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Licensing Software, the Freedom of Contract and (Legal) Unreality

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Abstract: The contract in practice governs the regime for computer contracts to a greater extent than underlying legal principles and yet there are certain standard or typical terms in such contracts whose legal efficacy is, at least, open to doubt but which nevertheless continue to be relied upon. Such terms thus set the agenda for the development of the law of computer licensing.

Part 1.

The role of contract and individual contract terms in setting the legal regime

1.1 The License

Whatever the underlying legal regime may be for the exploitation of software and hardware, the contract is always going to be the main vehicle for establishing the effective relationship between the parties involved in that exploitation. The tendency to emphasise the "license" format of many such contracts at the same time emphasises the degree of control which the exploiter/owner has in shaping the regime so that self regulation becomes the order of the day. Of course, this is not to say that the licensing background does not exist in all sale of goods contracts in that one is often receiving an "authorised" copy of a patented or copyright work. But somehow, with say a book or some apparently commonplace manufactured article, the idea that one is acquiring "intellectual property" does not readily spring to mind in the way that it does with software. It would not be customary to have attempts to impose complex restrictions, going beyond the general law, on these items as occurs even with "off the shelf' software. Generally with such items the property rights might well impinge on contracts of, for example, publishing, franchising and, perhaps, distribution but rarely when dealing with the general public. With software the expectation is usually there and the owner does expect to be able to mould the customers use of the product by the license terms.

1.2 Precedents as a "source" of law

To the commentator trying to analyse such self regulation there is an obvious difficulty. The phrasing of or even the existence of, a particular clause will vary with the many drafters involved in creating such contracts and there is thus possible doubt as to what really is commonplace. However the clauses which I comment on below are all of a type which appear, recommended, in the literature on the subject and the specific examples are drawn from actual contracts with which I have dealt.

The provision of precedents does seem often to be at the heart of publishing in the field of computer contracts and this represents another way in which it is the practitioner who sets the legal agenda.

Of course this is in many ways highly admirable in that we are able to see clauses which have stood the test of meeting the needs of their author's clients. On the other hand it may be that the objectives of the draftsman are not necessarily the clarification of legal doubts but rather their avoidance. Obviously one of those objectives will be to anticipate such legal doubts and to meet them so as to avoid litigation. However clarity as to the phrasing of the desired consequence in a given set of circumstances may be just as important: if the contract in plain language appears to cover the particular set of circumstances and it has been freely agreed to, then, in a dispute the parties are likely to concentrate more on the interpretation of the language of the contract than to consider more fundamental questions as to the legal effectiveness of a type or 'species' of clause. For example, as a matter of tactics, it might be preferable to include an exemption clause which clearly delimits every type of liability which the client wishes reasonably' (from his viewpoint but one can't totally ignore the 1977 Act) to avoid and, thus to risk the possibility that it may prove to fall foul of the the provisions of Unfair Contract Terms Act 1977. The alternative is to produce a clause which one could 'guarantee' as being reasonable (if this is actually possible!) but which is drawn so as to leave the client with much potential liability. The former course may well be regarded as the more desirable course. The fact that some potential liability is precisely covered by the clause may of itself discourage further dispute or, more likely, form the basis on which negotiations towards a compromise will be based. In any case, it will be rare for such disputes to reach the stage of litigation as there seems a marked and understandable reluctance to become involved in the cost, delay and uncertainty of litigation. Thus the potency of the clause will be greater than any theoretical doubt as to its success in litigation might suggest.

1.3 Contract Litigation

The relative lack of litigation shows the dominance of the contract in setting the legal agenda in another way. There is very little court guidance on the more controversial issues. Indeed it is noticeable how unhelpful the few cases are. Either like *Mackenzie-Patten v British Ollivetti* (1984 - unreported) they are indecisive on crucial issues or like *DPCE(UK) LTD v International Computers Ltd* (unreported 1985) they deal with atypical, but precise, situations. In the latter case it is the manufacturer who finds himself restricted by his own entire agreement clause and the precise wording of the contract. In the absence of court guidance, the devices used by the draftsmen become the orthodox view and there is nothing to challenge that view.

1.4 The "bias" of contract terms.

Against such a background one must ask for whom does the draftsman work? Often it will be the supplier/distributor and rarely the end user -if only because the number of transactions involved mean that the supplier/manufacturer will develop his own standard terms whereas one needs to be a very large scale purchaser to be involved to the same extent (as e.g. the Government). No criticism is implied or intended by pointing to this fact as it has long been the role of lawyers to use their ingenuity to provide solutions for their clients. Rather, I am suggesting that the bias as to the source of materials allows a lop-sided view of the law to be formed. If there is a perceived need for a particular legal result then it is for the legal advisor to point to provisions which might or should have that effect. It is I think naive to imagine the draftsman and his client or employer will aim for an evenhanded approach to the contract. Although I have on a number of occasions listened to practitioners extolling the virtues of such an approach on the grounds that it is necessary to the formation of a relationship in which good faith and trust are maintained, I have very seldom (if ever) seen an actual contract reflecting such an altruistic object. In this limited sense the draftsman will "try it on" if the objective is of sufficient importance to his client or employer.

Part 2.

Some examples of practically effective contractual terms.
In order, hopefully, to provide evidence for the views expressed in part 1, I will look at three types of clause where the validity of the clause(s) was untested at the time when the clause became commonplace. One can only assume that in practice they have been found to fulfil the function assigned to them by the draftsmen although one should not entirely underestimate the conservatism of some in the use of precedents!

2.1 Clauses restricting the use of software to individual machines or sites and shrink wrap licenses

During the controversy which existed at least until 1985 as to whether computer programs were copyrightable, there was no choice for those drafting contracts but to assume that they were and to restrict the terms of licenses which were granted in a manner similar to the restrictions imposed on other copyright works. One thinks of restrictions as to the period of the license and as to its geographical extent. This shows that - to the extent - a well drafted contract can ignore the underlying law or at least the doubts and controversies of the underlying law.

Naturally if there was doubt on the "big" question of copyrightability then issues as to the extent of that doubtful protection inevitably tended to become lost or ignored. This applied, for instance, to the issue of the "use" right. There has been, and still is, much debate about the existence and desirability of such a right. To some it seems that the professed ability to prevent or restrict the use of legitimate copies of a program is greatly out of line with the protection accorded to traditional media - Publishers do not prevent the existence of a second hand market in books nor do they restrict the location in which books are read or by whom. Certainly they don't prevent 'rabbit pie' being baked according to the (copyright) recipe of Mrs Beaton (a much quoted example taken from *Cuisenaire v Reed* [1963] VR 719). On the other hand the advocates of the use right point to the different nature of software when compared to other types of copyright work and thus to the need to modify the degree and type of the protection offered. Thus they argue say that software can actually perform the task that the recipe by analogy merely describes; that the great ease of transferability - especially within a network or by floppy disk - and of copying of software means that there is a need to restrict the use of individual copies; and that this restriction on use is essential to gaining the proper rewards of ownership.

Such doubts may have been a cause of concern to the copyright owners but given the perceived need for such a right, practical men simply made sure that contracts did contain simple provisions such as this : "This non-exclusive, non-transferable license granted gives the licensee the right to use each licensed program and any versions thereof on the designated equipment. A separate license is required where the designated equipment is interconnected with another system to form a single unit".

Such a clause by-passes the debate as to the entitlement to such a right by assuming that extra license fees / negotiations are required when a single legitimate copy is used on many machines or is to be used within an interconnected network. In doing this, the contract assumes not only what the law should be but also the basis of the exploitation of rights. Presumably the cost of legitimate copies would adjust upwards if there were no such rights and the balance of costs would be somewhat different.

The problem of relying on such contractual terms to remedy/clarify the underlying law comes when there are no direct contractual relations between the parties. Then the owner must then fall back on that underlying law. If use is not per se an infringement then such restrictions can only be imposed by contract. As one possible solution to the problem the copyright owner can take contractual steps to require his distributor to impose similar restrictions on his customers but if the distributor failed to do this then the owner would have no direct remedy against the end user who is presumably entitled to use the program in accordance with his expectations subject only to the general law of copyright. Those expectations would include the free portability of a legitimate copy - even perhaps within a network of machines?

One attempt to deal with this problem from the owner's viewpoint is to use the device of the shrink wrap license. The object of this device is to create direct contractual relations between the software producer and the end user who buys his software "off the shelf' and who thus signs no contract. The problem is that for such a contract to come into existence there must be consideration provided by the software owner which is separate from that which is given by the handing over of the program at the shop counter. For, to the customer, the contact appears to be complete at that moment. The only notice that the customer has that there might be any restrictions on his use is provided by a notice visible through the transparent packaging of the software which warns of further terms inside. Those terms include a statement that by loading the program or by taking a backup copy of the software, the customer is doing an act which is otherwise restricted by copyright. Thus if the owner gives the customer permission to do these acts, he is furnishing the customer with additional value for a second contract -which the customer accepts by making use of the program.

It seems to me that such a contractual device and analysis has its limitations. First it assumes that there is a use right which before the Copyright, Designs and Patents Act 1988 was at least doubtful. Secondly it assumes that no license in respect of use had been granted or implied at the time of sale; a customer who was not permitted, without further permission, to use a copy of a program which he has bought might well wonder what exactly it is that he has bought. Further, given that the "withheld" use right would depart so much from the the normal and reasonable expectations of the customer, is it not to be regarded as an onerous and unusual condition which falls foul of the rules illustrated in *Thornton v Shoe Lane Parking* [1971] 2 QB 163? That is to say that the terms of the clause would need to be specifically drawn to the attention of the customer (preferably in "red letters") and that, in any case, the specific notice would be too late in that it comes after the completion of the contract.

Irrespective of such doubts, however, such clauses are used and their validity will remain a possibility for as long as they are untested in the courts. Whether they effect the behaviour of the customers is another question - The control of some types of "off the shelf" purchasers is notoriously difficult but the existence of such arrangements may influence the activities of more responsible organisations who nevertheless supply some of their needs direct from retail outlets rather than from salesmen with their specific contracts.

Perhaps the greatest success of the contractual draftsmen and their associated lobbyists lies in respect of the use right and its acceptance by the Copyright,Designs and Patents Act 1988. By the time of the Act the exploitation of software by the restriction of use had become the orthodox view of the correct and necessary way to ensure the proper reward for ownership. This view is reflected in the Act which appears to make use an infringing act [see sections 17(2) and 17(6)]. Whether this deals with the problem of the validity of shrink wrap licenses is another matter. Given that the existence of a separate use right is an important part of the argument for the validity of the device, then it might seem that the Act would clarify the situation but it seems to me that it is at least arguable that the problems of notice remain and an implied license to use would certainly accord with my expectations!

2.2 Escrow Agreements

The use of Escrow agreements to sweeten the process of the exploitation of computer software is, in some senses, a remarkable development. Escrow is very little used outside such contracts and certainly it is not used for the same type of purpose. Its main previous use has been for the deposit of conditional documents in the course conveyancing pending one party meeting a condition. At such a time the deed or document must be released and given full legal effect. This temporary suspension of a transaction's enforceability seems a long way away from the complex arrangements which we know as software escrow - arrangements which are created to balance the interests of the software owner with those of either his distributor or the end user. In such a case the expectation of the parties (or at any rate, the software owner) is that the condition for the release of the software from escrow - usually either the bankruptcy of the software house or its failure carry out maintenance obligations - will never occur. The role of Escrow is that of a comforter to each side.

Yet such arrangements have been seized upon and welcomed because they seem to provide a balance between the interests of the parties which would otherwise appear to be an intractable problem. For the software house, the source code of its programs is one of its major assets. The ability to keep it confidential ensures not only that rival firms will be unable to ride 'piggy back' on the software house's skill and invention and that thus the owner can keep control of the exploitation of the ideas therein contained but also that "value added" services such as maintenance and updating will be provided solely by the owner. Loss of confidentiality by the release of the source code to those outside the software house would jeopardise the value of that asset. On the other hand, the customer needs reassurance that there will be support of its software if the software house fails in its obligations and especially if bankruptcy means that the software house is unable to sustain its contracted for services. The distributor too needs to be able to offer that comfort to his direct customers and end users and also he may wish to be able to step into the software house's shoes so as to maintain services on the licensed programs. These needs after the failure of the software house, can only practically be met if there is access to the source code. Yet, as we have seen above, the reason for the software house's reluctance to release the code is self evident. In such a situation it is an attractive idea to use some third party such as the National Computer Centre to hold a copy of the source code against the unlikely event (from the Software House's point of view) of the customer/distributor having a need for access to the code.

Even in the best drafted examples of such arrangements - and considerable ingenuity has been displayed to achieve an efficacious result - there are potential problems both legal and practical. The legal difficulties centre around the provisions of the Insolvency Act 1986 [see C.J. Millard : Software Escrow Arrangements and the Insolvency Act 1986 - (1989 January) Computer Law and Security Report 23]. In broad terms the question is whether the release of source code would deprive the Software House and its creditors of assets by effectively taking away the value of the software by impairing its confidentiality. Also there is the more technical question as whether the agreement if it was created within 6 months of the bankruptcy would be giving the releasee undue preference over other creditors. Careful drafting can attempt to reduce such difficulties particularly by limiting the use to which the released code can be put and by imposing obligations of confidentiality upon the releasee but some doubt must still remain. There is also the obvious problem of achieving sufficient precision in describing the situations which will trigger release. This leads to one of the practical problems: how to adjudge whether the code should be released - a potentially difficult matter ofjudgement for the Escrow agent. Another serious problem is in ensuring that the source code has actually been deposited in its most recent and effective form. It is prohibitively expensive for the Escrow agent to provide a validation service for the code which is deposited with it. Neither code owner nor the distributor/customer is likely to be willing to bear the cost. Thus the veracity of the code must be left as a matter of trust which might possibly be abused.

However in a sense such theoretical difficulties do not really matter. Those who use and provide the Escrow services appear to be satisfied with the way they work and as long as such agreements give confidence to the relationship they have achieved their object. If any of the potential difficulties do prove to create actual problems then it is for future draftsmen and others to seek to give effect to the device which appears to have shown its usefulness to all the parties involved. In this case the ignoring of theoretical difficulties seems to be justified.

2.3 Entire Agreement clauses and their effect on possible liability under the Misrepresentation Act 1967 and on future relationships between the contracting parties;

These clauses are almost universally present in many of the varieties of computer contract. The following example comes from a software license and maintenance agreement:

> "This agreement shall control and have precedence over the provisions of any purchase order from the licensee. This agreement contains the entire agreement and understanding between the parties respecting the subject matter hereof and supersedes and cancels all previous negotiations, agreements, commitments and writings in respect thereto, and may not be released, discharged, abandoned, changed or amended in any manner except by an instrument in writing signed by duly authorised representatives of the parties."

It will be seen that this attempts to restrict all the issues between the parties to the contents of the current written contract. Other examples may be more explicit in attempting to avoid terms implied from the previous relationship of the parties but this one does seem to be fairly comprehensive. I intend to concentrate on two of its intended effects: i) to discount any previous representations which might have been made and ii) to control the future relationships between the parties.

As to misrepresentations, the question is whether this clause is an attempt to exclude liability for misrepresentation which is subject to the provisions of s3 of the Misrepresentation Act 1967 as amended by s8 Unfair Contract Terms Act 1977. If it is then its effectiveness will depend upon whether it is regarded as being reasonable between the parties. The argument suggested as to such clauses is that they don't actually exclude such liability but that rather they prevent it from even arising. For the party is declaring that his entire understanding of the contract is contained in the written document so that no previous or alternative understanding can be regarded as having induced him to enter the contract. Thus the issue of liability and exclusion does not arise because one of the main tests for liability is not satisfied.

I submit that such an argument is unlikely to succeed nowadays. Although there is no case directly to the point on misrepresentation, I would argue that some assistance can be got from the case of *Walker v Boyle* [1982] 1 WLR 495 and that an analogy can be drawn from the arguments which failed in the cases of *Smith v Eric S Bush*, *Harris v Wyre D.C.* [1989] 2 All ER 514 and *Phillips v Hyland* [1987] 2 All ER 620.

Walker v Boyle concerned a condition from the National Conditions of Sale [of housing] which directly said that "no error, misrepresentation or omission in any preliminary answer concerning the property ... shall annul the sale." This was held to be subject to s3.

The directness of the prohibition obviously distinguishes it from our entire agreement clause. Yet would the clause in *Walker* have been so very different if it had said "no representation shall be taken to have induced the party into entering the contract"? *Harris v Wyre* was a case concerning liability for giving negligent advice. A surveyor was employed by a local authority to give a valuation on a house prior to the authority lending money by way of a mortgage. They attempted to make it clear that the valuation was for there own purposes alone and could not be relied upon in any way by the mortgagor and, indeed, the mortgagor signed a document to that effect. It later emerged that the house was subject to considerable subsidence that meant it was not worth the valuation put on it by the local authority's valuer. It was held that the clause was an attempt to exclude liability for negligence and was therefore subject to reasonableness requirement in s2(2) of the Unfair Contract Terms Act 1977. The interest to us lies in the argument which had succeeded in the Court of Appeal but was rejected in the House of Lords. This was to the effect that the clause meant that liability had never even arisen because the clause showed that the local authority had not, even impliedly, undertaken any responsibility in respect of the valuation of the property which is an element in the Tort in question; and, of course, if there is no liability then no question of exclusion need arise. The House of Lords took a more robust view of this argument which seemed likely to drive a coach and four through the provisions of the 1977 Act. Following the approach shown in *Phillips v Hyland* they suggested that the question to be asked is whether there would be liability without the existence of the clause i.e. can a duty be seen to exist between the parties. If the answer to that question is yes and the clause would remove that liability then it is an exclusion clause subject to the 1977 Act. It seems to me that, on the same basis entire agreement clauses are exclusion clauses. If there are statements made during precontractual negotiations that would satisfy the conditions required of an actionable misrepresentation then a clause, which seeks to show that such a statement had no effect in inducing the contract, is an exclusion clause subject to the Act.

Does this mean that the entire agreement clause is not worth having in the contract? Hardly! - after all the effect of a clause being regarded as an exclusion clause is usually that it is subjected to the requirement of reasonableness in the Act. While this brings an undesired element of doubt to those relying on the clause, it scarcely brings certainty to the other party. The latter cannot be sure of the unreasonableness of the clause and, in the negotiations to avoid litigation, will be constrained by the possibility of its being enforced. That gives the clause considerable utility which is only partly reduced by the theoretical and unlikely possibility that litigation will strike down the clause. Turning now to the part of the entire agreement clause above which states that the contract " may not be released, discharged, abandoned, changed or amended in any manner except by an instrument in writing signed by duly authorised representatives of the parties." It seems to me that such a provision is technically almost useless. If the parties were to come to some future oral agreement supported by consideration which had one of the effects listed in the clause then, of course the new - oral - agreement would be binding on the parties. Practically on the other hand it may be that it would be difficult to prove the existence of the oral contract and the clause might add to the difficulties of someone alleging the existence of such a contract. Further the clause may have the effect of persuading the parties to act in the manner suggested by the clause even if it is not strictly necessary. Thus even a clause of doubtful validity can have its uses.