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SECOND CIRCUIT REVIEW

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Copyright Law: When Customer 'Owns' Copy of Computer Program

In this month's column, we report on a decision issued last month by the U.S. Court of Appeals for the Second Circuit in which the court clarified when a customer "owns" a copy of a computer program, as opposed to merely licensing it.

In *Krause v. Titleserv, Inc.*,¹ the Second Circuit affirmed a grant of summary judgment dismissing plaintiff's claims for software copyright infringement. The court held that the defendant owned the software copy at issue and had broad rights under the Copyright Act to modify the software to fit its needs.

This decision has important implications for software licensing, but is unlikely to apply to common mass-market software—like Windows or Photoshop.

Background

Plaintiff William Krause was a computer programming consultant who wrote software for Titleserv Inc., a title service agency. Between 1986 and 1996, Mr. Krause wrote over 35 programs for Titleserv—eight of which were at issue in this suit—and was paid over \$350,000. The eight disputed programs constituted part of Titleserv's operating system, enabling it to manage client requests and other aspects of its business operations. In July 1996, before Mr. Krause and Titleserv could reach an agreement addressing the assignment of the copyright for these programs, Mr. Krause terminated his relationship with the company. The works-made-for-hire doctrine² did not apply to Mr. Krause, as an independent contractor, and he retained ownership of the copyrights.

When Mr. Krause left the company, he took the only copies of the source code for two of the programs, but left the source code for the



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other six programs on Titleserv's file servers and backup tapes. Source code allows other programmers to understand and modify a program; the source code must be compiled into executable object code to be used. Mr. Krause left copies of executable code for all eight programs and told Titleserv that it could continue using the executable code but not modify the source code. He also put lock commands on the executable code, preventing Titleserv from decompiling it to reveal the source code.

Titleserv believed this limitation crippled the software's value, since it could no longer fix bugs or even perform routine operations like changing a client's address without modifying the source code. In response, on July 16, 1996, Titleserv filed a misappropriation suit in state court against Mr. Krause. However, Titleserv was subsequently able to circumvent the "locks" and reverse engineer the programs back to their source code. Titleserv then modified the source code by fixing bugs, updating client information and adding new features such as check printing and providing for direct client access to the system. Titleserv also allegedly updated the programs to function on Titleserv's new Windows-based system, although Titleserv claims it stopped using Mr. Krause's programs when it switched to its new system by early 1998.

Mr. Krause brought a copyright infringement action against Titleserv in the U.S. District Court for the Eastern District of New York, alleging that Titleserv's source-code

modification constituted unauthorized copying and creation of derivative works. Titleserv moved for summary judgment. The district court granted Titleserv's motion for summary judgment after accepting the recommendations of Magistrate Judge William Wall, who found that Titleserv's use and modification of Mr. Krause's programs were protected under 17 USC §117.³

The District Court's Findings

Section 117(a) of the Copyright Act provides an affirmative defense against copyright infringement when the owner of a copy of a computer program makes a new copy or adaptation that "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."⁴ Parsing the statutory text, the district court first determined that Titleserv "owned" a copy of the program, having paid over \$350,000 for Mr. Krause's programming services. The court disregarded his claim of an "oral licensing agreement, as opposed to an ownership agreement" regarding the programs, noting that even if such an oral agreement existed, it would be "invalid under the Copyright Act's statute of frauds."⁵

The court next addressed whether Titleserv's modification was an "essential step" to using the programs in conjunction with Titleserv's machines. Relying on the Second Circuit's interpretation of §117 in *Aymes v. Bonelli*,⁶ where the Court of Appeals held that §117 protected the modification of programs for compatibility with a successive generation of computer systems, the district court found that §117 protected source code modifications for fixing bugs and updating business records. Finally, the district court concluded that Titleserv's modifications were "used in no other manner" as required by §117.

The district court granted summary judgment in favor of Titleserv, concluding that its modifications were protected under §117. Mr. Krause appealed to the Second Circuit.

Perhaps the most interesting aspect of the

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Second Circuit's opinion is the court's discussion of what it means to "own" a copy of software, as opposed to licensing it. Typically, an author owns the copyright of a book, while each purchaser of a copy of the book owns that copy. By contrast, software purchasers are typically bound by an End User License Agreement (EULA), so that they license the software rather than own it. Because the affirmative defense in §117 applies only to "the owner of a copy of a computer program," the Second Circuit needed to determine at the outset of its opinion whether Titleserv qualified as such an "owner."

Mr. Krause argued that Titleserv never owned title to the program copies, but merely possessed the copies as a licensee pursuant to an oral agreement. Rather than follow the district court's approach and dismiss the alleged oral license agreement as violating the statute of frauds, the Second Circuit looked more closely at whether Titleserv "exercises sufficient incidents of ownership over a copy of the program to be sensibly considered the owner of the copy for purposes of §117(a)."

Applying this nuanced approach, the court rejected Mr. Krause's argument that ownership should be limited to formal title owners, thus overruling *Applied Info. Mgmt. v. Icart*⁸ and resolving a split within the Second Circuit. The court noted that the legislative history of §117(a) did not support limiting ownership to formal title and, since formal title is determined by state law, permitting state law interpretation to control would undermine the national uniformity sought by the Copyright Act. Additionally, the court cited as support a Federal Circuit case that looked to "incidents of ownership" rather than formal title.⁹

'Incidents of Ownership'

Applying the "incidents of ownership" standard, the court determined that Titleserv was an "owner" because:

- (i) it had paid Mr. Krause substantial sums to develop the programs for its sole benefit;
- (ii) Mr. Krause customized the software for Titleserv's operations;
- (iii) copies were stored on Titleserv's servers;
- (iv) Mr. Krause never reserved the right to repossess the copies and agreed that Titleserv could possess them forever; and
- (v) Titleserv was free to discard or destroy the copies.

The Second Circuit's framework makes it far easier to be considered an owner of a program. Being an owner rather than a licensee has other implications under the Copyright Act, such as being entitled to limited "first

sale" rights.¹⁰

Having determined the question of ownership, the Second Circuit next found that owners had broad rights to modify their software under §117. Titleserv's modifications fell into four main categories: (i) bug fixes, (ii) updating client information, (iii) compatibility with the new Windows-based system, and (iv) adding new capabilities such as printing checks. The court found that each of these modifications was an "essential step" for using the computer program with Titleserv's machines. The first three categories were deemed to be straightforward applications of the Second Circuit's earlier *Aymes* opinion, which allowed modifications designed to keep the software in step with changes in the defendant's business.

Sophisticated purchasers/licensees will construct their contracts to convey "incidents of ownership" to maximize their rights to update the purchased software.

The court grappled with the fourth category, which consisted of changes that were not strictly necessary, but which improved the functionality for which the program was created. The court discussed at great length the definition of "essential," ultimately rejecting Mr. Krause's cramped interpretation. The court instead read "essential" in conjunction with "utilization" in the statute. Since "utilization" might refer more broadly to "making the program useful" to its owner, adding new functionality might qualify as an "essential step" in making the program useful. More relevantly, the "CONTU Report" referred to in the legislative history of §117 specifically contemplated adding new program features.¹¹ Between the textual ambiguity and the legislative history, the Second Circuit concluded that modifications adding new features could be "essential steps in the utilization of the computer program" within the meaning of §117.

Finally, the Second Circuit addressed Mr. Krause's objection that the modifications failed to be "used in no other manner" because Titleserv shared copies of the modified program with its subsidiaries, and granted two clients dial-up access to the program. The court deemed use by Titleserv's subsidiaries as merely a "continuation" of the original intended use—not use "in another manner." The court acknowledged that Mr. Krause's

argument was "slightly stronger" regarding the dial-up access to the programs, but noted that Mr. Krause's programs were designed to aid Titleserv in managing transactions with client banks. Thus, the modifications merely improved the versatility of the programs by allowing client banks to access the programs' data directly, rather than having Titleserv's personnel access it at the request of the client. While the court read this as "use in the same manner," this logic seems questionable in light of commercial reality, where many programs on the market—including Microsoft Windows—are sold either as stand-alone or as more expensive remote-access versions.

Conclusion

The Second Circuit thus concluded that Titleserv was entitled to summary judgment since it owned copies of Mr. Krause's software and satisfied the other requirements of the §117(a) affirmative defense. The court's articulation of software "ownership" and the resulting broad modification rights have important implications for software licensing. Sophisticated purchasers/licensees will construct their contracts to convey "incidents of ownership" to maximize their rights to modify and update the purchased software. Licensors, of course, will press the opposite position in negotiations. However, since mass-market software, such as Windows XP, is nearly always sold with a EULA that restricts the end user's rights, this decision likely will not enable people to reverse engineer and modify Windows.

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1. 402 F3d 119 (2d Cir. March 21, 2005).
2. In the case of a work made for hire, the employer owns the copyright. 17 USC §201(b).
3. *Krause v. Titleserv, Inc.*, 289 FSupp2d 316 (EDNY 2003).
4. 17 USC §117(a)(1).
5. *Krause*, 289 FSupp2d at 318 n.2.
6. 47 F3d 23 (2d Cir. 1995).
7. *Krause*, 402 F3d at 124.
8. 976 FSupp 149 (EDNY 1997) (holding erroneously that §117 applied only to title owners of a copy of a computer program).
9. *DSC Communications Corp. v. Pulse Communications, Inc.*, 170 F3d 1354 (Fed. Cir. 1999).
10. 17 USC §109 (providing limited first-sale rights for copies of computer programs).
11. Final Report of the National Commission on New Technological Uses of Copyrighted Works 13 (1978) (commonly referred to as the CONTU Report).

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