable in the marketplace, as are financing companies who finance software licence fees receivable.
- The personal property right to possess and use a copy of software under a lease is theoretically different from a right to possess and use all intellectual property in the software. This may sound like a difference without a distinction. If the lessor and the licensor are the same party, or the

lessor has permission from the licensor to license the software to the lessee-licensee, then the theoretical difference is not noticeable as a practical matter. Also, a lease can be viewed as conveying an implied licence. To illustrate, assume that the software is a mainframe program protected by trade secret law and that the lessee-user finances possession and use of the software under a lease, but does not obtain the trade secret owner's permission to possess and use the trade secrets in the software under a licence. The very existence of a lease can easily be viewed to imply that it conveys to the lessee-user both personal property and intellectual property rights to possess and use the leased software. Also, the lessor may convey both types of rights expressly or by implication in the lease. If the lessor owns the trade secrets or has the permission of the trade secret owner to grant the user licence, then there is no problem. However, independent lessors who convey express or implied licences must be careful to obtain permission to do so.

- One situation where the trade secret licensor may argue that the lessee has no right to possess and use its intellectual property in the leased software arises when the original lessee-licensee-user subleases the software to a third party, for example, a company spun off from the lessee-licensee, with the approval of an independent lessor, but without the knowledge or contractually required approval of the trade secret licensor. Generally speaking, the owner of trade secrets must know who has copies and grant permission for their possession and use in order to preserve their status as trade secrets.

Legal concept of licence

A licence conveys a personal privilege or right to do one or more things with the licensed item, for example, to possess it; to use it; to make or reproduce it; to distribute one or more copies by specified means (for example, sale, licence, etc); to publicly display or operate the licensed item; to prepare modified versions or translations of the licensed item, etc. A licence agreement usually incorporates payment terms and hence is like a financing arrangement, but it can be used to convey more than the rights to possess, use, resell or otherwise dispose of the licensed item. For example, a licence of software can convey to the licensee the right to prepare a foreign language translation of the software, or a right to make many copies of the software and distribute them commercially. In the absence of a licence grant authorising them, the purchaser or the lessee of a

copy of copyrighted software cannot do these things without infringing the copyright in the software:

- **Property licence**: Grants limited right to use and not possess, real property. No property right is conveyed as a part of this privilege of use. This privilege is revocable and unassignable except for prior written agreement.
- **Software licence**: Assuming the software is protected by intellectual property law, the licence grant conveys permission for possession and specified conduct with respect to the software. Use may or may not be allowed, depending on the type of licence agreement. For example, a distributor may be licensed to distribute copies supplied to him, but not licensed to use a copy of the software in his business.

Weaknesses of the software licence concept

Many legal concepts are defeasible concepts. In other words, they are capable of being defeated by certain circumstances. For example, the concept of a contract is defeated if there is no consideration to support the parties' agreement. The concept of a software licence embedded in a contract called a software licence agreement is likewise defeated, or nullified, if the agreement is not valid. Generally speaking, an offer, its acceptance, and consideration are required to create a valid contract.

The existence of a software licence can also be destroyed by other circumstances. A software licence agreement may qualify as a valid and enforceable contract in every legal sense, but it may be characterised by a court as a valid and enforceable sale contract rather than a valid and enforceable licence agreement. For example, a licence grant in a software licence agreement can be adulterated to the point of destruction by sale language in the agreement. In its pristine form the concept of a licence does not pass title. A sale passes title. If a software licence agreement contains the terms 'sale', 'purchase' or 'purchaser', the licence concept underlying the licence grant is adulterated. One, or more, uses of such terms anywhere in a software licence agreement may cause a court to characterise the contract as a software sale agreement.

Another example of a licence grant and underlying concept adulteration is a perpetual term in a software licence agreement. If the licensee can keep the software forever after payment of a fee, a court may decide that there is no substantive difference between the so-called licence agreement and a sale agreement.

Mass-market software such as shrink-wrapped business software and leisure or entertainment software often contain licence grant terms such as 'a perpetual royalty free non exclusive transferable licence' and is 'sold for a once only retail price'. Notwithstanding that the only part of the product which is 'goods' is the media upon which or within which the software is embodied, to all intents and purposes the whole item is perceived as a 'good' which in consumer terms involves a number of implied statutory rights which might not be included in a 'supply' or true licensing situation.

Similarly, a licence grant can be destroyed by the actions of the licensor. If the licensed software is advertised or promoted as software that is sold or purchased, such advertising or promotion is inconsistent with the legal concept of a licence that underlies the grant provision in a software licence agreement. It serves as a notice that the licensor really believes he is selling copies, and creates customer expectations that title to a copy will be acquired when a copy is acquired. Almost any advertising or promotion of sold or purchased copies contaminates the licence grant sufficiently that a court might characterise the software licence agreement as a software sale agreement.

Courts pay heed to substance over form, and substance includes more than the title given to a contract. The case of *St Albans City and District Council v International Computers Ltd 2 [1996]* has, amongst other things, decided that software is 'goods' as much as the media upon or within which the software program is supplied, unless the language of the licence agreement clearly specifies that the media is 'sold' and the program and the user manual is 'licensed and supplied' only.

Thus, in order for a software licence agreement to be analysed by a court as such, the agreement must be a valid, unadulterated and uncontaminated contract. The legal concept of a sale is stronger than the legal concept of a licence and they are inconsistent concepts. The concept of a licensed copy of software will be overcome by the concept of a sold copy of software if the software licence agreement is invalid (defeated), adulterated (not genuine), or contaminated by actions outside of the agreement's terms (not pure, i.e. not treated as a software licence transaction).

In contrast, the concept of a software lease is consistent with the concept of a software licence. Where the licence is a licence to possess and use, a software lease is virtually identical to a software licence. The lease conveys a personal property right to possess and use the leased item and the licence conveys an intellectual property right to possess and use the licensed intellectual property.

Both finance or may be viewed as financing the acquisition and use of the software, especially if a licence agreement calls for more than one payment. The very existence of such a lease may be interpreted to convey such a licence. However, the concept of a software licence is broader than the concept of a software lease because the licence concept is not limited to usage: it can cover reproduction, distribution, etc. In addition, a software licence agreement is not always a financing vehicle. Royalty-free licences are granted in some situations where non-monetary consideration is involved.

In mass-market software products the language of the transaction and marketing invariably includes the words 'sale', 'product', 'sale price' and 'goods', and, as a consequence, a court will more likely than not imply statutory rights attaching to the sale of goods rather than the supply of resources and materials.