he old adage that “possession is ninth-tenths of the law” may not be true any longer, at least with respect to software. The US Court of Appeals for the Ninth Circuit recently held, in Vernor v. Autodesk, that an individual who purchased and then resold secondhand software was not the “owner” of that copy of the software and therefore could not resell it when the license agreement accompanying the software restricted such resale.1

Prior to the Ninth Circuit’s decision, most people probably believed that they owned the CDs or DVDs (or in earlier times, floppy disks) containing the software that they had purchased and generally could dispose of those discs as they pleased, just as with the books and movies that they purchased. Indeed, although copyright owners have exclusive rights under the Copyright Act to distribute and reproduce their works—i.e., to prevent others from doing so—those rights are limited. Significantly, the exclusive distribution right granted by copyright law is limited by the first sale doctrine, which insulates the owner of a copy of a copyrighted work from liability for copyright infringement for resale or redistribution of that copy of the work.2 However, the first sale doctrine applies only to the owner of a copy of the copyrighted work, and according to the Ninth Circuit in Vernor, “ownership” of a copy of software can be a more elusive concept than you might think.

The Facts of Vernor

The facts in Vernor were not in dispute.

Timothy Vernor purchased used copies of Autodesk’s AutoCAD software from Cardwell/Thomas & Associates, Inc. (CTA), which itself had purchased the software new. Before installing the Autodesk software, the user is required to agree to the terms of Autodesk’s software license agreement (SLA), which contains certain transfer and use restrictions. The SLA also requires that, if the software is an upgrade of a previous version, the user must destroy all copies of the previous version.

CTA had been using the Release 14 version of AutoCAD but later upgraded to the next version. After installing the latest version, however, instead of destroying its Release 14 CDs as required by the SLA, CTA made them available for purchase at an office sale. Vernor purchased these Release 14 CDs from CTA, at a substantial discount from the original price, and subsequently listed them for sale on eBay.

Autodesk learned of Vernor’s eBay listing and sent a series of notices asking eBay to take down the listing on the ground that the sale of the Release 14 CDs would infringe Autodesk’s copyright. Vernor eventually filed a declaratory relief action against Autodesk to “establish that his resales of used Release 14 software [were] protected by the first sale doctrine.”3 Because Vernor’s eBay account had been suspended due to Autodesk’s “repeated charges of infringement,” Vernor also sought damages and injunctive relief.4

Ruling on pre-trial motions prior to the completion of discovery, the district court found that Vernor’s sales were “non-infringing under the first sale doctrine and the essential step defense.”5 After discovery, the district court granted judgment on the copyright infringement claim in favor of Vernor, holding that he was an “owner” of these copies of the software for purposes of the Copyright Act.6 Autodesk’s appeal to the Ninth Circuit followed.
Licensees Are Not “Owners” Under the Copyright Act

The Ninth Circuit reversed the judgment of the district court and held that the software copies at issue in Vernor were licensed rather than sold. Thus, the licensees were not “owners” and therefore were not entitled to invoke the first sale doctrine as protection from a copyright infringement claim. Instead, their rights were dictated almost entirely by the terms of the license agreement. The Ninth Circuit set forth a three-part test to determine whether a copy of software is licensed or sold: “We hold today that a software user is a licensee rather than an owner of a copy where the copyright owner (1) specifies that the user is granted a license, (2) significantly restricts the user’s ability to transfer the software and (3) imposes notable use restrictions.”7

Applying its three-part framework, the Ninth Circuit found that Vernor was not an “owner,” as that term is used in the Copyright Act, of the copies of Release 14 that he had purchased from CTA. It concluded that (1) the SLA between Autodesk and CTA stated that CTA was to be granted only a license, (2) the SLA imposed significant transfer restrictions (such as reserving title to the software and imposing a nontransferable license), and (3) the SLA imposed notable use restrictions (such as limiting the use of the software to the western hemisphere and terminating the license if there was unauthorized copying). Because CTA was not an owner of its copies of Release 14, its sale to Vernor was not protected by the first sale doctrine, and in addition to failing to pass good title to Vernor, the transfer constituted both breach of contract and copyright infringement.

On its face, the holding appears quite sweeping and favorable to software developers. Virtually all commercial software is already accompanied by a license agreement stating that the software is “licensed, not sold” to the user. To the extent that they have not already done so, this decision may prompt more software developers to include provisions in their license agreements that restrict transfer of the software and impose “notable” restrictions on use in an effort to meet the three-part test. By establishing that the purchaser is a mere licensee, developers would be able to substantially restrict the secondary market for resale of their software and potentially capture new customers who might otherwise have purchased the software secondhand.

“Essential Step” Defense Also Unavailable

The Ninth Circuit also addressed Vernor’s contention that the persons who installed and used the copies of Release 14 sold by Vernor would be entitled to assert the “essential step” defense as protection from an infringement claim. This affirmative defense to a copyright infringement claim allows a software user who is the “owner” of a copy of a copyrighted software program to make a copy of the computer program if the new copy is “created as an essential step in the utilization of the computer program in conjunction with a machine and is used in no other manner.”8 However, having already found Vernor’s claim of ownership lacking, the Ninth Circuit had no trouble disposing of this argument. “Because Vernor was not an owner, his customers are also not owners of Release 14 copies. Therefore, when they install Release 14 on their computers, the copies of the software that they make during installation infringe Autodesk’s exclusive reproduction right because they too are not entitled to the benefit of the essential step doctrine.”9

Policy Considerations Acknowledged But Not Dispositive

The Ninth Circuit acknowledged the “significant policy considerations raised by the parties and amici on both sides.”10 On the one hand, Autodesk argued that judicial enforcement of software license agreements restricting transfers of copies of the work allowed for tiered pricing (e.g., reduced pricing for students and educational institutions), increased sales, lower prices for consumers (by spreading costs among a large number of purchasers), and a reduction in piracy. On the other hand, Vernor argued that such enforcement may force consumers to trace the chain of title to ensure that a first sale occurred and ignores the economic realities of the transactions. Several amici set forth other arguments supporting each side. Although “serious,” the Ninth Circuit noted that these
considerations did not alter its conclusion based on prior precedent, and “Congress is free, of course, to modify the first sale doctrine and essential step defense if it deems these or other policy considerations to require a different approach.”

One particular fact in Vernor that the court chose not to address, but may have influenced the court’s decision: CTA, the original purchaser of the software, sold Vernor an older version of the software after upgrading to a new version. In other words, CTA enabled the simultaneous existence of two copies of the software, the old version and the new version, in violation of the terms of the upgrade and the SLA. The Ninth Circuit mentioned this fact only in passing, and there is no reference to it at all in the district court’s opinion. Yet it could be significant. The first sale doctrine, codified before the widespread use of digital technologies, is predicated on there being a transfer of one copy of the work, for example, a physical copy of a book handed from one owner to another. CTA was entitled to only one copy of the software and instead had two.

**Vernor’s Implications**

The Ninth Circuit left some questions unanswered. For example, it did not explain how to weigh the three factors in its test, or whether any additional factors may be considered in determining whether a transaction is a license or sale. It also explicitly declined to decide the issue of which party bears the burden of proving the applicability of the first sale doctrine or the absence thereof, since the facts in the case were undisputed.

The Ninth Circuit was careful to explain how its reversal of the district court would not, as Vernor had argued, create a split among the federal appellate courts. Vernor urged in his supporting brief that reversing the district court would result in a circuit split in the interpretation of the term “owner” in § 117. William Krause sued his former employer, Titleserv, Inc., for copyright infringement for making modifications to his software program. Titleserv defended by asserting the “essential step” defense under § 117, and therefore the court was forced to consider whether Titleserv was the “owner” of a copy of the software. The Second Circuit noted that “formal title” was not “an absolute prerequisite” and instructed courts to “inquire into whether the party exercises sufficient incidents of ownership over a copy of the program to be sensibly considered the owner of the copy for purposes of § 117(a).” The Krause court relied on the totality of the circumstances in concluding that Titleserv was the “owner” of its copy of the software.

Like the Krause court, the Federal Circuit in DSC considered what circumstances gave rise to “ownership” for the purposes of § 117. The DSC Court ultimately concluded that a determination of whether a company is the “owner” of a copy of software must be made “[i]n light of the restrictions on the [licensee’s] rights in the copies.”

Some might argue that, rather than creating a circuit split, the Ninth Circuit in Vernor may have reconciled an existing split with MAI on the one hand and Krause and DSC on the other, because its three-part test overlaps with and accounts for the material factors considered both in Krause and DSC. The chart below compares the factors considered in Vernor with those outlined in Krause and DSC.

At issue in Krause was the interpretation of the term “owner” in § 117. William Krause sued his former employer, Titleserv, Inc., for copyright infringement for making modifications to his software program. Titleserv defended by asserting the “essential step” defense under § 117, and therefore the court was forced to consider whether Titleserv was the “owner” of a copy of the software. The Second Circuit noted that “formal title” was not “an absolute prerequisite” and instructed courts to “inquire into whether the party exercises sufficient incidents of ownership over a copy of the program to be sensibly considered the owner of the copy for purposes of § 117(a).” The Krause court relied on the totality of the circumstances in concluding that Titleserv was the “owner” of its copy of the software.

Like the Krause court, the Federal Circuit in DSC considered what circumstances gave rise to “ownership” for the purposes of § 117. The DSC Court ultimately concluded that a determination of whether a company is the “owner” of a copy of software must be made “[i]n light of the restrictions on the [licensee’s] rights in the copies.”

Some might argue that, rather than creating a circuit split, the Ninth Circuit in Vernor may have reconciled an existing split with MAI on the one hand and Krause and DSC on the other, because its three-part test overlaps with and accounts for the material factors considered both in Krause and DSC. The chart below compares the factors considered in Vernor with those outlined in Krause and DSC.
Comparing Vernor, Krause, and DSC

<table>
<thead>
<tr>
<th>Factors</th>
<th>Vernor</th>
<th>Krause</th>
<th>DSC</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. “Wether the copyright owner specifies that a user is granted a license.”</td>
<td>The “presence or absence of formal title may of course be a factor in this inquiry, but the absence of formal title may be outweighed by evidence that the possessor of the copy enjoys sufficiently broad rights over it to be sensibly considered its owner.”</td>
<td>While not adopting the Ninth Circuit’s “characterization of all licenses as non-owners,” it still made this a consideration, stating that “the agreements characterize the RBOCs as non-owners of the software[.]”</td>
<td></td>
</tr>
<tr>
<td>2. “Whether the copyright owner significantly restricts the user’s ability to transfer the software.”</td>
<td>“Krause never reserved the right to repossess the copies used by Titleserv and agreed that Titleserv had the right to continue to possess and use the programs forever, regardless whether its relationship with Krause terminated.”</td>
<td>“Each of the DSC-RBOC agreements limits the contracting RBOC’s rights to transfer copies of the . . . software or to disclose the details of the software to third parties.”</td>
<td></td>
</tr>
<tr>
<td>3. “[W]ether the copyright owner imposes notable use restrictions.”</td>
<td>“[Krause] agreed that Titleserv had the right to continue to possess and use the programs . . . and was similarly free to discard or destroy the copies any time it wished[.]”</td>
<td>“The agreements also prohibit the RBOCs from using the software on hardware other than provided by DSC.”</td>
<td></td>
</tr>
</tbody>
</table>

Even if a circuit split existed, however, it is not clear that this would be reason enough for the Supreme Court to grant a petition for a *writ of certiorari*. This very argument was made by the appellants in *Krause* and *DSC* in petitions to the Supreme Court, arguing that their respective decisions would exacerbate an existing split with other circuits’ interpretation of “owner” under § 117, necessitating the Supreme Court’s intervention. The Supreme Court rejected these petitions.

*Vernor* was argued on the same day as two other cases involving the first sale doctrine, *MDY Industries v. Blizzard Entertainment, Inc.* and *UMG Recordings, Inc. v. Augusto*. In *Blizzard Entertainment*, the issue was whether the use of a third-party computer program called a bot in combination with the popular World of Warcraft software constituted copyright infringement. The alleged copyright infringers defended on the ground that their actions were protected under the essential step defense. The district court held that the software at issue was licensed rather than sold, and therefore the essential step defense was unavailable. The Ninth Circuit agreed, applying *Vernor’s* three-step approach. First, the software company reserved title in the software and granted players a “non-exclusive, limited license.” Second, the software company allowed transfer of the software only under certain circumstances. Third, there were a “variety of use restrictions,” including that the software could be used only for non-commercial entertainment purposes, could not be used in cyber cafes and computer gaming centers, and users could not run any unauthorized third-party programs with the software.

The *UMG Recordings* case involved the eBay sales of CDs that were labeled for promotional use only and not for sale, a so-called “label license.” The district court held that the label license did not create an agreement between the record company and the original recipients of
the CDs and that the sales were protected by the first sale doctrine and did not constitute copyright infringement. The Ninth Circuit agreed, but on different grounds. It found that in applying the Vernor test, there was a sale, and alternatively, the Unordered Merchandise Statute created a “sale” under the first sale doctrine, once again affirming the application of the Vernor test.

The results in Vernor, Blizzard, and UMG suggest that license restrictions on transfer and use of software are likely to be more prevalent and powerful. The decision also could affect conduct in the secondary markets for all copyrighted works, not just secondhand software. It’s not difficult to imagine software-style licensing terms being attached to other kinds of works. Indeed, many copyright owners who distribute their works electronically already use technological measures to restrict transfer and use by anyone other than the original purchaser, and these measures may be backed by license agreements that also limit transfer and use, and explicitly state that the purchaser does not own the copy of the purchased work. Vernor may bolster such agreements and weaken markets for resale of secondhand copies of all types of copyrighted works, particularly those distributed electronically, whether software, music, movies, or books.

NOTES

1 Vernor v. Autodesk, 621 F.3d 1102 (9th Cir. 2010).
3 Vernor, 621 F.3d at 1105-06.
4 Vernor, 621 F.3d at 1106.
7 Vernor, 621 F.3d at 1111.
9 Vernor, 621 F.3d at 1112.
10 Vernor, 621 F.3d at 1114.
11 Vernor, 621 F.3d at 1115.
12 Vernor, 621 F.3d at 1107, n.7.
13 Vernor, 621 F.3d at 1113.
14 402 F.3d 119 (2d Cir. 2005).
15 170 F.3d 1354 (Fed. Cir. 1999).
16 Krause, 170 F.3d at 124.
17 DSC, 170 F.3d at 1360.
18 DSC, 170 F.3d at 1362.
19 Vernor, 621 F.3d at 1110.
20 Krause, 402 F.3d at 124.
21 DSC, 170 F.3d at 1361.
22 Vernor, 621 F.3d at 1110-11.
23 Krause, 402 F.3d at 124.
24 DSC, 170 F.3d at 1361.
25 Vernor, 621 F.3d at 1111.
26 Krause, 402 F.3d at 124.
27 DSC, 170 F.3d at 1361.
28 Compare Brief of Petitioner-Appellant, Krause v. Title Serv., Inc., No. 05-166, 2005 U.S. Briefs 116B, at *5 (Aug. 1, 2005) (“[T]he Second Circuit’s decision conflicts with other circuits’ construction of Section 117. The Second Circuit’s interpretation of ‘owner of a copy’ conflicts with decisions of the Ninth and Federal Circuits.”) with Brief of Petitioner-Appellant, Pulse Comm'ns, Inc. v. DSC Comm'ns Corp., No. 99-81, 1999 WL 33639928, at *17-18 (July 9, 1999) (“This Court should grant certiorari to resolve these conflicts in lower court authority and to ensure that a clear, nationally uniform analysis is employed by federal courts analyzing § 117 rights and software licenses. Absent review by this Court, the two courts that can be expected to have the greatest role in disputes of this kind—the Ninth Circuit . . . and the Federal Circuit . . . — will continue to employ divergent standards, both of which incorrectly interpret § 117[,]”) (emphasis in original).
29 At the time of the writing of this article, Vernor’s petition for a rehearing by an en banc panel of the Ninth Circuit was denied by the Ninth Circuit. Order Denying Rehearing En Banc, Vernor v. Autodesk, Inc., No. 09-35969 (9th Cir. Jan. 18, 2011). Vernor has ninety days to file an appeal to the Supreme Court. Sup. Ct. R. 13.