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"Even if a Stranger Could Create Such a Work . . ." Software, Piracy, and Implications of the Implied Covenant of Good Faith: Has the SAS Court Gone Too Far?, 9 Computer L.J. 145 (1989)

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"EVEN IF A STRANGER COULD CREATE SUCH A WORK . . ." SOFTWARE, PIRACY, AND IMPLICATIONS OF THE IMPLIED COVENANT OF GOOD FAITH: HAS THE *SAS* COURT GONE TOO FAR?

By WILLIAM W. TOOLE

TABLE OF CONTENTS

I. INTRODUCTION

The continued growth of the computer software industry depends upon adequate protection for the work of the program author. Software piracy adds no value to a work and deprives the innovator of the opportunity to recoup development investments. Yet, continued software development depends upon access to existing ideas and protocols found within programs. Government policy recognizes that subsequent developers often create entirely new products using ideas present in existing technology, and so permits limited access and use of otherwise protected programs.

However, the balance between the rights of the innovator and the rights of a developer[1] who subsequently adds value may be upset by the 1985 *SAS Inst., Inc. v. S & H Computer Sys.* decision.[2] In that case, the court for the Middle District of Tennessee applied the implied covenant of good faith to hold that licensees of a computer program may not develop competing programs, even if a stranger could create such a work.

A developer may combine this protection against subsequent competition with trade secret protection of ideas and copyright protection of expression to create a powerful set of protections for the innovator. Such stacking may exceed the degree of protection that best promotes software development. Combine such protection with a software innovator who has economic power, and the innovator has a nearly absolute monopoly over the market for a particular software product. Such combinations bar from competition subsequent developers who significantly add value to a product, or even create an entirely new product, where a contractual relation between the original innovator and the latter developer once existed. The result is that development of new products declines and standardization is nearly impossible. For reasons of public policy, courts should limit the scope of *SAS* to cases of egregious conduct where the breach involves manifest harm to the licensor, where the licensee adds no value to the development of competing software, and where copyright protection already exists.

II. LEGAL METHODS TO PROTECT SOFTWARE

The demand for applications software continues to exceed the supply, creating a lucrative market for developers. However, the nature of computer software is such that "pirates" with very little knowledge or investment can make perfect copies of software and use these unauthorized copies to compete directly against the innovator. Piracy is a serious concern to software innovators since the pirate does not need to recoup significant development costs. Because copying software is so easy, a pirate does not lose time to development before entering a market. Thus, a pirate can compete against an innovator at reduced price and almost at the very instant the innovator enters the market. Without adequate legal protections from piracy, there is little economic incentive for a true innovator to produce innovative software. The pirate may too easily preempt the innovator's market.

Recognizing that legal protection is necessary to encourage technological development, courts and Congress have acted to protect com-

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1. For the purposes of clarity, this Article shall adopt the convention that "innovator" refers to the first creator of a software product. "Developer" shall refer to one who makes subsequent modifications of the innovator's original work.

2. SAS Inst., Inc. v. S & H Computer Sys., 605 F. Supp. 816 (M.D. Tenn. 1985)[hereinafter *SAS*].

puter software developers. Software protection may be in the form of trade secret protection, patent protection, copyright protection or a combination of the three. Additionally, innovators may use licensing schemes to protect software programs.

Trade secret protects any "formula, pattern, device or compilation of information" that relates to a process or device used by a business.[3] Trade secret effectively provides a business with protection of an idea for as long as that idea is not generally known to competitors. A business may license the use of the trade secret without violating the secrecy requirement. The owner of this information must keep it secret from competitors in order to maintain trade secret protection. "Matters which are completely disclosed by the goods which one markets cannot be his secret."[4] Thus, absent contractual relations to the contrary, competitors may lawfully acquire the good and subsequently analyze the product (in a process called reverse engineering) for information contained within the product.[5]

The policy permitting reverse engineering encourages the dissemination and use of knowledge in development of competing substitutes as well as new products. Society benefits from the policy insofar as the prohibition against an absolute monopoly in ideas permits product development.

Computer software is undoubtedly a subject of trade secret protection, and various courts so hold.[6] Misappropriation occurs where a party violates a confidential relation; for example, where the party reverse engineers software in express violation of a license term. However, because computer software "completely discloses" within its code the process by which it operates, innovators feel inadequately protected by trade secret, particularly where the product is sold rather than licensed. Thus, strong reasons exist to find alternative legal methods to protect software from piracy.

Patent protection may protect software in some cases. Patents protect *processes* which are new and useful.[7] Matters obvious at the time of invention to a person having ordinary skill in the field to which the subject matter pertains are unpatentable.[8] Similarly, the same is true of

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3. RESTATEMENT OF TORTS, § 757 comment b (1937).

4. *Id.*

5. For a description of reverse engineering in the software context, *see* E.F. Johnson Co. v. Uniden Corp. of Am., 623 F. Supp. 1485 (D. Minn. 1985).

6. McCormack & Dodge Corp. v. ABC Mgm't Sys., 222 U.S.P.Q. 432, 444 (Wash. Super. Ct. Dec. 22, 1983); *see also* Univ. Computing Co. v. Lykes-Youngstown Corp., 504 F.2d 518 (5th Cir. 1974).

7. *See generally* 35 U.S.C. §§ 101, 102 (1982).

8. 35 U.S.C. § 103 (1982).

laws of nature, natural phenomena and abstract ideas.[9]

After a series of decisions, the Supreme Court extended patent protection to all software that is part of a larger patentable process.[10] The District Court of Delaware since extended patent protection to computer programs that stand alone.[11] However, these cases do not resolve the scope of patent protection in the software context.

Patent approval grants the innovator "the right to exclude others from making, using, or selling the invention throughout the United States" for seventeen years.[12] A condition of approval is that the innovator supply information specifying the scope of the patented process.[13] Thus, patents promote development by at once giving innovators an economic monopoly on a particular process while simultaneously requiring dissemination of an idea with the possibility that it might aid in the future development of other processes.

Computer software exhibits a unique combination of literary expression and technological process. Recognizing these unique qualities, and that existing protection was inadequate, the National Commission on New Technological Uses of Copyright Works (CONTU) recommended that Congress expressly extend copyright protection to computer software.[14] Copyright law now protects novel *expression* within computer software.[15] Cases hold that expression may be in the form of source code, object code,[16]or structure, sequence and organization.[17] The holder of a copyright also has an absolute right to develop "derivative works".[18]

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9. Diamond v. Diehr, 450 U.S. 175, 185 (1981).

10. *Id.* at 191-192 A rubber curing process used a computer program to continuously monitor internal temperatures and make adjustments. The court held that the software program which contained an unpatenable mathematical formula was part of an industrial process and therefore was patentable.

11. Paine, Webber, Jackson & Curtis, Inc. v. Merrill Lynch, Pierce Fenner & Smith, Inc., 564 F. Supp. 1358 (D. Del. 1983) (data processing software patentable). *See e.g.* Summer and Lundberg, *The Versatility of Software Patent Protection: From Subroutines to Look and Feel*, 3 COMPUTER LAW. 1 (June 1986). Such a holding seems overly expansive of the limited holding of Diamond v. Diehr, 450 U.S. 175 (1981).

12. 35 U.S.C. § 154 (1982).

13. 35 U.S.C. § 111 (1982).

14. National Commission on New Technological Uses of Copyrighted Works, Final Report (1978) [hereinafter *CONTU*].

15. 17 U.S.C. § 117 (1982).

16. Apple Computer, Inc. v. Franklin Computer Corp., 714 F.2d 1240 (3rd Cir. 1983), *cert. dismissed*, 464 U.S. 1033 (1984) (holding programs imbedded in ROM chips are copyrightable where there is no merger of idea and expression).

17. Whelan Assoc. v. Jaslow Dental Lab., 797 F.2d 1222 (3rd Cir. 1986), *cert. denied*, 107 S.Ct. 877 (1987).

18. 17 U.S.C. § 103 (1982). Defining derivative works is problematic. *See* Nimmer and Krauthaus, *Copyright and Software Technology Infringement: Defining Third Party De-*

Copyright protection statutorily excludes ideas, processes, and procedures or methods of operation.[19] In this sense copyright differs from trade secret or patent protection. Copyright does not provide protection when the idea and expression of that idea are indistinguishable.[20] Reverse engineering of copyrighted code and subsequent borrowing of ideas does not establish copyright infringement, absent copying of expression.[21] "One is always free to make a machine perform any conceivable process . . . but one is not free to take another's program."[22] Thus, policy balances monopoly incentives for the innovator with society's need for access to ideas that further the development of useful goods.

Due to the unique nature of computer software, it is possible to protect a program with patent and copyright simultaneously.[23] Copyright offers a monopoly to the holder of a work made for hire for between 75 to 100 years.[24] A more powerful combination involves the stacking of trade secret and copyright protections.[25] So long as the information pertaining to a trade secret stays generally secret, trade secret protection of ideas may last in perpetuity. Although there is some tension between trade secrecy requirements and copyright disclosure, copyright does not require the *full* disclosure of the expression in order to protect the work.[26] Thus, the combination of copyright and trade secret offers inno-

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velopment Rights, 62 IND. L.J. 13, 30-32 (1986) [hereinafter *Software Technology Infringement*].

19. 17 U.S.C. § 102(b) (1982). *See also* Baker v. Selden, 101 U.S. 99 (1879)(where blank forms were necessary to the process taught in an accounting book, those blank forms were not a copyrightable expression).

20. Morissey v. Proctor and Gamble Co., 379 F.2d 675 (1st Cir. 1967)(where there is at best only a limited number of forms of expression of a subject matter, a form of expression is not subject to copyright).

21. Certain case law indicates reverse engineering is inappropriate where copyright exists, since reverse engineering necessarily requires the making of an unauthorized copy. *See* Hubco Data Prods. v. Management Assistance Inc., 219 U.S.P.Q. 450, 456 (1983). *But see E.F.Johnson Co.*, 623 F.Supp. at 1501 n.17. For a discussion of the scope of possible copyright infringement, *see* Hazen, *Contract Principles as a Guide for Protecting Intellectual Property Rights in Computer Software: The Limits of Copyright Protection, The Evolving Concept of Derivative Works, and the Proper Limits of Licensing Arrangements*, 20 U.C.D. L. REV. 105, 116-25 (1986) (arguing that a license agreement cannot create greater rights than a valid copyright) [hereinafter *Computer Software Protection*].

22. *CONTU, supra* note 14, at 20.

23. Patent protects *process*; copyright *expression*. Thus, where a new and useful process receives patent protection, it may be expressed in such a way that copyright protection also applies.

24. 17 U.S.C. § 302 (1982).

25. Warrington Assocs. v. Real-Time Eng'g Sys., 522 F. Supp. 367 (N.D. Ill. 1981) (Copyright Act did not preempt claim of trade secret misappropriation).

26. Required disclosure is limited. An applicant need only file the first and last 25 pages of a program with the Copyright Office in order to receive copyright protection. 37 C.F.R. § 302.20(c)(2)(vii)(1986). Techniques to further limit disclosure include depositing

vators significant protection from acts of software piracy by permitting legal control of ideas as well as expression.

Original software innovators seek to maintain absolute control over the right to develop subsequent products because protection of ideas and unpatented processes enhances the value and life of the product. With such protection the innovator can either extend the commercial life of the product or adapt the original work to meet changing market needs. The greater the protections offered original innovators, the greater the incentive to create the original work.

However, government policy recognizes that subsequent developers often create entirely new products using ideas present in existing technology. Additionally, where grants of monopoly are too expansive, the holder tends to rest without making subsequent improvements. Thus, in each of the protective measures granted innovators, a countervailing measure exists to protect the public need for continued product development. Subsequent developers may save time and cost by using proven ideas and technology when they add new value.[27] There is no absolute requirement that a subsequent developer who adds value must reinvent the wheel.

This government policy also recognizes the advantage of standardization.[28] Standardization is particularly important for computer software, where compatibility is essential for the sharing of data between programs. Standardization requires access to software communication codes, or protocols. The greater protection given the innovator, the more difficult it is to access the protocols, and therefore, achieve product standardization. Thus, software protections balance the needs of society with the desire of the original innovator to be a monopoly holder.

III. *SAS* AND THE IMPLIED COVENANT NOT TO COMPETE

The holding of *SAS* may upset the balance between encouraging

object code to preserve the trade secret requirement of secrecy. *See* Davidson, *Protecting Computer Software: A Comprehensive Analysis*, 1983 ARIZ. ST. L.J. 611, 736-41.

27. Added value is non-trivial, creative enhancement to the original that creates a new product. In this sense it is distinguishable from piracy, which is solely copying for profit. The concept of "derivative work", *supra* note 18, is added value that is copyright protected. Not all value additions are copyright protected, however. For a model analyzing added value in the computer software context, *see Software Technology Infringement*, *supra* note 18, at 36-39.

28. *See* E.F. Johnson Co. v. Uniden Corp. of Am., 623 F.Supp. at 1501-03 (holding that protocol 'Barker word' necessary for communication with original developer's software was idea subject for reverse engineering). *See also CONTU*, *supra* note 14, at 20. (". . . [W]hen specific instructions, even though previously copyrighted, are the only and essential means of accomplishing a given task, their later use by another will not amount to an infringement.")

the innovator and preserving public access to ideas. In *SAS*, the plaintiff developed and marketed a special statistical applications program that ran on IBM and IBM compatible hardware. The plaintiff recognized that a program suitable for use on the VAX system of computer hardware would fill a substantial market, and began final testing of such a version. In the meantime, the defendant sought and received a license from the plaintiff to use the copyrighted IBM version of the SAS program. The court concluded that the defendants licensed the program in order to copy, convert, and market the program for use on VAX computers.[29]

The case was unusual in that there were numerous instances of egregious conduct on the part of the defendants. The defendants were on notice that their effort to convert the SAS program was legally suspect.[30] When the defendants obtained the license from the plaintiffs, they did not reveal their intent to develop a competing program.[31] In developing the competing work, the defendants violated contractual agreements not to copy, transport, or use the program after termination of the license agreement.[32] In addition, the defendants made no effort to improve the SAS program. Prior to trial the defendants altered and destroyed evidence,[33]and further evidence suggested that the defendants perjured themselves during testimony.[34]

The court found that the defendants infringed the plaintiff's copyright and violated the implied contractual covenants of good faith and fair dealing. Citing *Nimmer on Copyright*,[35]the court concluded that the content of the implied covenant in the copyright context included a promise not to create a competing work based upon the licensed "idea, theme, or title, *even if a stranger could create a new work with such idea, theme or title without infringing the grantor's copyright*."[36] Based on this finding, the court held in part that the defendants "agree[d] as a matter of law not to use proprietary SAS materials in the process" of developing statistical software for the VAX environment.[37]

A broad reading of this holding, when stacked on trade secret and

29. *SAS*, 605 F.Supp. at 820.

30. *Id.*

31. *Id.* at 821.

32. *Id.* at 827.

33. *Id.* at 823.

34. *Id.* at 826 ("the actual method employed by S & H was not the method described in its testimony").

35. M. NIMMER & D. NIMMER, NIMMER ON COPYRIGHT, (1983) [hereinafter NIMMER].

36. *SAS*, 605 F.Supp. at 827-28 (*citing* 3 NIMMER, *supra* note 35, § 10.11[B]) (emphasis added).

37. *Id.* at 828. In trying to avoid application of the implied covenant, defendant S&H argued that the implied covenant was limited to instances where a licensee had a duty to *promote* the licensed work. The court rejected this argument.

copyright protection, allows the first author to preempt future software development. This combination of protections grants to the innovator a nearly *perpetual* monopoly over ideas as well as expression. The holding prevents users of licensed programs from observing an idea, enhancing it, and independently developing a new competing program. Such a reading could have prevented the development of the Lotus 123 spreadsheet, which built upon the VisiCalc idea of individual cell addresses. The decision upsets the balance between the rights of the software developer and the needs of society. Thus, it is important to look more closely at the sources Nimmer relies upon in defining the implied covenant of good faith, which the *SAS* court adopted.

IV. IDENTIFYING THE IMPLIED COVENANT OF GOOD FAITH

A. ADDED VALUE AND MANIFEST HARM

The implied covenant of good faith as applied in the copyright context first developed with the rise of the movie industry.[38] In these cases, book publishers had licensed stage rights to theatre companies, prior to contemplation of the existence of the moving picture. Later, as the infant film industry sought material, both book publishers and theatre companies claimed the exclusive right to license the previously unconsidered film rights. In these cases, the courts assumed that film distribution would destroy any economic value in the the right to produce a stage version. The courts also found that the right to grant such rights frequently remained with the publisher. However, it was recognized that:

> [T]here is implied a negative covenant . . . not to use the ungranted portion of the copyright estate to the detriment, if not destruction, of the licensees' estate. . . . [If the parties] permitted photo-plays of Ben Hur to infest the country, the market for the spoken play would be greatly impaired, if not destroyed.[39]

These cases applied the negative covenant to situations where the parties did not anticipate the existence of competing rights.

Nimmer cites *Nelson v. Mills Music, Inc.*[40]for the proposition that good faith implies that the grantee will not create a new work "based upon the same idea, theme or title . . . ."[41] In *Nelson*, plaintiff composers assigned their song "Red Roses for My Blue Baby" on a royalty ba-

38. *E.g.* Manners v. Morosco, 252 U.S. 317 (1920); Kirke La Shelle Co. v. Paul Armstrong Co., 263 N.Y. 79, 188 N.E. 163 (1933).

39. Harper Bros. v. Klaw, 232 F. 609, 613 (S.D.N.Y. 1916) (holding that neither party to a license for stage rights could license film rights without the consent of the other).

40. Nelson v. Mills Music, Inc., 278 App. Div. 311, 104 N.Y.S.2d 605 (1951), *aff'd*, 304 N.Y. 966, 110 N.E.2d 892 (1953).

41. 3 NIMMER, *supra* note 35, § 10.11[B] n.12.

sis, only to find their publisher subsequently distributing a song entitled "Red Roses for a Blue Lady". Because the plaintiff's composition was the source of the second work, the court found that "good faith" obligated the publishing company "not [to] use plaintiff's composition for the purpose of fashioning a competing song to be sold in place of plaintiff's song."[42]

However, Nimmer notes that in *Van Valkenburgh, Nooger & Neville, Inc. v. Hayden Publishing Co.*[43]the publisher breached no covenant "to promote the author's work," even though it published a series that competed directly with the work plaintiff assigned to the same publisher.[44] In this case, the plaintiff author wrote a five volume series titled *Basic Electricity* and another five volume set titled *Basic Electronics*. These were published in 1954 and 1955, quickly became the publisher's best sellers, and accounted for a substantial portion of its income. The author received a 15% royalty. In 1962 the parties began negotiating for updated versions, but the negotiations broke down after a year when the author refused to accept a lower rate. The publisher then hired outside authors to prepare two seven volume series on the same subjects. Organization, presentation and picturing "could well be regarded as an exact description of the [plaintiff] author's existing books", although there was no finding of actual appropriation.[45]

The court held that absent express provision to the contrary there is a "general freedom of action of the publisher to produce competing works . . . ."[46] A covenant to use best efforts to promote the author's work "does not close off the right of a publisher to issue books on the same subject, to negotiate with and pay authors to write such books and to promote them fully according to the publisher's economic interests . . . ."[47] However, the court noted that "there may be a point where that activity is so *manifestly* harmful to the author, *and must have been seen by the publisher so to be harmful*, as to justify the court in saying there was a breach of the covenant to promote the author's work."[48]

In *Nelson*, the equities were with the plaintiff composers. The infringing publisher substantially copied the original work without significantly adding value. Thus, the infringer depended upon the efforts of

42. *Nelson*, 278 App. Div. at 312, 104 N.Y.S.2d at 607.

43. Van Valkenburgh, Nooger & Neville, Inc. v. Hayden Publishing Co., 30 N.Y.2d 34, 281 N.E.2d 142, *cert. denied*, 409 U.S. 875 (1972)

44. NIMMER, *supra* note 35, § 10.11[B] n.12.

45. *Van Valkenburgh*, 30 N.Y.2d at 35, 281 N.E.2d at 143.

46. *Id.* at 36, 281 N.E.2d at 145. The court did find that the publisher breached an express "best efforts" clause insofar as the publisher's salesmen had devoted a large portion of their time promoting the later work. *Id.* at 36, 281 N.E.2d at 144.

47. *Id.* at 36, 281 N.E.2d at 144.

48. *Id.* 281 N.E.2d at 145 (emphasis added).

the original composers to make a work that manifestly harmed the position of those authors. There was evidence that the infringing publisher attempted to avoid paying royalties to the original authors by publishing the second work. The publisher must have seen such "unclean dealing" as manifestly harmful to the original authors.

Van Valkenburgh differs from *Nelson* in that the alleged infringers independently added value to the original work. The public benefitted from having updated information about a rapidly changing field. There is no indication that development of the second work would create manifest, unjust harm to the original author insofar as the publisher appeared to make a good faith effort to deal. When the original author indicated unwillingness to pursue the market opportunities presented by such an updated version, the publisher seems justified in pursuing his own economic interests independently of the original author.

Where a subsequent author independently adds value to an idea, and where that author deals honestly with the original author, there seems to be no violation of the implied covenant. The rule reaches the two-pronged goal of promoting innovation by protecting the rights of the original innovator and the need society has for continued value added effort. Thus, a subsequent software developer may use the idea within a licensed program to compete with the original work so long as the subsequent developer uses the idea in a way that both adds new value and does not use guile. Such a rule necessarily requires a case by case analysis of the facts, yet it is less burdensome than creating an unbargained prohibition against competition that significantly inhibits software development.

Applying this rule, there was no violation of implied good faith where a wholesale manufacturer sold a trophy designed along the lines of one commissioned by the wholesaler's customer.[49] The manufacturer's trophy was "similar in some respects", but "the angle of extension of the right arm from the body" differed between the two trophies of a cowboy.[50] Thus, the court found the wholesaler added value. There was no manifest indication that the manufacturer's action would harm the distributer.

There is little difficulty in applying the rule of added value and manifest harm to the facts in *SAS*. The defendant, S & H, was well aware that making unauthorized copies and transporting the program to an unlicensed site was manifestly harmful to the plaintiff, and it attempted to act in secret. S & H continued to use the program after the

49. Williams v. Kaag Mfrs., 338 F.2d 949 (9th Cir. 1964), *cited in* 3 NIMMER, *supra* note 35, § 10.11[B], n.12.

50. *Williams*, 338 F.2d at 951. In other words, though the idea of a cowboy was similar, the expression of that idea was different.

expiration of the license agreement. S & H did not add value to the original work. Rather, S & H was guilty of attempting to write a competing work that relied almost exclusively upon the efforts of the original authors.

Other cases decided during the time of the *SAS* decision, not involving software, follow this proposition. Where there was evidence that a publisher "directly lifted" a grantor's material and used it in a subsequent competing work to avoid royalty payments, there may have been a breach of the implied covenant of good faith.[51] A publisher's use and subsequent composition of a "new, similar derivative theme" that supplanted the composers' pre-existing theme, depriving them of the right to royalties, also may have breached the implied obligation not to use the same theme to compete.[52] In both cases, there was evidence that the alleged infringer acted in a way that manifestly harmed the wronged party by affecting royalty rights, without significantly adding new value to the original work.[53]

However, in *Wolf v. Illustrated World Encyclopedia, Inc.*,[54]the plaintiff illustrator did not violate an implied covenant of good faith when he sold illustrations to a competitor that he had previously provided to the defendant under a contract. The court felt compelled to follow *Van Valkenburgh*, though it did not "express approbation for the conclusion".[55]

Nimmer calls the *Wolf* decision "questionable" and "shocking".[56] The illustrator added no value through independent effort to the second set of illustrations, and there appeared to be no good faith attempt to do so. The *Wolf* court decided the case on an incorrect reading of *Van Valkenburgh*. There is little doubt that *Wolf* passes over the line of manifest harm drawn by the *Van Valkenburgh* court. It takes no effort to imagine that the illustrator must have seen the harm that would result from distributing the same illustrations to competing encyclopedia publishers.

51. Ekern v. Sew/Fit Co., 622 F. Supp. 367 (D.C. Ill. 1985), *cited in* 3 NIMMER, *supra* note 35, at § 10.11[B] n.11.1.

52. Cortner v. Israel, 732 F.2d 267 (2nd Cir. 1984), *cited in* 3 NIMMER, *supra* note 35, § 10.11[B] n.11.1.

53. *See also* Miller v. Universal Pictures, Co., 180 N.E.2d 248 (1961) (where court refused to grant recovery on basis of implied covenant of good faith). In *Miller* the defendant movie company sought and obtained a license to use original manuscripts in a movie soundtrack from the widow of Glenn Miller. The defendants re-recorded all songs in stereophonic sound, and marketed the result in competition with the plaintiff's original recordings, causing a reduction in royalties.

54. Wolf v. Illustrated World Encyclopedia, Inc., 41 A.D.2d 191, 341 N.Y.S.2d 419 (1973), *cited in* 3 NIMMER, *supra* note 35, § 10.11[B] n.12.

55. *Wolf*, 41 A.D.2d at 192, 341 N.Y.S.2d at 421.

56. 3 NIMMER, *supra* note 35, § 10.11[A] n.2.

The *Wolf* court suggested that in the future contractors should be certain to include covenants not to compete in order to avoid such situations. Though this is the best course, such covenants are not always bargained for. Nor should it be necessary to bargain for good faith dealing where the licensee adds no value and competes in a manner that is manifestly harmful to the licensor. The true issue is whether a court should imply a covenant not to compete where the parties in fact may have reserved such a right, or where the harm is not manifest and where a subsequent author adds value through good faith efforts to improve a work.

B. "EVEN IF A STRANGER COULD CREATE SUCH A WORK"

Nimmer's restatement, and the *SAS* court's adoption, of the implied covenant asserts that a licensee is barred from creating a new competing work "even if a stranger could create a new work with such idea, theme or title without infringing the grantor's copyright."[57] Nimmer does not cite cases for the proposition that the covenant reaches property that would otherwise receive no protection. Apparently, Nimmer bases this assertion upon the fact that arms-length transactions may create rights where none previously existed.[58] However, this appears to be a misstatement of the scope of the implied covenant of good faith between licensee and licensor in the copyright context.

In *Miller v. Universal Pictures Co.*,[59]a case which Nimmer fails to cite, the New York Supreme Court reversed the lower court finding that the defendant had breached an implied duty of good faith.[60] The defendant motion picture company had licensed the right to portray the plaintiff widow of Glenn Miller and her family in a film about the life of the great band leader. The plaintiff also purported to license the right to "simulate the style, manner and manner of playing" of Miller and his orchestra.[61] The plaintiff received substantial royalties from the movie distribution. The license made no reference to the right to market recordings of the movie soundtrack.

To create a soundtrack suitable for the then novel stereo technology, Universal used its own orchestra to "meticulously" recreate the big

57. *SAS*, 605 F.Supp. at 827-28 (*quoting* 3 NIMMER, *supra* note 35, § 10.11[B]).

58. Action for breach of implied covenant of good faith is action on the contract. *See Nelson*, 278 A.D. 311 (action is for breach of contract or trust); *Van Valkenburgh*, 30 N.Y.2d at 34 (there is implicit in all contracts an implied covenant of fair dealing and good faith).

59. Miller v. Universal Pictures Co., 11 A.D.2d 47, 201 N.Y.S.2d 632 (1960), *rev'g* 18 Misc.2d 626, 188 N.Y.S.2d 386 (1959), *amended on other grounds*, 13 A.d.2d 473, 214 N.Y.S.2d 645, *aff'd mem.*, 10 N.Y.2d 972, 180 N.E.2d 248 (1961).

60. *Id.*

61. *Id.* at 48, 201 N.Y.S.2d at 634.

band sound of the Glenn Miller orchestra. The defendant never used the original RCA recordings. In marketing the resulting soundtrack, the defendant's album competed directly with the exclusive recording license Miller's widow granted RCA records.

The lower court found plaintiff had a property interest in the Glenn Miller "sound" that the defendant appropriated. The New York court rejected this proposition. "Plaintiff never had, and certainly does not now have, any property interests in the Glenn Miller 'sound'. Indeed, . . . even while Glenn Miller was alive, others might have meticulously duplicated or imitated his renditions."[62] The New York court declined to imply a negative covenant because "plaintiff . . . had no protectible [sic] interest as such in the Glenn Miller sound . . . if plaintiff wished to restrict Universal Pictures in the use of its sound track, she should have expressly so provided in the agreement."[63]

This repudiation of the Nimmer claim that the implied covenant applies even if a stranger might compete receives ample case support. In *Ekern* the court stated that a suit for breach of the implied covenant might be brought only "if [copyright] infringement is shown."[64] Where there was no copyright infringement of the cowboy trophy, the *Williams* court declined to find unfair competition.[65] And where the *Van Valkenburgh* defendant used the plaintiff's organization and structure, ideas that are in the public domain and not copyright protected, there was no breach of the implied covenant of fair dealing.[66]

As discussed earlier, *Nelson* found that the plaintiff's copyright song was the source of the later composition and thus breached the implied covenant.[67] Though the state court did not consider the question of copyright infringement, the implication is that no stranger could have created the second work without infringing the original copyright. The *Wolf* court noted that the holder of the original work made no claim of copyright protection in its claims against the work's illustrator.[68] Thus, the holder would have had no claim against a stranger who created the same subsequent work.

The *SAS* court concluded there was an interest subject to copyright protection. Consequently, it did not reach the question whether the scope of the implied covenant extended to works that would not be otherwise protected by copyright. The earlier memorandum decision, however, indicated that enforceability of the SAS license depended

62. *Id.* at 49, 201 N.Y.S.2d at 634.
63. *Id.* at 49-50, 201 N.Y.S.2d at 635.
64. *Ekern*, 622 F.Supp. at 372.
65. *Williams*, 338 F.2d at 949.
66. *Van Valkenburgh*, 30 N.Y.2d at 34.
67. *See supra* text accompanying notes 38-50.
68. *Wolf*, 41 A.D.2d at 191.

upon a finding that the subject matter was copyrightable.[69] Thus, a proper reading of the *SAS* decision may warrant application of the implied covenant only where protections pre-exist the implied negative covenant.

Strong policy considerations urge a narrow reading of the *SAS* negative covenant, particularly for software. The covenant against subsequent development severely restricts the public's access to valuable information. Contrary to the express intent of copyright law[70], such an implied covenant protects ideas even though the parties have not bargained for such protection. A contractual obligation of this nature would severely limit the future development and use of computers, because without software, computer hardware is useless. Though such a restriction on subsequent development protects the property rights of the software copyright owner, legal rulings that limit development of computer applications software could seriously affect the continued everyday use of the computer. Limitations could be particularly harmful when computer use and access is critical to this country's growth. The courts should decline to imply a covenant that extends copyright-like protections to a product where no independent protection exists, and none has been bargained.

An additional concern is that the duration of the implied covenant could be indefinite. Implying a covenant not to compete for an infinite duration effectively grants a party an unrestrained, unbargained permanent monopoly interest in an idea. There is no need to create these interests. If a party is entitled to absolute protection from competition, then the civil procedure rules should provide the party with injunctive relief.

The Supreme Court recognized that express contractual obligations in the patent context can upset the balance between the rights of the first innovator and those of the public as represented by the subsequent developer.[71] Thus, a license/royalty agreement extending payments beyond the life of the patent is unenforceable since it is contrary to the purpose of promoting product development.[72] Accordingly, where an implied covenant would extend a license agreement beyond the life of a copyright and upsets the goals balanced in copyright law, the courts should also decline to apply such a covenant.

69. *See* S & H Computer Sys. v. SAS Inst., Inc., 568 F. Supp. 416, 420-421 (M.D. Tenn. 1983). *See also Computer Software Protection*, *supra* note 21, at 149-50.

70. *See supra* note 19 and accompanying text.

71. *See* Brulotte v. Thys Co., 379 U.S. 29, 32 (1964).

72. *See* Boggild v. Kenner Prods., 776 F.2d 1315 (6th Cir. 1985), *cert. denied*, 477 U.S. 908 (1986). For a discussion of the nuances in this area, see *Computer Software Protection*, *supra* note 20, at 148.

V. THE IMPLIED COVENANT AND ECONOMIC POWER

The obvious limitation to the implied covenant is that these covenants can not exist without a contract. Given the possibility that courts will imply the covenant frequently, software innovators will seek to preempt subsequent development through license agreements whenever possible. As noted earlier, license agreements protect trade secret ideas as well.[73] Thus, software innovators with economic power will almost always choose to license software and preempt future development rather than lose control of the product through absolute sale.[74]

The question of enforceability of end-user licenses occurs in two separate contexts. In the first, the end-user pays a one-time use fee, receives the software from a retailer and "assents" to the license through some action, such as opening the package. These "shrink wrap" or box top licenses occur most frequently in the mass distributed, microprocessor market. Commentators suggest that box top licenses are unenforceable.[75] Arguably, these licenses are either unconscionable or contracts of adhesion. Arguably the end-user has not assented to the terms of the license despite opening the box. The retailer has no ability to negotiate the terms with the customer, and the user believes that in fact a sale has taken place. Where the substance of the transaction is a sale, there is no reason why a court should artificially extend license protection based upon form. This is especially true where the software developer can dictate the terms of the license based upon his economic position.

The second situation involves specific application software that is in limited distribution. There are relatively few customers and the programs generally work on large mainframe computers. This situation describes the market context in *SAS*. Excessively restrictive limited distribution licenses may be void on grounds of either statutory preemption or public policy.

Statutory preemption may apply where a covenant to compete is unqualifiedly implied in every software license. Such unqualified application will significantly upset the statutory balances sought through copyright and patent. The courts could find that federal law preempts any implied covenant not to compete where a stranger could create the same product without infringement.[76]

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73. *See supra* text accompanying notes 3-6.

74. The first sale doctrine permits the purchaser to use a copyright product in any manner that does not affect the grant of copyright. Thus, a sale would permit the purchaser to reverse engineer. *See* 17 U.S.C. 109 (1984); Burke & Van Heusen, Inc. v. Arrow Drug, Inc., 233 F.Supp. 881 (Pa. 1964).

75. *See e.g. Computer Software Protection*, *supra* note 21, 150-57.

76. *See e.g.*, *Brulotte*, 379 U.S. at 32.

The preemption approach requires mandatory denial of the implied covenant of good faith where such an application would upset the balance between public and private interests. The public policy approach requires a case by case review of the facts. Public policy concerns include maintaining the balance between private and public interests, especially in the context of economic power.

There is a rebuttable presumption that the holder of a copyright in the software context has economic power.[77] Distributors of protected limited distribution software have a significant economic advantage that allows a distributor to insist upon limited licensing agreements. This is particularly true where a software innovator has monopoly control over an especially useful and necessary software program. If an implied covenant not to create competing software adheres to all licenses, and the only means to gain access to such software is through a license, then limited distributors preempt nearly all competition from entering the marketplace. Thus, the license limits customers in a further search to find either alternative program sources or improved application programs. If a license unilaterally denies in perpetuity a customer the right to remove himself from the terms of a license, the terms of such a license should be void as against public policy. However, the implied covenant not to compete, even though a stranger could compete effectively, binds licensees to the licensor in perpetuity. Thus, the combination of economic power and the duties implied through the covenant give to limited distribution software innovators more strength than is necessary to protect software innovation from piracy. In fact, this combination usurps the needs of society by retarding further software development.

The effect of such a combination can be seen if legal protections implied that book publishers might restrict readers from using ideas found within published books. There would be a significant decrease in the application of ideas, thus affecting the number and quality of products. The number of new ideas entering the marketplace would decline, because ideas found in one source could not be used as the foundation of new ideas. Implying such contractual agreements certainly would impair the progress of innovation and the application of ideas for the benefit of society.

Absent express statutory authority, courts should give no greater protection to licenses in the mass market context than is absolutely necessary. This means that there should be no covenant not to create competing works implied in a valid license. In the limited distribution software context, the implied covenant not to compete appears to offer

77. Digidyne Corp. v. Data General Corp., 734 F.2d 1336 (9th Cir. 1984), *cert. denied*, 473 U.S. 908 (1985), *reh'g denied*, 473 U.S. 926 (1985).

the software innovator too much protection, particularly where there is economic power.

VI. WHEN TO APPLY THE IMPLIED COVENANT OF GOOD FAITH

This discussion urging limitation of the implied covenant not to compete is not meant to urge absolute rejection of the doctrine. There certainly are occasions where the doctrine is applicable. The incredibly egregious conduct of S & H merits the use of the doctrine. However, the covenant should be applied in a manner that does not upset the balances between public and private needs.

In implying the covenant, the court should first determine whether a party has infringed an interest existing independently of the implied covenant. Such an interest may find its source in copyright, trade secret, patent, or express provisions of the underlying license. If there is such an infringement of underlying rights, then the question becomes whether such infringements are so egregious as to shock the conscience and violate good faith.

Egregious conduct that violates good faith involves copying of material that the infringer knows is protected, and in such a manner that the infringer knows will cause manifest harm to the protected party. The *SAS* court spoke of "unnecessary, intentional duplication of expression".[78] "Copying occurs when the second programmer *chooses* to duplicate, rather than create in a context where a realistic choice exists. Repetitive choices to duplicate contradict claimed new product development."[79]

However, where the material is unprotected, a stranger could create a competing work. Thus, the scope of the implied covenant does not extend to bar second, value added works that a stranger could create. Nor would the implied covenant inhibit standardization of computer software. Consequently, such an application of the implied covenant does not upset the balance sought by intellectual property law.

VII. CONCLUSION

The court in *SAS* stated that there exists in every license an implied agreement between licensor and licensee not to create competing works, even if strangers could do so. Such a broad covenant upsets the balance between public and private rights. In addition, such a broad reading of the implied covenant of good faith is not warranted in the law.

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78. *SAS*, 605 F.Supp. at 825.

79. *Software Technology Infringement*, *supra* note 18, at 51 (emphasis in original).

The ultimate question to ask when deciding to apply the implied covenant is whether a court should provide more protections to a party than the parties intended or public policy requires. Where a party has no right to independent protection, the court should not bar subsequent developers of value added software from competing in the marketplace.