

**WALL DATA INC. V. LOS ANGELES
COUNTY SHERIFF'S DEPARTMENT:
LICENSE VERSUS SALE AT THE CROSSROADS
OF CONTRACT AND COPYRIGHT**

By Christopher B. Yeh

Technological innovation poses a unique challenge to the traditional framework of copyright.¹ When Congress made the decision to incorporate computer software into the existing copyright framework, some questioned whether copyright would provide adequate protection for a form of expression distinct from “traditional” forms of expression like print and artistic works.² Since then, software developers’ use of software licenses as a means of maintaining control over their exclusive rights raises questions about the extent to which rights provided by those licenses may conflict with, and to some extent preempt, copyright doctrine. The software industry insists that it is possible to “contract out” of limits on copyright protection such as fair use, reverse engineering, and essential step,³ while

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1. See, e.g., Ernest Miller & Joan Feigenbaum, *Taking the Copy Out of Copyright, in Security and Privacy in Digital Rights Management: ACM CCS-8 Workshop DRM 2001*, Philadelphia, PA, USA, November 5, 2001. Revised Papers 233, 244 (Tomas Sander ed., 2002), available at <http://www.springerlink.com/content/y57pk5487ymrdqk8/fulltext.pdf>.

2. See, e.g., Stacey L. Dogan & Joseph P. Liu, *Copyright Law and Subject Matter Specificity*, 61 N.Y.U. ANN. SURV. AM. L. 203, 207 (2005) (“CONTU recognized that the pairing [of copyright and software] might present challenges for the law, but suggested that the flexibility of copyright doctrine would allow for accommodation to software’s unique character.”); Michael A. Dryja, *Looking to the Changing Nature of Software for Clues to Its Protection*, 3 U. BALT. INTELL. PROP. L.J. 109 (1995) (“Since the first judicial decisions on the legal protection of computer software more than twenty years ago, the appropriate mechanism for the protection of computer software, patent or copyright, has been a point of debate in the legal community.”); Bruce Abramson, *Promoting Innovation in the Software Industry: A First Principles Approach to Intellectual Property Reform*, 8 B.U. J. SCI. & TECH. L. 75, 80 (2002) (describing the contentious debate leading to the decision to protect software through copyright).

3. See, e.g., Raymond T. Nimmer, *Breaking Barriers: The Relation Between Contract and Intellectual Property Law*, 13 BERKELEY TECH. L.J. 827, 882-86 (1998) (arguing that first sale and fair use may be non-infringing under copyright but precluded by contract); Christian Nadan, *Software Licensing in the 21st Century: Are Software “Licenses” Really Sales, and How Will the Software Industry Respond?*, 32 AIPLA Q.J. 555, 653 n.324 (2004) (noting confusion in case law regarding fair use and reverse engineering); David Nimmer, Elliot Brown & Gary N. Frischling, *The Metamorphosis of Contract*

others disagree.⁴ Ultimately, these arguments come to a head in an ongoing debate over whether software contracts may be construed as licenses or sales.

This tension between contract and copyright is evident in the Ninth Circuit's decision in *Wall Data Inc. v. Los Angeles County Sheriff's Department*.⁵ Viewed in the context of the ongoing "license versus sale" debate against which *Wall Data* is set, the Ninth Circuit's ruling against the Los Angeles County Sheriff's Department ("LASD") ultimately favors those on the side of licensing. This pro-license tilt is apparent in the court's analysis of fair use and essential step, and in the court's recognition of the debate (despite its refusal to fully engage in it). The court's ruling is significant to the extent that it adds one more voice to the growing consensus that software agreements should be interpreted as licenses rather than sales.

Part I of this Note explains copyright and licensing protection for software, the basic principles underlying software licensing, and key arguments and court decisions that fuel both sides of the license versus sale debate. Part II provides the factual and procedural background of *Wall Data*, as well as a summary of the Ninth Circuit's holding. Part III analyzes the Ninth Circuit's reasoning in *Wall Data*, and identifies its role in the greater license versus sale debate.

I. PROTECTION FOR SOFTWARE

Most computer software is protected by both copyright and contract,⁶ which together serve as two distinct yet overlapping means of enforcing the software developer's rights in the product.⁷ Copyright provides one layer of protection by creating enforceable property rights in the work, though that protection is also subject to exceptions like fair use and the first sale doctrine.⁸ Software contracts, which most often take the form of software licenses, allow the software developer to expand protection for the software product beyond that provided by copyright through terms and

into Expand, 87 CALIF. L. REV. 17, 30, 35 n.49, 63-68 (1999); Robert W. Gomulkiewicz, *The License is the Product: Comments on the Promise of Article 2B for Software and Information Licensing*, 13 BERKELEY TECH. L.J. 891, 901-03 (1998).

4. See Gomulkiewicz, *supra* note 3, at 186 (concluding licensing does not avoid first sale); see also Nimmer, Brown & Frischling, *supra* note 3, at 30-31 (stating that essential step and fair use should apply to licensed software).

5. *Wall Data Inc. v. L.A. County Sheriff's Dep't*, 447 F.3d 769 (9th Cir. 2006).

6. See Nadan, *supra* note 3, at 557.

7. See R. Nimmer, *supra* note 3, at 844.

8. See *id.* at 844, 880.

restrictions tailored to the specific circumstances of a given transaction.⁹ The scope of these overlapping protections has generated an ongoing debate, however, especially with regard to the first sale doctrine. Generally, courts have held that software contracts should be interpreted as licenses rather than sales, but a few notable outliers have challenged this dominant view.¹⁰

A. The Need to “Protect” Software

In copyright law, a “license” is the transfer of anything less than a totality of a work.¹¹ Thus by definition, a license grants a licensee less than the total bundle of intellectual property rights possessed by the copyright holder.¹² In the context of computer programs, software licenses take the form of contracts which grant “nonexclusive authorizations for use subject to agreed terms and conditions.”¹³ The “law draws a sharp distinction between an ‘exclusive’ license, which is considered a transfer of copyright ownership, and a ‘nonexclusive’ license,” in which the licensor retains ownership.¹⁴

In the software industry, almost all software is licensed rather than sold (i.e. transferred with full ownership).¹⁵ This is due to the ease with which software can be reproduced, as well as the structure of the market for software. In terms of ease of reproduction, software can be quickly and

9. *See id.* at 844-45, 853. A myriad of issues may arise in a business transaction, including product issues, liability issues, and performance issues, all of which fall within the realm of contracts, and none of which would be within the scope of a copyright regime, which is only concerned with granting or withholding certain rights. *Id.* at 835.

10. RAYMOND T. NIMMER, *LAW OF COMPUTER TECH.* § 1:112 (2006) (“The very few lower court cases that hold to the contrary [that software is sold rather than licensed] are outside the mainstream and inconsistent with commercial practice. Among the few courts that have suggested this result, two were reversed on appeal . . . [and] two were vacated[.]”) [hereinafter *LAW OF COMPUTER TECH.*]; *see also* Deanna L. Kwong, *The Copyright-Contract Intersection: SoftMan Products Co. v. Adobe Systems, Inc. & Bowers v. Baystate Technologies, Inc.*, 18 *BERKELEY TECH. L.J.* 349, 358 (2003) (“There are only a few lower court cases holding that copies of software are sold. The majority of courts conclude that copies of software are licensed.”).

11. *CORPUS JURIS SECUNDUM COPYRIGHT* § 27 (West 2007) [hereinafter *CORPUS JURIS SECUNDUM COPYRIGHT*].

12. IAN BALLON, *E-COMMERCE & INTERNET LAW* § 21.02 (West LegalWorks 2001).

13. David A. Rice, *Licensing the Use of Computer Program Copies and the Copyright Act First Sale Doctrine*, 30 *JURIMETRICS J.* 157, 158 (1990).

14. *CORPUS JURIS SECUNDUM COPYRIGHT*, *supra* note 11. Hereinafter, all references to “licenses” or “licensing” will be in reference to the nonexclusive license, which does not grant ownership to the licensee.

15. Nadan, *supra* note 3, at 557.

easily duplicated at a nominal cost, for instance, that of a blank data CD.¹⁶ Software can also be distributed with relative ease due to the myriad of available programs that facilitate the movement of large amounts of data over the internet.¹⁷ While the exclusive rights provided by copyright provide some means for software developers to safeguard their product, they do not always serve as an adequate deterrent due to the ease of duplication and reproduction, as well as the impracticality of pursuing litigation against thousands or millions of infringers—many of whom lack substantial financial resources.¹⁸

Licenses form an integral part of the software industry's business model because they provide a means to get around the first sale doctrine¹⁹ and thus control (and in some cases prevent) subsequent transfers of the software that would otherwise interfere with a functioning software market.²⁰ The first sale doctrine within copyright law extinguishes the copyright holder's right to control subsequent use and distribution of a copyrighted work once it has been sold.²¹ If a developer is unable to avoid the doctrine through contract, this may substantially limit a software developer's ability to profit from its product, which may in turn decrease the affordability or availability of the product to the public.²² For example, different commercial customers, possessing the need to deploy the software on varying degrees of scale, may be willing to pay more or less than other consumers for the exact same software product.²³ By controlling distribution, developers can maximize revenue from their software product by en-

16. See, e.g., *Adobe Sys. Inc. v. Stargate Software Inc.*, 216 F. Supp. 2d 1051, 1059 (N.D. Cal. 2002).

17. Examples of this kind of software include BitTorrent, KaZaA, and other peer-to-peer file sharing programs. See David Operbeck, *Peer-to-Peer Networks, Technological Evolution, and Intellectual Property Reverse Private Attorney General Litigation*, 20 BERKELEY TECH. L.J. 1685 (2005); Andrew J. Lee, Note, *MGM Studios, Inc. v. Grokster, Ltd. & In re Aimster Litigation: A Study of Secondary Copyright Liability in the Peer-to-Peer Context*, 20 BERKELEY TECH. L.J. 485 (2005).

18. Michael B. Rutner, *The Ascap Licensing Model and the Internet: A Potential Solution to High-Tech Copyright Infringement*, 39 B.C. L. REV. 1061 (1998) ("Those who can locate infringers often find that the infringers lack the financial resources to make legal action worthwhile."); see also Ian C. Ballon, *Pinning the Blame in Cyberspace: Towards a Coherent Theory for Imposing Vicarious Copyright, Trademark and Tort Liability for Conduct Occurring Over the Internet*, 18 HASTINGS COMM. & ENT. L.J. 729, 735 (1996) (stating that on-line infringers tend to be judgment-proof as a result of being too young or poor to satisfy a judgment award).

19. See BALLON, *supra* note 12, § 21.02.

20. See Nadan, *supra* note 3, at 573-74.

21. See BALLON, *supra* note 12, § 21.02.

22. See Nadan, *supra* note 3, at 567-70.

23. See *id.* at 557.

sure that different end users are charged differently according to their use.²⁴ If they were deprived of this means to control subsequent transfers, the developers' attempt to price discriminate would be thwarted through arbitrage.²⁵

Licenses solve this problem because the first sale doctrine only allows "owners" of a copy of a copyrighted work to transfer the work without permission, and since a license grants less than full "ownership," the first sale doctrine does not protect licensees.²⁶ Licenses allow a software company to market a software product targeted at single-user markets separately from products for use in multi-user commercial networks, and accordingly charge different prices, even though the software product itself is identical in both cases.²⁷ If the software developer were subject to the first sale doctrine, it would not be permitted to contractually distinguish what rights it grants or withholds, thus forcing it to sell only one package of rights: full ownership of the software.²⁸

24. *See id.* at 559, 567-72.

25. In the hands of a large number of users, it would be difficult to maintain the separation across different market segments without the restrictions on use that licenses provide. *Id.* at 568. Without the legal safeguard that licenses provide, "market seepage" would force software developers to compete against themselves, while those who have purchased the software at the lower price level offer to resell the software to large-scale entities for less than the software developer's price. *Id.*

26. *ISC-Bunker Ramo Corp. v. Altech, Inc.*, 765 F. Supp. 1310, 1331 (N.D. Ill. 1990) ("[A] copyright holder does not lose his right to control distribution of copies of his work that have never been sold. Thus, given the substantial evidence that [defendant] only licensed and did not sell its copyrighted software, the first sale doctrine has no application . . . as a matter of law.").

27. This ability of a single copy of software to be marketed as separate products with different sets of rights as provided for by different licensing terms means that, in essence, the licenses themselves are the product. The same copy of software is often marketed to several different end-users or market segments. By allowing or disallowing different types of uses, licenses create different packages of rights. This ability to segment the market and price discriminate creates a situation where, rather than choosing among different software programs, consumers choose among different packages of use. R. Nimmer, *supra* note 3, at 841-42. This key distinction sets computer software apart from traditional tangible goods. Indeed licenses, rather than the software, are the product around which the software industry is built. Gomulkiewicz, *supra* note 3, at 896; *see* Nadan, *supra* note 3, at 558, 567-72, 588; *see also* Frank Easterbrook, *Contract and Copyright*, 42 HOUS. L. REV. 966, 968 (2005) ("Contract terms are product attributes, no different functionally from the quality of a car's tires.").

28. *See* Nadan, *supra* note 3, at 567-68. It has been argued that this "one-size-fits-all" transaction model would increase product prices while decreasing variety and choices available to consumers. *See* Gomulkiewicz, *supra* note 3, at 903.

Software licensing's ability to avoid the first sale doctrine also allows software developers to control downstream transfers of the software.²⁹ A licensee cannot transfer more rights than she received, since the licensing limitations run with the software and bind every subsequent transferee.³⁰ Thus, even if an end-user successfully redistributes the software to a subsequent transferee, that transferee would have no greater rights than the original end user possessed.³¹ If a subsequent transferee exceeds the scope of the license, even if unknowingly or in good faith, that transferee is liable for copyright infringement because contractual privity and intent are irrelevant to a copyright infringement claim.³² Thus, assuming that a license does not permit distribution, it is impossible for end users to sell their licensed copy or copies of a given piece of software without infringing the software company's copyright.³³ This ability to ensure that restrictions survive through several transfers of possession enables the software creator to use multiple tiers of distribution, without the need to have a contractual relationship with everyone in the chain, and with the confidence that its product will not be transferred without permission.³⁴

B. License versus Sale and the Intersection of Copyright and Contract

Software licenses and copyright law share an uneasy coexistence; aspects of each both reinforce and conflict with the other. On one hand, software licenses are ineffective without a copyright law that defines authorship and creates exclusive property rights for them to enforce,³⁵ and contracts are necessary to identify the infinitely divisible property rights granted by copyright and separate them into spheres of exploitation.³⁶ At the same time, software licenses may conflict with copyright in cases where it provides contractual software protection that closely resembles the exclusive rights provided by copyright, or expressly provides for ex-

29. See *Nadan*, *supra* note 3, at 578 ("For example, if a licensee receives an 'educational use only' license to a copy of software, she cannot use it for other purposes, and all subsequent transferees would have no greater rights than she had.").

30. See, e.g., *Adobe Sys. v. One Stop Micro, Inc.*, 84 F. Supp. 2d. 1086, 1092-93 (N.D. Cal. 2000) (holding that transferee was bound by restrictions of original agreement).

31. See *Nadan*, *supra* note 3, at 578-79.

32. *Id.* at 579-80; see also 17 U.S.C. § 501(a) (2006).

33. See *Nadan*, *supra* note 3, at 566.

34. See *id.* at 580-83.

35. See *Nimmer, Brown & Frischling*, *supra* note 3, at 63 ("If a copyright owner contracts to exploit a work up to the limits of his constitutionally and congressionally conferred monopoly, he is acting legitimately.").

36. *Id.* at 24-26, 63.

emptions to traditional copyright defenses like the first sale doctrine.³⁷ Within this context, the legal community continues to debate the extent to which licenses may take precedence over copyright. Some argue that copyright is nothing more than a default legal regime, where express license terms can “contract out” of those rules.³⁸ Others argue that copyright law embodies certain fundamental rights and protections that should continue to carry weight even in the face of contractual relationships to the contrary.³⁹

1. *Software Licenses: Copyright and Contract*

The license versus sale debate is a subset of the larger discussion about the complimentary yet conflicting nature of contract and copyright. The debate concerns the extent to which software licenses can contract out of the first sale doctrine, which in turn implicates everything from contract interpretation issues to the § 117 essential step defense, which specifies that only owners may exercise the defense or make legal backups of software.⁴⁰ The predominant view takes the position that given the integral and essential role licensing plays in underpinning the software industry’s business model, the only practical way to ensure the continued viability of that model is with licenses.⁴¹ Critics argue that despite the myriad of practical rationales for software licensing, the literal terms of most software licensing agreements suggest a sale rather than a license.⁴²

Supporters of software licensing point to the diversity and complexity of issues that face the software industry, and suggest that no other scheme

37. See R. Nimmer, *supra* note 3, at 861-62, 882.

38. See, e.g., *id.* at 844-45.

39. See, e.g., Nimmer, Brown & Frischling, *supra* note 3, at 50-63.

40. Notwithstanding the provisions of section 106, it is not an infringement for the owner of a copy of a computer program to make or authorize the making of another copy or adaptation of that computer program provided . . . that such a new copy or adaptation is created as an essential step in the utilization of the computer program in conjunction with a machine and that it is used in no other manner, or . . . that such new copy or adaptation is for archival purposes only and that all archival copies are destroyed in the event that continued possession of the computer program should cease to be rightful.

17 U.S.C. § 117(a).

41. Early cases deferred to the software owner’s characterization of the transaction without much examination. See Nadan, *supra* note 3, at 590-604. This “consensus” continued, for the most part, with courts upholding the license classification, until the *SoftMan* decision in 2001. *Id.* at 609. For further discussion of *SoftMan*, see *infra* Section I.B.2.

42. See, e.g., Microsoft Corp. v. DAK Indus. (*In re DAK*), 66 F.3d 1091, 1096 (9th Cir. 1995) (discussing the “economic realities” doctrine).

besides licensing can bring such a degree of flexibility and nuance to a transaction.⁴³ Countless issues may arise in a given business transaction (including product issues, liability issues, and performance issues) that do not fall within the scope of a copyright regime, which is only concerned with granting or withholding certain rights.⁴⁴ The key rationale, however, for supporting a licensing regime is concern for preservation of the software industry's business model. The first sale doctrine is the bane of the business model because it prevents software developers from controlling subsequent transfers of their product, which in turn prevents them from generating revenue from it.⁴⁵ Indeed, given that the licenses themselves rather than the software are the object of the transaction,⁴⁶ proponents insist that it is absolutely necessary that licenses be employed to avoid the doctrine.⁴⁷

Critics of software licenses emphasize the overriding public policy interest embodied in the Copyright Act to uphold the "delicate balance" between the rights of the consumer and the content creator.⁴⁸ Some critics are wary of software contracts, regarding them as a means for companies to "tip the balance" by expanding their exclusive rights at the expense of the end user's freedom and flexibility.⁴⁹ Critics express concern that acceptance of a blanket ability to contract out of copyright doctrines would allow copyright holders to perform an "end-run" around other traditional protections, like fair use, that were instituted by Congress to counterbalance the exclusive rights granted by copyright.⁵⁰

43. See, e.g., R. Nimmer, *supra* note 3, at 888 ("The idea that property rights law, with its concentration on vested rights and positions stated against third parties, can ever provide an adequate template for the complex and increasingly diverse information economy borders on the absurd and certainly entertains the impossible.").

44. *Id.* at 835.

45. Nadan, *supra* note 3, at 567-70.

46. Gomulkiewicz, *supra* note 3, at 896; see Easterbrook, *supra* note 27, at 968.

47. See Nadan, *supra* note 3, at 567-68.

48. Nimmer, Brown & Frischling, *supra* note 3, at 43.

49. See Gomulkiewicz, *supra* note 3, at 900.

50. Nimmer, Brown & Frischling, *supra* note 3, at 43, 55. These concerns are magnified by their concern that many EULAs (including shrink-wrap licenses) are adhesion contracts that threaten to impose unconscionable terms on consumers. See Easterbrook, *supra* note 27, at 968; see also R. Nimmer, *supra* note 3, at 847. Their concern that consumers are bound by these contracts, often unwittingly and with no chance for negotiation, by virtue of merely installing the software or even opening the box, opens the door for abuse by the copyright owner. This potential for abuse challenges one of the basic assumptions of licensing: as a bargained-for exchange, licensees should not be able to protest the terms. See Easterbrook, *supra* note 27, at 969.

2. License versus Sale: Restrictive Terms and Economic Realities

In recent years, the arguments of both proponents and critics of software licensing have been weighed and considered in several court decisions dealing with the question of license versus sale and the scope of ownership rights associated with subsequent transferees of software.⁵¹ This Section discusses those decisions and extracts several distinct themes that have arisen from them.

The presence of terms in the agreement that restrict the rights of the end user signals that a software agreement confers a license rather than a sale. The leading case for this principle is *MAI Systems Corp. v. Peak Computer, Inc.*, where Peak copied MAI's software from removable media to the computer's RAM by simply turning on the computer for the purposes of repair.⁵² The Ninth Circuit held that Peak could not employ the § 117 essential step defense because it was not an "owner" of the software within the meaning of the statute.⁵³ Unfortunately, the court did not elaborate on why it deemed Peak was a licensee rather than an owner, a move that has been widely criticized.⁵⁴

The Ninth Circuit's holding in *MAI* was reiterated, albeit with more sound reasoning, in *DSC Communications Corp. v. Pulse Communications, Inc.*⁵⁵ In *DSC*, the Federal Circuit had to determine whether Pulsecom's interface cards violated the software copyright in DSC's telecommunication switching system.⁵⁶ Every time DSC's communications device

51. All of these cases have been decided within the last 15 years. See *MAI Sys. Corp. v. Peak Computer, Inc.*, 991 F.2d 511 (9th Cir. 1993); *Microsoft Corp. v. DAK Indus. (In re DAK)*, 66 F.3d 1091 (9th Cir. 1995); *DSC Coms. Corp. v. Pulse Commc'ns, Inc.*, 170 F.3d 1354 (Fed. Cir. 1999); *Adobe Sys. Inc. v. One Stop Micro, Inc.*, 84 F. Supp. 2d 1086 (N.D. Cal. 2000); *SoftMan Prods. Co. v. Adobe Sys. Inc.*, 171 F. Supp. 2d 1075 (C.D. Cal. 2001); *Adobe Sys. Inc. v. Stargate Software Inc.*, 216 F. Supp. 2d 1051 (N.D. Cal. 2002).

52. *MAI*, 991 F.2d 511.

53. *Id.* at 519 n.5.

54. The court appeared to take it as a given that Peak was a licensee rather than an owner, leaving a significant gap in reasoning with respect to the distinction between the owner of the copyright in the software (which is usually licensed) versus the owner of the media containing the software (which is usually owned). Thus, the *MAI* court did not foreclose the possibility that a copyright owner could license the software to the end user, while the end user retained ownership rights over the *copy* of software. See 2 MELVILLE B. NIMMER & DAVID NIMMER, NIMMER ON COPYRIGHT § 8.08[B][1]; cf. *Wall Data Inc. v. L.A. County Sheriff's Dep't*, 447 F.3d 769, 786 n.9 (9th Cir. 2006).

55. *DSC*, 170 F.3d 1354.

56. *Id.* at 1359 ("DSC's theory of contributory infringement is that each time an RBOC powers up a Pulsecom POTS card in one of its Litespan systems, it directly in-

was activated, it copied DSC's proprietary firmware into the resident memory of Pulsecom's third-party interface card. DSC claimed this violated its exclusive right of reproduction.⁵⁷ In its defense, Pulsecom argued that it was entitled to the § 117 essential step defense, which required the court to determine whether Pulsecom was an "owner" of the firmware within the meaning of the statute.⁵⁸ The Federal Circuit ultimately rejected the defense, holding that the lower court erred in ruling, as a matter of law, that Pulsecom was an owner.⁵⁹ In relying on *MAI*, the Federal Circuit in *DSC* provided a fuller explanation of the Ninth Circuit's reasoning:

[T]he agreement between MAI and Peak . . . imposed more severe restrictions on Peak's rights with respect to the software than would be imposed on a party who owned copies of software subject only to the rights of the copyright holder under the Copyright Act. And for that reason, it was proper to hold that Peak was not an 'owner' of copies of the copyrighted software for purposes of section 117.⁶⁰

The court's reasoning turned on the fact that the agreement between DSC and Pulsecom, like that between MAI and Peak, "imposed severe restrictions."⁶¹ The agreement's conditions required, among other things, that the end user not disclose or make the software available without DSC's express written consent, and required that end users could not use the software on any hardware other than that provided by DSC.⁶² The court held that these conditions "substantially limit[ed] the rights of [end users] compared to the rights they would enjoy as 'owners of copies' under the Copyright Act," and thus supported characterizing them as "non-owners."⁶³

Adobe Systems Inc. v. One Stop Micro, Inc.,⁶⁴ a district court case and the first case in the "Adobe Trilogy,"⁶⁵ invoked the "restrictive terms" rea-

fringes DSC's POTS-DI software copyright by copying the POTS-DI software from the Litespan into the resident memory of a Pulsecom POTS card.").

57. *Id.* at 1358-59.

58. *Id.* at 1359-61.

59. *Id.* at 1362.

60. *Id.* at 1360.

61. *Id.* at 1360.

62. *Id.* at 1361.

63. *Id.* at 1361-62. The court did not hold "owner" and "licensee" to be mutually exclusive categories. *Id.* at 1360 ("We therefore do not adopt the Ninth Circuit's characterization of all licensees as non-owners.").

64. *One Stop*, 84 F. Supp. 2d 1086.

65. The "Adobe Trilogy" refers to three district court actions brought by Adobe against intermediate resellers of its software in which district courts were tasked with determining whether Adobe's sales agreements with the resellers constituted a license or

soning of *DSC* and *MAI*.⁶⁶ In *One Stop*, a district court again faced the issue of whether the agreement between Adobe and an intermediate distributor of its software constituted a license or sale.⁶⁷ The court ultimately held that Adobe licensed rather than sold its software.⁶⁸ The key to the court's reasoning was the fact that the agreement possessed restrictions that conveyed less than ownership.⁶⁹ The court also found that other elements in the software agreement suggested a license rather than sale: the terms stated explicitly that end-users were only granted a license to use the software.⁷⁰ Though no mention was made of intermediate distributors, the court reasoned that "[i]t would be incongruous to conclude that educational resellers are owners of the Adobe educational versions, while the end users who the resellers distribute to are granted a mere license."⁷¹ The court also looked to industry practice, noting that even though the agreement used words like "sale" and "buy," the dominant practice in the software industry was to license the software.⁷²

An alternative means courts have used for determining whether a license exists is to look at the "economic realities" of the software transaction.⁷³ The economic realities test was established in *Microsoft Corp. v. DAK Industries, Inc.*, a Ninth Circuit case in which DAK Industries

sale. *Adobe Sys. Inc. v. One Stop Micro, Inc.*, 84 F. Supp. 2d 1086 (N.D. Cal. 2000); *SoftMan Prods. Co. v. Adobe Sys. Inc.*, 171 F. Supp. 2d 1075 (C.D. Cal. 2001); *Adobe Sys. Inc. v. Stargate Software Inc.*, 216 F. Supp. 2d 1051 (N.D. Cal. 2002). The three district court cases all featured similar fact patterns (that of a distributor reselling the software manufacturer's product in violation of the distribution agreement). In two of the three (*One Stop* and *Stargate*), the district court held that the agreement constituted a license rather a sale. *One Stop*, 84 F. Supp. 2d 1086; *Stargate*, 216 F. Supp. 2d 1051. *SoftMan* was the only case of the three to hold that the sales agreement constituted a sale rather than a license. 171 F. Supp. 2d 1075. For more on the Adobe Trilogy, see Nadan, *supra* note 3, at 604-22.

66. *One Stop*, 84 F. Supp. 2d at 1091 ("These numerous restrictions imposed by Adobe indicate a license rather than a sale because they undeniably interfere with the reseller's ability to further distribute the software.").

67. *Id.* at 1089-90.

68. *Id.* at 1092.

69. *Id.* at 1090-91.

70. *Id.*

71. *Id.* at 1091.

72. *Id.*

73. See, e.g., *Microsoft Corp. v. DAK Indus.*, 66 F.3d 1091, 1096 (9th Cir. 1995) ("For these reasons, the economic realities of this agreement indicate that it was basically a sale, not a license to use."); *SoftMan Prods. Co. v. Adobe Sys. Inc.*, 171 F. Supp. 2d 1075, 1085 (C.D. Cal. 2001) (holding that the economic realities of the transaction suggested a sale, even though it was labeled a "license"); cf. *LAW OF COMPUTER TECH.*, *supra* note 10, § 1.24[1], at 1-143 to 1-144.

("DAK"), a bankrupt software and hardware vendor, owed money to Microsoft for software it had procured and distributed under an agreement the two had entered.⁷⁴ DAK continued to distribute the software even after it filed for bankruptcy, which in turn prompted Microsoft to petition for administrative expenses as a result of these sales.⁷⁵ Whether or not DAK owed a debt to Microsoft for the software turned on whether the sales agreement could be categorized as a sale or license.⁷⁶ To determine this key question, the Ninth Circuit looked to the "economic realities of th[e] particular arrangement."⁷⁷ After an analysis of the circumstances of the transaction, the court ruled that the sales agreement constituted a sale, not a license.⁷⁸ The pricing structure of the agreement, the fact that DAK received full rights under the agreement when the term commenced, and the fact that the agreement granted DAK "a right to sell" the software rather than "permission to use" it were all features of the agreement that persuaded the court that the agreement constituted a sale.⁷⁹

Critics of software licenses have used the economic realities test to argue that software agreements constitute sales rather than licenses, despite even the existence of restrictive terms.⁸⁰ This reasoning was employed in the district court case *SoftMan Products Co. v. Adobe Systems Inc.*⁸¹ In *SoftMan*, a district court held that Adobe's agreement with SoftMan Products ("SoftMan"), a software reseller, constituted a sale rather than a license, and that consequently, SoftMan was an "owner" of Adobe's software.⁸² The court reached this conclusion principally by adopting the economic realities test in *DAK* as its primary paradigm for judging Adobe's agreement.⁸³ It also downplayed the express terms of the license, endorsing the view that "[o]wnership of a copy should be determined based on the actual character, rather than the label, of the transaction by which the user obtained possession. Merely labeling a transaction as a lease or li-

74. *DAK*, 66 F.3d at 1092-93.

75. *Id.* at 1093.

76. *Id.* at 1094-95.

77. *Id.* at 1095.

78. *Id.*

79. *Id.* at 1095-96.

80. See, e.g., LAW OF COMPUTER TECH., *supra* note 10, § 1.24[1], at 1-143 to 1-144 (arguing that in a situation where a copy of a software program is transferred for a single payment and for an unlimited term, the transferee should be considered an owner of the copy of the software program regardless of other restrictions on his use of the software).

81. *SoftMan*, 171 F. Supp. 2d at 1084-85. *SoftMan* was the second case in the Adobe Trilogy.

82. *Id.* at 1089.

83. *Id.* at 1084-85.

cense does not control.”⁸⁴ *SoftMan* explicitly rejected the analysis of *One Stop*, refusing to find that a given agreement constituted a license just because the agreement labels itself a license, and instead opted to focus on the “substance” of the agreement through the economic realities test.⁸⁵ A number of circumstances suggested to the court that the economic realities suggested a sale: Adobe’s agreement provided for the purchaser to obtain a single copy of the software for a single price, which the purchaser paid at the time of the transaction in exchange for possession of the software for an unlimited period of time.⁸⁶ Additionally, the agreement transferred Adobe’s software with title and “risk of loss,” features that the court believed characterized a sale.⁸⁷

DAK and *SoftMan*’s rulings that the economic realities of a license should be used to determine sale or license were disputed in subsequent cases.⁸⁸ The Federal Circuit in *DSC* downplayed the concept of economic realities (such as a single payment for perpetual right of possession), holding that even though the economic realities of a transaction might suggest a sale, it was not dispositive proof that the transfer was a sale, when “the software is heavily encumbered by other restrictions that are inconsistent with the status of owner.”⁸⁹ Additionally, the court in *Adobe Systems Inc. v. Stargate Software Inc.* drew a distinction between ownership of the “package” containing software (such as a CD-ROM), and ownership of the software itself, hinting that the economic reality might apply only to the media that contained the software.⁹⁰ Thus, even if *SoftMan* was correct

84. *Id.* at 1084-86 (citing LAW OF COMPUTER TECH., *supra* note 10, § 1.18[1], at 1-103).

85. *Id.* at 1084.

86. *Id.* at 1085-86; *cf.* LAW OF COMPUTER TECH., *supra* note 10, § 1.24[1], at 1-143 to 1-144.

87. *SoftMan*, 171 F. Supp. 2d at 1085.

88. *SoftMan* has also been criticized for a number of reasons other than its use of the “economic realities” doctrine. *See* *Nadan*, *supra* note 3, at 613-20.

89. 170 F.3d at 1362.

90. *Stargate*, 216 F. Supp. 2d 1051. *Stargate* was the third case in the Adobe Trilogy. The court stated:

The CD-ROM itself is worth not much more than a nominal amount, and it is the code that justifies the purchase price of the product. That being the case, the economic reality of this transaction is that a consumer is ultimately paying for the software contained on the CD-ROM, rather than the CD-ROM itself. Despite this fact, this case is still based on the ownership of each particular copy of software distributed by Adobe.

Id. at 1055.

Furthermore, this Court notes that, within the context of this case, when a ‘single payment’ is made for a particular copy of software, the pay-

in holding that the physical media was being sold under the agreement, it did not foreclose the possibility that the defendants would still need to license the software contained within it.

II. *WALL DATA INC. V. LOS ANGELES COUNTY SHERIFF'S DEPARTMENT*

Wall Data v. Los Angeles County Sheriff's Department provided the Ninth Circuit with its first chance to revisit the license versus sale debate since *Stargate*. The Ninth Circuit held that the Los Angeles County Sheriff's Department's ("LASD") use of hard drive imaging to install Wall Data's software on more computers than those for which it had purchased licenses exceeded the scope of its licenses, and thus violated Wall Data's copyright in the software.⁹¹ The court rejected the LASD's fair use defense, and ruled that it could not claim a § 117 essential step defense because it was not an "owner" of the software.⁹² This part explains the events leading to the dispute between the LASD and Wall Data, and the claims and defenses raised by each party in the initial suit. The Ninth Circuit's analysis will be discussed in further detail in Part III.

A. Background

In 1997, the LASD prepared to open the doors to its highly-anticipated Twin Towers Correctional Facility.⁹³ The facility housed various computer workstations connected to a central mainframe.⁹⁴ In order to allow the workstations to communicate with the mainframe, the LASD required a terminal emulation program.⁹⁵ Between December 1996 and February

ment is being made for the value of the objective code that is burned on the CD-ROM. Absent this 'valuable' information and intellectual property, a CD-ROM would be almost worthless. The true economic value of the product is derived from the intellectual property embodied within it.

Id. at 1058-59.

91. *Wall Data*, 447 F.3d at 777.

92. *Id.* at 785.

93. InfoWorld Gripeline by Ed Foster, *The Sheriff and Drive Imaging: A Case Study* (hereinafter "*The Sheriff and Drive Imaging*"), InfoWorld Gripeline, http://weblog.infoworld.com/gripeline/archives/2006/08/the_sheriff_and.html (last visited Aug. 1, 2006, 12:46 AM); see also Gale Holland, *No Escaping How High Tech the Place Is*, USA TODAY, Jan. 27, 1997, at 3A.

94. Foster, *The Sheriff and Drive Imaging*, *supra* note 93.

95. *Id.*

1999, the LASD purchased licenses for 3,663 copies of Wall Data's "Rumba Office" and "Rumba Mainframe" software.⁹⁶

Initially, the LASD installed the software on each individual workstation, but soon realized after 750 installations that this time-consuming process could delay the opening of the facility.⁹⁷ In order to speed up the installation, the LASD decided to install the Rumba software by means of hard drive imaging.⁹⁸ The image was uploaded to a central server connected to all the computers and Wall Data's software was quickly installed on every workstation in the facility.⁹⁹ This process saved time and eliminated potential errors that might occur during a nonuniform software installation.¹⁰⁰

Using the image-based installation, Rumba was installed on 6,007 workstations, at least 2,344 installations in excess of the Sheriff's Department's license.¹⁰¹ Rather than renegotiate the terms of the volume license with Wall Data, the LASD created its own solution; because Wall Data's software would only function on a computer when the computer had access to the main server, IT administrators planned to assign a unique identification number called a logical unit ("LU") to each computer accessing the central server.¹⁰² Software installed on computers without an assigned LU became "ghost copies" and were unusable.¹⁰³ Thus, by controlling which computers were assigned an LU, the LASD could control how many computers accessed the software. This system provided the added benefit of flexibility, since the software was potentially available on every workstation in the prison.¹⁰⁴ By the time the process was completed in mid-2001, the LASD had installed the software on every computer throughout the prison and, at least according to the LASD, assigned LUs

96. *Wall Data*, 447 F.3d at 773-74.

97. *Id.* at 774.

98. The imaging process involved installing the software (as a part of a larger suite of other operating system and application software) only onto a central server, which would then copy this "image" or collection of software programs onto every computer. This resulted in every computer in the facility having an identical installation of Wall Data's software. *See id.* at 774, 785; *see also* Foster, *The Sheriff and Drive Imaging*, *supra* note 93.

99. *Wall Data*, 447 F.3d at 774.

100. *Id.* at 779.

101. *Id.* at 774-75, 787.

102. *Id.* at 775 n.3.

103. *Id.*; *see also* Foster, *The Sheriff and Drive Imaging*, *supra* note 93.

104. *Wall Data*, 447 F.3d at 775 n.3.

to 3,663 of them—precisely the number of licenses it had purchased from Wall Data.¹⁰⁵

The LASD claimed Wall Data was fully aware of this installation process.¹⁰⁶ How much of the practice it disclosed to Wall Data was disputed, however, since the court excluded evidence from the LASD that purported to show that Wall Data was aware of the practice.¹⁰⁷ Nonetheless, the LASD's system did not come under scrutiny until 2000, when Wall Data, acquired by NetManage, Inc., demanded that the LASD pay a license fee for all ghost copies.¹⁰⁸ Settlement talks broke down and the LASD removed the ghost installations, but refused to pay for them.¹⁰⁹

In January of 2002, Wall Data filed suit in federal court alleging that the LASD's "over-installation" of its Rumba software violated its shrink-wrap, click-through, and volume licenses.¹¹⁰ The LASD argued there was no breach of contract because the terms of the click-through license permitted installation on "a single Designated Computer for which the software has been activated,"¹¹¹ and the ghost copies had not technically been "activated."¹¹² It also claimed affirmative defenses on the grounds that it was fair use to use Wall Data's software so long as the number of useable installations at any given time did not exceed the number of software licenses it purchased,¹¹³ and because the hard drive imaging was an "essential step" of installation within the meaning of § 117.¹¹⁴

The district court granted summary judgment to Wall Data as to the LASD's fair use defense,¹¹⁵ and after a four-day trial a jury found the LASD liable for copyright infringement and awarded Wall Data \$210,000

105. *Id.* at 774-75. Since the LU system was ultimately unverifiable, neither party was certain how many computers had access to the Rumba software. See InfoWorld Gripeline by Ed Foster, A Matter of Trust, http://weblog.infoworld.com/gripeline/archives/2006/08/a_matter_of_tru.html (Aug. 4, 2006, 09:02 AM).

106. Appellants' Reply Brief at 4, *Wall Data Inc. v. L.A. County Sheriff's Dept.*, 447 F.3d 769 (9th Cir. 2005) (No. 03-56559), 2004 WL 2085188 ("LASD was prohibited by the court's *in limine* rulings from introducing documents and testimony showing Wall's awareness and toleration of such practices.").

107. *Wall Data*, 447 F.3d at 782. The Ninth Circuit held that this exclusion was "not reversible error." *Id.* at 783.

108. Foster, *The Sheriff and Drive Imaging*, *supra* note 93.

109. *Wall Data*, 447 F.3d at 775.

110. *Id.*

111. *Id.* at 775 n.5.

112. *Id.* at 781.

113. *Id.* at 776.

114. *Id.*

115. *Id.*

in damages.¹¹⁶ On appeal, the LASD challenged the court's summary judgment ruling as well as the jury instructions regarding the essential step defense.¹¹⁷

B. The Ninth Circuit Decision

The Ninth Circuit unanimously affirmed the lower court's ruling.¹¹⁸ After applying a four-factor fair use analysis (including an unorthodox statement of the fair use standard),¹¹⁹ the Ninth Circuit held that there was no fair use.¹²⁰ The court determined that all four factors weighed against the LASD.¹²¹ The "purpose and character of the infringing use" was commercial because the software was installed on multiple computers to "save the expense of purchasing additional authorized copies."¹²² The "nature of [Wall Data's] copyrighted work" was not completely creative, but was a computer program protected by copyright law.¹²³ The "amount and substantiality of the portion used" weighed against the LASD because hard drive imaging created verbatim copies of the Rumba software.¹²⁴ The fourth fair use factor—"the effect on the potential market"—weighed

116. *Id.*

117. *Id.*

118. *Id.* at 774, 787.

119. As we balance these factors, we bear in mind that fair use is appropriate where a reasonable copyright owner would have consented to the use, i.e., where the custom or public policy at the time would have defined the use as reasonable. Subcomm. on Patents, Trademarks & Copyrights of the Sen. Comm. on the Judiciary, 86th Cong., 2d Sess., Study No. 14, Fair Use of Copyrighted Works 15 (Latman) (Comm. Print 1960).

Wall Data, 447 F.3d at 778. It is unclear why the court opted to cite a standard of fair use from the committee report of a Senate Subcommittee, given that it is a standard not commonly associated with the fair use doctrine. The Ninth Circuit's standard is also troubling because it appears to be at odds with a core principle underlying fair use: that certain uses of copyrighted material, though unauthorized by the copyright owner, ought to be protected regardless of the lack or even likelihood of permission. *See, e.g.*, *Campbell v. Acuff-Rose Music, Inc.*, 510 U.S. 569, 592 (1994). The *Campbell* court stated:

The market for potential derivative uses includes only those that creators of original works would in general develop or license others to develop. Yet the unlikelihood that creators of imaginative works will license critical reviews or lampoons of their own productions removes such uses from the very notion of a potential licensing market. "People ask . . . for criticism, but they only want praise . . ."

Id. (citations omitted).

120. *Wall Data*, 447 F.3d at 782.

121. *Id.* at 780-82.

122. *Id.* at 779.

123. *Id.* at 780.

124. *Id.*

against fair use because “[w]henver a user puts copyrighted software to uses beyond the uses it bargained for, it affects the legitimate market for the product.”¹²⁵

The Ninth Circuit rejected the LASD’s essential step defense on two grounds.¹²⁶ First, the defense was not applicable because it applied only to “owners” and not licensees of the software.¹²⁷ The Court reasoned that restrictions in the click-through and volume license agreements indicated that the LASD was not an “owner” for the purposes of § 117.¹²⁸ Furthermore, even if the LASD were deemed an “owner” of the software, the court reasoned that it still would not be entitled to the essential step defense because its system of installation through hard drive imaging was not “inherently necessary” but rather “a matter of convenience.”¹²⁹

III. *WALL DATA’S* ROLE IN THE LICENSE VERSUS SALE DEBATE

The Ninth Circuit’s decision in *Wall Data* appears to indicate that contract law will continue to play a vital role in the protection of computer software. In particular, the Ninth Circuit’s holdings that (1) the software agreement was a license, rather than a sale, such that the LASD was not an owner for the purposes of the essential step defense,¹³⁰ and (2) that the LASD could not claim fair use as a defense,¹³¹ implicated conventional licensing software rationales like market segmentation and price discrimination. The court’s most significant holdings can be found in its analysis of the essential step defense, in which it explicitly faced the issue of license versus sale, as well as in the analysis of the fair use defense, where an endorsement of the value of licenses in the realm of copyright permeates its analysis.¹³²

A. Limited Discussion of the Broader Debate

Wall Data presents a more straightforward question of software licensing than previous cases like *MAI* and *DAK*, which were complicated by a questions about whether RAM copies infringed copyright and by points of

125. *Id.* at 781.

126. *Id.* at 784-86.

127. *Id.* at 785.

128. *Id.*

129. *Id.*

130. *Id.*

131. *Id.* at 782.

132. *Id.* at 778, 784.

bankruptcy law, respectively.¹³³ Despite the fact that the issue of whether software agreements should be construed as sales or licenses is still very much a contentious issue (as evidenced by the cases noted in previous Sections), the Ninth Circuit made little effort to weigh in on the debate other than to acknowledge in a single footnote that its “decision in *MAI* has been criticized.”¹³⁴ Indeed, it cited *MAI* as support for a finding that the LASD was a licensee rather than an owner of the software.¹³⁵ While it noted the controversy surrounding *MAI* however, it declined to revisit its ruling, holding that the LASD’s essential step defense would have failed even if the department were assumed to be the “owner.”¹³⁶

The court’s lack of significant comment on the license versus sale debate continued through the opinion. Immediately following its mention of *MAI* in footnote nine, the court cited *One Stop* for the proposition that “the first sale doctrine rarely applies in the software world because software is rarely ‘sold.’”¹³⁷ The Court, however, did not balance this claim with citations to critics of software licensing—indeed, *SoftMan* was cited only once in the entire *Wall Data* opinion, and only as a means of explaining click-through licenses.¹³⁸ Rather, the court elaborated further the rationales for why software agreements should be interpreted as licenses rather than sales: “[B]y licensing copies of their computer programs, instead of selling them, software manufacturers maximize the value of their software, minimize their liability, control distribution channels, and limit multiple users on a network from using software simultaneously.”¹³⁹ Other than this footnote, discussion of the broader license versus sale debate, central to the Adobe Trilogy and related cases, was conspicuously absent.

By limiting the discussion of the sale versus licensing issue, the court pronounced a perhaps stronger endorsement of software licensing than it would have if it had elaborated on the existence of the debate and attempted to weigh in on it more substantially. The court sent the message that the debate over license versus sale was not significant enough to warrant an in-depth analysis.

The Court’s most striking blow to defenders of the view that agreements are sales occurred in its discussion of the LASD’s essential step de-

133. See *MAI Sys. Corp. v. Peak Comp.*, 991 F.2d 511 (9th Cir. 1993); *Microsoft Corp. v. DAK Indus.*, 66 F.3d 1091 (9th Cir. 1995).

134. *Wall Data*, 447 F.3d at 786 n.9.

135. *Id.* at 785.

136. *Id.* at 785-86.

137. *Id.* at 786 n.9.

138. See *id.* at 775 n.5.

139. *Id.* at 786 n.9.

fense. The court refused to find that the LASD was an “owner” within the meaning of § 117.¹⁴⁰ The court arrived at this conclusion in part by applying the “restrictive terms” test originally found in the *MAI* and *DSC* line of cases.¹⁴¹ The court noted that the licensing agreement included with the Rumba software “imposed severe restrictions on the Sheriff’s Department’s rights with respect to the software.”¹⁴² “Such restrictions,” it continued, “would not be imposed on a party who owned the software.”¹⁴³ The court announced this principle in broad terms: “*Generally*, if the copyright owner makes it clear that she or he is granting only a license to the copy of software and imposes significant restrictions on the purchaser’s ability to redistribute or transfer that copy, the publisher is considered a licensee, not an owner, of the software.”¹⁴⁴ This willingness on the part of the court to announce the pro-license “restrictive terms” rule (rather than the pro-sale “economic realities” paradigm) as a general rule when interpreting software license terms was a significant endorsement of the interpretation of software agreements as licenses.

B. Licensing Issues in the Fair Use Analysis

Much of the court’s analysis in *Wall Data* revolved around the consideration of the LASD’s fair use defense. Two key licensing issues played into the court’s decision that the LASD had no fair use defense for its hard drive imaging: (1) it could have negotiated for more flexible terms, (2) the manner in which it set up its imaging system prevented Wall Data from enforcing its license. At the same time, the court declined to explore the extent to which the imaging would have undermined licensing rationales such as market segmentation and price discrimination. It also accorded little or no weight to the apparent “good faith” on the part of the LASD.

1. LASD Could Have Negotiated For Better Terms

The Rumba license restricted the LASD’s use to “a single designated computer” and prohibited the LASD from using “the Software in any other multiple computer or multiple user arrangement.”¹⁴⁵ The Ninth Circuit observed these restrictions and acknowledged the LASD’s desire for flexibility and efficiency in installing the software: “By using hard drive imaging, the Sheriff’s Department saved man hours and eliminated possible errors associated with separately installing the individual software pack-

140. *Id.* at 785.

141. *Id.*

142. *Id.*

143. *Id.*

144. *Id.* (emphasis added).

145. *Id.* at 779.

ages onto each computer in the Twin Tower facility. Hard drive imaging also ensured that those users who needed to use Rumba would be able to access the software at whatever computer they were assigned to work.”¹⁴⁶

Despite these rationales, however, the court suggested that given that the LASD had engaged in the practice for almost ten years, it should have approached Wall Data to ask for more flexible terms.¹⁴⁷ This was relevant to the court’s first factor analysis, concerning the purpose and character of the use. The court ruled that the purpose and character of the LASD’s use was commercial because the copies made through hard drive imaging “were made to save the expense . . . of purchasing a more flexible license.”¹⁴⁸ It was also important in the fourth factor analysis, concerning harm to the market for the copyrighted work. The court ruled that the LASD’s failure to renegotiate harmed the potential market because “whenever a user puts copyrighted software to uses beyond the uses it bargained for it affects the legitimate market for the product.”¹⁴⁹

2. *Hard Drive Imaging Precluded Wall Data From Enforcing Its License*

The Sheriff’s Department also justified its infringement on the grounds of “efficiency.”¹⁵⁰ The LASD used hard drive imaging to copy Wall Data’s software onto more computers than they were permitted under the terms of the license in order to save time and open the Twin Towers prison on schedule.¹⁵¹ The Ninth Circuit made it clear that this use was not permitted however, since the fair use defense frowns upon purpose and character of use that is intended “to save the expense of purchasing authorized copies.”¹⁵² It reaffirmed the lower court’s finding that the LASD’s process of hard drive imaging was not “for a legitimate, essentially non-exploitative purpose.”¹⁵³

Despite its ruling, the court took pains to emphasize that its was not to be construed as a rejection of efficiency as a potential rationale for the fair

146. *Id.*

147. *Id.* (“Such flexibility could only have been achieved by purchasing licenses for each of the computers on which the software was loaded, or by negotiating with Wall Data for a less restrictive license.”).

148. *Id.*

149. *Id.* at 781.

150. *Id.* at 779 n.6 (“[I]f the Sheriff’s Department had saved time and money by hard drive imaging RUMBA software onto the number of computers for which it had licenses, its “efficiency” would not create a problem.”).

151. *Id.* at 774.

152. *Id.* at 779.

153. *Id.*

use defense: "To be clear, we do not hold that a fair use defense is not available simple because the infringer uses technology to make efficient use of its licenses."¹⁵⁴ Rather, the court was concerned with the manner in which the LASD attempted to accomplish it, and suggested that such efficiency had to be narrowly tailored: "The problematic aspect of the Sheriff's Department's use is that it took in excess of what it bargained for, not that it was technologically efficient."¹⁵⁵

The key problem for the LASD was that its hard drive imaging system was not "narrowly tailored," because it was unable to verify which of the prison's computers had been used to access the Rumba software and which ones had not.¹⁵⁶ The court expressed concern with the LASD's scheme of assigning Logical Units to terminals, suggesting that it amounted to a "sub-licensing" system where it, rather than Wall Data, granted users permission to use the software.¹⁵⁷ Since the system potentially made copyright infringement easier (since no physical installation was necessary) while also making detection of infringement "almost impossible,"¹⁵⁸ Wall Data was relegated to the position of having to "trust" that the LASD was not using the Rumba software in excess of its authorization under the license.¹⁵⁹ Worse yet, the LASD appeared unable to even keep track of how many computers were accessing the software at any given time; a Sheriff's Department employee admitted in an e-mail that he was not sure how to tell which computers had accessed Rumba.¹⁶⁰

Ultimately, the court took issue with the fact that the LASD's system threatened the ability of Wall Data to fully enforce and capitalize on its license. When the court ruled that Wall Data should not be expected to "trust" that the LASD was not using the software in excess of its authorization under the license,¹⁶¹ the court echoed the basic licensing principle that the copyright holder should be able to control subsequent transfers of its software and determine the extent and scope of exclusive rights that may accrue to subsequent transferees.¹⁶² Indeed, the court's concern that

154. *Id.* at 779 n.6.

155. *Id.*

156. *Id.* at 781.

157. *Id.*

158. *Id.*

159. *Id.*

160. *Id.*

161. *Id.*

162. The key principle underlying the right to control subsequent transfers is the concern that without the ability to contract out of the first sale doctrine that licenses provide, software copyright holders cannot control how software is duplicated and distributed. Without this fundamental ability, they are unable to profit off subsequent transfers of the

hard drive imaging “made detection of over-use more difficult” meshes well with the view that copyright holders should be able to control the use of their product in order to better facilitate market segmentation.¹⁶³

3. *The Unexplored Effect on Software Licensing Rationales*

The fourth factor of the fair use analysis requires that the court look at the “effect of the use upon the potential market.”¹⁶⁴ In considering the harm to the market for Wall Data’s product caused by the LASD’s hard drive imaging process, the Ninth Circuit had the opportunity to consider the effect on market segmentation, price discrimination, and other rationales associated with software licensing (and avoidance of the first sale doctrine). Though it hinted at some of these principles, it declined to engage in a direct discussion of the rationales. For example, the court expressed concern that “unrestricted and widespread conduct of the sort engaged in by the defendant would . . . lead to over-use of the software.”¹⁶⁵ Viewed in the context of market segmentation and price discrimination, such “over-use” is a bad thing when it prevents a software manufacturer like Wall Data from isolating segments of the market population and charging them different prices for different bundles of software. However, this sort of substantive reasoning about segmentation and discrimination is nowhere to be found in the court’s opinion.

The court did recognize the ease with which software can be reproduced could potentially lead to widespread unauthorized distribution,¹⁶⁶ a practice that if widespread, would undermine the ability of software companies to isolate segments of the market and charge accordingly. However, the court did not address this directly either, instead expressing concern that “software can be more readily and easily copied on a mass scale in an extraordinarily short amount of time and relatively inexpensively. . . .”¹⁶⁷ The court also noted that “widespread use of hard drive imaging in excess of one’s licenses could seriously impact the market for Wall Data’s product.”¹⁶⁸ Beyond this language however, it did not discuss in detail the impact of the LASD’s behavior on Wall Data’s ability to engage in price discrimination or market segmentation.

software. *Cf. Nadan, supra* note 3, at 558, 567-70 (discussing in further detail the market segmentation rationale of software licensing).

163. *Wall Data*, 447 F.3d at 781; *Nadan, supra* note 3, at 558, 567-70.

164. *Wall Data*, 447 F.3d at 780.

165. *Id.* at 781.

166. *Id.*

167. *Id.*

168. *Id.* at 781-82.

4. "Good Faith" as an Extra Fair Use Factor?

Though they installed the Rumba software on more computers than the license permitted, the LASD may have reasonably believed that its actions constituted a sort of "good faith" compliance with the spirit, if not the letter, of the software license. The extra copies were nothing more than "ghost copies," unusable until activated with an LU.¹⁶⁹ The LASD made an attempt to ensure that the number of activated copies was within the number of licenses purchased.¹⁷⁰ All of the extra copies were made on the LASD's own computers, and given that the software was intended to be used solely within the Twin Towers prison, there did not appear to be any intent on the part of the LASD to resell or distribute the software to a third party.¹⁷¹ Had it wished to do so, the Ninth Circuit could have considered the LASD's "good faith" as an extra factor, weighing in the LASD's favor. But it did not, and in fact reaffirmed the lower court's finding that the LASD's use was not "for a legitimate, essentially non-exploitative purpose."¹⁷²

IV. CONCLUSION

Given the backdrop of the license versus sale debate, in which the Ninth Circuit's ruling in *MAI* had been criticized and a split existed in California district courts, *Wall Data* presented the Ninth Circuit with an opportunity to make a strong statement in favor of either interpreting software agreements as either licenses or sales. Instead, the court managed to avoid delving into any substantial questions of software contract interpretation, and instead opted to focus on the issue of fair use and to a lesser extent, the essential step defense. The court declined to revisit *MAI* and scarcely recognized outlier cases like *SoftMan*, meaning a final authoritative voice on the issue of whether to interpret software contracts as licenses or sales remains in dispute. There were some occasional rays of insight in the opinion, however. Throughout its fair use and essential step

169. *Id.* at 775, 781; see also Foster, The Sheriff and Drive Imaging, *supra* note 93.

170. [T]he Sheriff's Department argued that, even though it had installed RUMBA Office onto 6,007 workstations, it had configured the software so that the software could only be accessed by 3,663 workstations at a time. The Sheriff's Department argued that this constituted a fair use under 17 U.S.C. § 107 because the number of "useable" copies of the software did not exceed the number of licenses held by the Sheriff's Department.

Wall Data, 477 F.3d at 776.

171. *Id.* at 774.

172. *Id.* at 779.

analysis, the court consistently cited precedent which was deferential toward licenses, meaning that the software industry and its supporters may seize upon *Wall Data* as further ground to argue for the continued existence of software licenses. The court's decision, however, seems compelled as much by pragmatic policy necessity (to avoid dismantling the industry's software model) as much as it was by a pro-licensing outlook, which lends hope to the idea that perhaps eventually a unified scheme to protect software that takes into account all of its unique features will emerge as a replacement for the current copyright and contract system. Whatever the case, it appears that in the meantime, the industry's business model will live to see another day.

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