Software Licensing and Distribution in the EU

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Agenda

> Part 1  Licensing Issues in the EU
> Break
> Part 2  Compensation Rights of Sales Agents, Resellers and Distributors
> Part 3  Antitrust Issues
> Part 4  Choice of Law, Venue and Arbitration
European Union, as of October 2003

> 15 Member States: in alphabetical order, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the United Kingdom
European Economic Area ("EEA"), as of October 2003

> 15 EU Member States PLUS Iceland, Norway and Liechtenstein
> 15 current Member States PLUS 10 new members: in alphabetical order, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovak Republic and Slovenia = 25 in EU and 28 in EEA
Part 1

Licensing Issues in the EU
Licensing Issues in the EU

- Restrictions on the Licensor
- Enforceability of End-User License Agreements
- Selected Warranty Issues
- Software Licenses and Insolvency
Restrictions on the Licensor: Overview

> Rule of Exhaustion
> CPU Clauses (license limited for use on identified CPU or network)
> Testing, Back-up Copies and Alterations
> Reverse Engineering
Rule of Exhaustion – General Rule

> Software licensor has the right to control distribution of its software

> Once a copy of the software is sold in the EEA, should the licensor be able to restrict resale of that copy?

- General principle is that it cannot, for its rights are considered “exhausted”

- Exhaustion cannot be avoided by contract
  - CONTRAST TO U.S.: Contracts can prevent first sale doctrine from being applied
Rule of Exhaustion – Other Issues

> Rule of Exhaustion applicable only to perpetual licenses, not applicable to limited-term licenses
  - U.S.: Might not even apply to perpetual licenses, if binding agreement with licensee limits use, resale, etc.
  - UK: Standard retention of title in software agreements

> Application of the Rule for online “distribution” doubtful
  - Germany: No court decision yet, but very likely that not applicable since distribution means “physical” delivery (disputed)
  - UK: Not applicable to online transmissions
  - U.S.: No legal distinction between online and traditional distribution, but online distribution can be limited by contract or by technical means (Digital Rights Management software)

> No exhaustion regarding the right to control further rental of that copy
Rule of Exhaustion – Transfers of Copies

> Transfer of copies is valid
  
  • Germany: The validity of a clause restricting the right to transfer a perpetual software license in standard agreements is highly doubtful, but such clauses are nevertheless common
  
  • UK: Theoretical question of whether or not there is a “purchaser,” but prohibition standard practice

> Possible claim for damages against transferring party for breach of contract?
  
  • UK: In principle yes, although not yet tested
  
  • Germany: Most likely not in standard agreements, due to restrictions by German Civil Code

> CONTRAST TO U.S.: Restrictions on transferability of software are enforceable and routinely included in end-user license agreements
CPU Clauses – General Rule

> Relevance
  • Use of the software copy only on identified processor
  • No quality upgrade of the identified processor

> EU Software Directive
  • No express restriction on licensor
  • Rule of Exhaustion may apply
CPU Clauses – Specific National Rules

German Law

> Contractual obligation (CPU Clause) in standard terms may be invalid as it restricts user’s rights in an inadequate way.

> “CPU Decision” of the German Federal Court of October 24, 2002:
  
  • “CPU Clause in a limited-term license does not unreasonably restrict user rights.”

  • Decision covers limited-term licenses only; issue is not yet decided for perpetual license agreements.

English Law

> Standard retention of title in software agreements allows licensor to impose CPU clauses.

> CONTRAST TO U.S.: CPU clauses in standard, non-negotiated contracts are enforceable, unless they are unconscionable.
Testing, Back-up Copies and Alterations

> GENERAL RULE: Where necessary for the use of the software, including for error corrections, the reproduction and alteration of the software is allowed in the absence of specific contractual provisions

> IMPLICATIONS:

- Back-up copy may be made by a person having a right to use
- Observe, study or test the functioning of the software in order to determine the ideas and principles which underlie any element of the program
- These rules cannot be limited by contract

> CONTRAST TO U.S.: No such implied rights
Reverse Engineering – General Rule

Decompilation/Reverse Engineering is allowed if reproduction/translation is indispensable for interoperability with other programs.

This rule is valid provided that:

- the reverse engineering is performed by the licensee or another authorized person;
- the information has not previously been readily available to these persons;
- only those parts are decompiled that are necessary to achieve interoperability.
Reverse Engineering – Licensor’s Ability to Limit

> German and English Law

Contractual exclusion or limitation not allowed, but agreement as to support and provision of information by licensor, which could make decompilation unnecessary, may be possible.

> CONTRAST TO U.S.:

No comparable restriction on licensor’s ability to restrict reverse engineering.
Enforceability of End-User License Agreements: Overview

> Parties to End-User License Agreements

> Shrink-Wrap/Click-Wrap/Browse-Wrap Agreements
  - U.S.
  - Germany
  - UK
Parties to End-User License Agreements

Licensor

Alt. 1 (License)
(Sublicense)

Distributor/Reseller

Alt. 2 (License)

End User

Alt. 1 (License)
(Sublicense)
Reseller/Distributor as Licensee

- Advantages to Licensor:
  - B2B agreement, i.e., subject to fewer statutory restrictions/consumer protections than B2C agreements
  - No need to deal with individuals: all claims to be handled by reseller/distributor
  - Insolvency risk regarding end user is reseller/distributor’s problem
Reseller/Distributor as Licensee

> Disadvantages to Licensor:

• (1) No direct contractual relationship with the end user
  - Reseller/distributor may have little or no incentive to enforce terms against its own customers in order to protect the licensor
  - Licensor enforcing as a third-party beneficiary does not always work
    > UK Contracts (Right of Third Parties) Act 1999
Reseller/Distributor as Licensee

> (2) Licensor cannot dictate terms to Reseller/Distributor’s license to end user (directly or indirectly)

• But certain minimum copyright-related terms can be imposed

• **CONTRAST TO U.S.:** No such problem

• **However,** copyright laws provide broad criminal protection against illegal software copying for sale, hire, importation and distribution
  
  – Germany: Maximum sentence 3 years of imprisonment
  
  – England: Maximum sentence 2 years of imprisonment or an unlimited fine or both

• Distributors might have post-termination compensation claims
End-User as Licensee

Contractual relationship between licensor and end user must be established:

- Directly (via its own sales organization; sales agents; online distribution)
- Indirectly (imposed with reseller/distributor’s cooperation)
  - registration cards to be sent to licensor
  - shrink-wrap agreement
  - require end user to negotiate with licensor
  - HOWEVER, reseller/distributor may insist that product be licensed in same agreement with its own products
Shrink-wrap/Click-wrap/Browse-wrap Agreements: Terminology

> Shrink-wrap agreement:
  - Originally, formed by user opening up the plastic “shrink-wrap” surrounding computer software
  - Subsequently, applied to an agreement formed by a user’s opening and use of a product

> Click-wrap agreement:
  - Formed by user clicking on and accepting terms, either on a website or as a screen in the installation procedure for the product
  - Also referred to as “click-and-accept” or “web-wrap” agreements

> Browse-wrap agreement:
  - Formed by user visiting and/or using a website or downloading content
Enforceability of Shrink-wrap, Click-wrap and Browse-wrap Agreements in U.S.

> According to the *Ticketmaster* and *Netscape* cases, posting terms on the bottom of the first page of a website, or asking a user to read and accept terms, does not make those terms legally enforceable against users of that website.

> For those terms to constitute a legally-binding contract, the website operator must meet a two-part test:

  (1) The user must know or should have known that acceptance of those terms was a condition for using the website.
  
  • Must one set out the terms of the agreement in full?
  
  (2) The user must affirmatively manifest his or her assent to that agreement by taking a demonstrable step:
  
  • A “click-and-accept” on registration, download or ordering
  
  • “Constructive notice” probably is not enough
Enforceability of Click-Wrap, Shrink-Wrap and Browse-Wrap Agreements in U.S.

> Courts will enforce online agreements, so long as their terms are “commercially reasonable” and not otherwise unconscionable or subject to any other defense available under contract law.

- *Williams v. AOL*: Overriding two defaults; litigating in another state is too burdensome for consumer

- *Comb v. PayPal*: Court found agreement to be substantively unconscionable to consumer due to five lopsided provisions (arbitrate in far-away state; arbitrate under commercial arbitration rules; no consolidation of claims; unilateral ability of licensor to amend agreement; freezing of consumer’s account during dispute)

  - BUT courts not as sympathetic to non-consumers – *DeJohn v. .TV Corporation International*
Enforceability of Click-Wrap, Shrink-Wrap and Browse-Wrap Agreements in Germany

> No court decisions yet in Germany

> However, German contract law requires:
  - Awareness and intention to execute an agreement
  - Standard terms and provisions must be included/presented, at the very latest, when the agreement is executed

> Shrink-wrap: Not likely to be enforceable

> Click-wrap:
  - May be enforceable when online download
  - May not be enforceable when download from CD-ROM

> Browse-wrap: Not likely to be enforceable
Enforceability of Click-Wrap, Shrink-Wrap and Browse-Wrap Agreements under English Law

> Significant legal difficulties surround enforceability of shrink-wrap licenses:
  - Contract with retailer – offer/acceptance/consideration
  - Contract with manufacturer – offer/acceptance/consideration
  - Scottish law experience – Adobe case

> Click-wrap agreements avoid the problems of shrink-wrap as direct contractual relationship, provided properly concluded:
  - E-commerce Directive
  - Distance Selling Directive
  - Authority to bind
  - Terms included prior to formation
  - Outsourcing – active agents

> Non-clickable browse-wrap terms and conditions still useful to give users notice of certain facts:
  - Ownership of copyrights and trademarks
  - Data privacy
Selected Warranty Issues

> England
> Germany
> Contrast to U.S.
English Law

> The EU directive provides a mandatory two-year warranty period for consumer contracts.

> The EU directive only covers consumer software warranties, not software warranties between businesses. It is a matter for the individual member states whether they wish to regulate B2B warranties at the same time.

   • Germany has done so; however, such regulation is unlikely in the UK.

> Statutory implied terms of merchantability and fitness for purpose can be excluded between businesses.

> Limitations of liability between consumers and on standard terms limitations need to be reasonable – otherwise they are invalid.

   • Cannot exclude liability for personal injury or death caused by negligence or fraudulent misrepresentation.
Germany: Warranty Period

> Warranty Period for Perpetual License:
  - Statutory Warranty Period: **24 months** – applies if no explicit agreement or explicit agreement is void (e.g., shrink-wrap agreement); mandatory for all consumer contracts
  - For non-consumer standard agreement: **12 months**
  - The parties may freely negotiate any other term

> Warranty Period for Limited-Term License:
  - As long as the license term!
  - In standard agreements, a reduction is not enforceable

> **CONTRAST TO U.S.:**
  - No federal minimum warranty periods
  - States may theoretically impose minimum periods, but we are not aware of any that do so
Germany: Statutory Warranty Rights

- Repair of defects or replacement of software
- Reduction of the license fee (pro rata)
- Rescission/termination for cause
- Repair defects and be reimbursed by licensor (limited-term licenses)
- Compensation for damages
- May be varied by contract
CONTRAST TO U.S.: Warranty Rights

> Only rights as stated in contract
  - EXCEPTION: Magnusson-Moss federal warranty statute where written warranty on consumer goods
    - general vs. limited warranty
    - requires explicit language stating that the user may have additional rights under state law
    - state consumer protection laws may provide additional rights on a state-by-state basis

> Uniform Commercial Code (UCC) Article 2 implied warranties for sale of goods
  - Merchantability, fitness for a particular purpose, non-infringement
  - CAUTION: UCITA in Maryland and Virginia

> Product Liability
Germany: Definition of Defect

- Any negative deviation from agreed specifications
- Software cannot be used as intended by the parties
  - CONTRAST TO U.S.: Implied warranties are routinely disclaimed, subject to Magnusson-Moss language in contracts for consumer goods
- Minor defects may not cause warranty rights
- Licensee has burden of proof that software was defective when delivered/accepted (different in B2C agreements – burden of proof with licensor for the first six months after delivery)
Germany: Practical Advice

> Licensor should reserve the right to cure defects at least two times before licensee is entitled to rescind/reduce the fee.

> In negotiated agreements, right to rescind/claim damages may be excluded to a great extent.

> Try to cover warranty claims through maintenance agreement.

  • However, in standard agreements, a “double charge” (warranty and maintenance) may be void. During warranty period, a lower maintenance fee may be agreed.
Germany: Limitation of Liability

> Not possible to exclude liability for wilful misconduct or mandatory liability (e.g., Product Liability Act)
  
  • CONTRAST TO U.S.: No such general rule – subject to possible state rules and unconscionability

> In standard agreements no exclusion for:

  (1) Gross negligence

  (2) Bodily injury or death

  (3) Breaches of main obligations may only be limited to a certain degree

  • CONTRAST TO U.S.: No such exclusions corresponding to (2) and (3), although some states (California) refuse to enforce exclusion of all direct damages
Software Licenses and Insolvency

> U.S.
> Germany
> England
U.S.: Rejecting Agreements in Bankruptcy

> Under U.S. bankruptcy law, a clause purporting to allow termination of a license agreement upon either party’s seeking the protections offered by U.S. bankruptcy law is unenforceable.

  - For technical reasons (e.g., references to insolvency situations not involving federal bankruptcy filings), many U.S. license agreements retain such clauses.

> If a licensor becomes subject to a bankruptcy proceeding, the bankruptcy trustee can reject executory contracts (where both licensor and licensee have continuing obligations).

  - Generally, rejection of license agreement will be deemed to be a breach by licensor immediately prior to bankruptcy filing, for the purposes of the licensee bringing a damage claim.
  - Almost all license agreements will be considered executory, and thus subject to rejection.
    - 1988: *Lubrizol* case involved rejection of non-exclusive license
  - Applies to both exclusive and non-exclusive licenses, regardless of the length of those licenses
    - However, courts have found exclusive patent licenses to be assignments, and not executory contracts subject to rejection.
U.S.: Licensee Election to Keep License

> In response to *Lubrizol*, to protect licensees from losing critical license rights when their licensor’s contracts are rejected, a special rule was added as Section 365(n) of the Bankruptcy Code.

- Upon rejection of an intellectual property license by a bankruptcy trustee, a licensee may elect to either:
  - continue to use the license rights, waive claims against the licensor for breach of contract, and continue to pay ongoing royalties (excluding payments for the licensor’s other performance-based obligations for services, maintenance, etc.); or
  - treat the license as terminated, cease using those rights and sue licensor for damages (most likely as an unsecured creditor)
- This election does not extend to trademark licenses
  - trademark licensees may therefore request security interests in the licensed trademarks to gain leverage

> From a U.S. perspective, a licensee may still feel exposed if it is licensing from a non-U.S. party.

- Alternatives: Co-ownership rights, with pledge not to use until bankruptcy; assignment of rights, with license back to licensor; take license only from U.S. entities.
Germany: Depends on Nature of License

> Perpetual licenses
  - Remain untouched by insolvency (of the licensor or of the licensee) if the main contractual obligations have already been fulfilled

> Limited-term licenses and maintenance/support agreements:
  - No termination right of the other party if insolvency is filed
  - Insolvency receiver has option whether to fulfill contractual obligations or to terminate the agreement (statutory termination right)
    - No resulting option of licensee if agreement is terminated, as in Sec. 365(n) of U.S. Bankruptcy Act
Germany: Protection of Licensor

> Agree on termination right in case of imminent insolvency of the licensee.

- Validity of such a clause doubtful, but may be included in term license agreements/maintenance agreements.
England: Depends on Nature of License

- Unrestricted, exclusive licence – treated as akin to an assignment. Court will not uphold clause terminating license in event of insolvency.

- Restricted, exclusive licence – treated as quasi-intellectual property right. Court may nevertheless be persuaded to uphold clause terminating in event of insolvency.

- Non-exclusive licences – no intellectual property right. Court likely to uphold clause terminating in event of insolvency.

- Insolvency trustee has the right to set aside onerous agreements.
Part 2

Compensation Rights of Sales Agents, Resellers and Distributors
EU Commercial Agency Directive

> EU Directive 86/653 regarding self-employed commercial agents:

  • A self-employed intermediary who has continuing authority to negotiate the sale or the purchase of goods on behalf of a “principal,” or to negotiate and conclude such transactions on behalf and in the name of that principal.

> This would apply to sales representatives, manufacturers’ representatives and commissioned sales agents, as those terms are used in U.S. practice, even though they do not have authority to “negotiate and conclude” agreements on behalf of the principal.
EU Commercial Agency’s Directive Rules on Post-Contractual Compensation

> Compensation for having brought new customers to principal or for increasing volume of business with existing customers
  
  • Reason: Principal continues to derive benefits from business with such customers after termination

> The post-contractual compensation claim is mandatory, Art. 19. It cannot be waived by contract.

> Compensation must be equitable with regard to business won by principal/commissions lost by commercial agent.

> Maximum amount of compensation: Commissions earned in one year (calculated on average earned in the preceeding five years)
UK: Commercial Agents

> Upon termination of agreement covered by the Regulations, principal must make a payment to agent on either an indemnity or compensation basis.

  - If the agreement is silent, compensation basis will apply.

> Indemnity basis is more favorable for principal, as Regulations cap it at one year’s commission based on the annual commission over the preceding five years.
**UK: Commercial Agents**

> Compensation basis recognizes that agent may have made a lasting contribution to the principal’s goodwill.

> It is a matter for the courts to calculate what measure of compensation would be reasonable in the circumstances.

> Debate as to whether the UK implementation conforms with the EU Directive.
CONTRAST TO U.S.: Regulation of Sales Representative Agreements

- No federal legislation
- 35 states have laws regulating sales representatives, but those statutes are limited to:
  - Requiring the agreement be in writing
  - Clear definition as to how commissions are calculated
  - When commissions are paid
  - How much notice must be given when those agreements are terminated
- No comparable U.S. federal or state statutes on post-termination compensation for sales representatives
  - Conceivably, terminated sales representative could bring claim based on “good will” generation, unless disclaimed by contract
EU: Resellers and Distributors

> To the extent resellers and distributors are comparable to commercial agents, particular legal provisions on commercial agents apply (e.g., post-contractual compensation claim):

- They must be “integrated” into licensor’s distribution organization
- Licensor must be able to make use of their customer base (e.g., transfer of customer data)

> TRAP TO BE AVOIDED: When one agreement appoints an EU party both as a sales representative and distributor
CONTRAST TO U.S.: Termination of Reseller and Distribution Agreements

> No federal or state legislation on this issue

> U.S. agreements routinely disclaim post-termination compensation or indemnity when distributor is terminated pursuant to terms of agreement, whether with or without good cause

  • Routine ban on claims for indirect damages and lost profits further limits ability of reseller/distributor to recover post-termination

> These disclaimers will often be respected in European countries where 1) the agreement is governed by U.S. law and 2) the Commercial Agency Directive is not applicable to the reseller/distributor

  • Germany and UK will respect such disclaimers

  • EXCEPTIONS:
    - Benelux and Scandinavian countries
    - when reseller/distributor also qualifies as commercial agent
EU Law: Practical Advice

> Not permissible to exclude or circumvent these mandatory stipulations

> However, to reduce the risk of paying post-termination compensation when terminating sales agents, resellers and distributors covered by the Commercial Agency Directive should:

- Avoid appointing the same party as both a sales representative and reseller/distributor
- Choose U.S. governing law AND agree on U.S. venue for claims
  - This approach may not be effective in all EU countries
- Appointments should be non-exclusive; only terminate for good cause
- Document in detail all prior customers and contacts
- Consider such post-contractual compensation claims when agreeing on the commission rate
Part 3

EU Antitrust Issues
Fixing of Price and Terms and Conditions

> Article 81 of the EU Treaty

- Strictly prohibits all agreements that may affect trade between Member States and that have as their object the prevention, restriction or distortion of competition within the common market
  - in particular, prohibits agreements that directly or indirectly fix purchase or selling prices or any other trading conditions

> Consequences for software distribution:

- Licensors are not allowed to fix resale prices or require resellers/distributors to use the licensor’s terms and conditions
  - any such agreement would be void in the EU
    > may impact the choice of alternative methods for implementing End-User License Agreements

- CONTRAST TO U.S.: Can’t fix minimum resale prices, but can impose licensor’s terms and conditions
Other EU Antitrust Issues

> Non-competition covenants

> Field of use and territorial limitations

> Applying dissimilar conditions to equivalent transactions, thereby placing parties at a competitive disadvantage

> Making the execution of the contract subject to acceptance of supplementary obligations that have no connection with the subject of such contract
Exceptions from EU Antitrust Rules

> By an individual decision from the EU commission
  - Impending procedural change as of May 2004
  - No more notification to EU Commission required to obtain antitrust clearance, but company’s own review is now required

> De minimis rule

> By a Block Exemption Regulation (safe harbor)
  - Technology Transfer Block Exemption
  - Vertical Agreements Block Exemption
  - Research and Development Block Exemption
Part 4
Choice of Law, Venue and Arbitration
Choice of Law: Common Alternatives

> U.S.
  • Licensor’s state
  • Neutral state (e.g., New York, subject to certain threshold requirements)
> Local law of licensee (e.g., German or English law)
> Neutral law of a third country
  • Connection to selected country (?)
  • Will automatically apply, in lieu of normal commercial code rules, to U.S.-German parties, unless explicitly excluded by the parties
  • Will not apply to U.S.-UK agreements
Reasons for Proposing U.S. Law

> Habit/customs

> Standard agreements developed based on U.S. law

> Ease of administration:
  - Having all of your agreements governed under the same laws
  - Consistency of application

> Leverage in disputes

> Avoid some mandatory law (e.g., German law on general contract terms)
Reasons for Accepting Local Law

> Required by customers in the market
> U.S. law may not be applied when contrary to local public policy (e.g., consumer protection laws)
> Ease of enforceability before local courts (especially in seeking preliminary injunctions)
Place of Jurisdiction/Arbitration

> Advantages of U.S. venue
  - See discussion on choice of law
  - Costs
  - Logistics – avoid travel time
  - U.S. jury trials (?)

> Reasons for accepting non-U.S. venue
  - See discussion on choice of law
  - Avoid difficulties in enforcing U.S. court judgments.
  - Limited pre-trial discovery; no depositions

> Arbitration or litigation?
  - Easier to enforce arbitration awards
  - Arbitrators tend to “split the difference”
Jurisdiction: Practical Advice for Germany

If German courts have jurisdiction, draft license agreements in English and German (two columns), but German version should prevail.

• German courts generally do not accept documents provided in any language other than German.
Arbitration: Common Alternatives

> International Chamber of Commerce (ICC):
  - Expensive – arbitrators charge based on amount in dispute

> American Arbitration Association (AAA)

> German Institute of Arbitration (DIS)

> London Court of International Arbitration (LCIA)

> Compromises:
  - Location: See discussion on venue above
    - Compromise on location: Arbitration occurs in home city of party which did NOT initiate arbitration
    - EXCEPTION: Not with Asian parties

> Practical advice: Avoid multi-party arbitration
Conclusions

> Licensee has a much stronger position based on mandatory EU law

> Local contract law may refuse to enforce certain provisions in U.S. standard license agreements

> Contractual relationships with resellers/distributors vis-a-vis end users should be reconsidered

> Be aware of antitrust traps in the EU
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