Software in Asset Deals: Buying IP Rights on the Software, Buying Hardware or Buying a (mere) Copy of the Software?

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The buyer was entitled to invalidate a sales contract (an asset deal for the sale of a car dealership that included software) for fraud that was committed by the seller (Art. 28 SCO) because the seller had not disclosed to the buyer that it did not own the intellectual property rights on the software but only had a license to use the software granted by a third-party licensor.

Judgment of the Federal Supreme Court of 17 June 2022
Case Reference : 4A_502/2021

Facts

A (the "Seller") operated a car dealership ("the Business") that he wished to sell (including two parcels of real estate where the garage and a parking lot were located).

A entered into negotiations with an individual (B) who had connections with various companies, including X SA ("X"), Y SA ("Y") and Z AG ("Z"). Z's statutory corporate purpose included the supply of software.

Two separate contracts were concluded on September 30, 2014. The first, entitled "Sales Contract" (the "Sales Contract"), was concluded between A (as Seller) and Z (as Buyer). It covered the sale of furniture and of business software ("the Software") that were used by A to operate the Business, for a price of CHF 500,000. The second contract, entitled "Contract of Sale, Delivery of Goodwill" ("the Other Contract"), was concluded between A and Y and concerned the delivery of the goodwill, i.e. all the clientele and current contracts, and expressly excluded from its scope the furniture and the Software.

In particular, the Sales Contract contained the following clauses (unofficial translation from French to English):

"ARTICLE ONE

The seller undertakes to deliver to the buyer all the furniture and business management software stored at the premises located at [street address] in [city], in accordance with the inventory attached hereto as an integral part of this contract, and to transfer ownership thereof to the buyer.

ARTICLE 2 – SALE PRICE

The buyer undertakes to pay the seller the sum of CHF 500,000 (…) for the purchase of the aforementioned furniture and software.

ARTICLE 8 – WARRANTY IN CASE OF EVICTION AND WARRANTY FOR DEFECTS

The seller certifies that all the furniture and software referred to in article 1 are its property and free of any obligation.

(…)

With regard to (…) the warranty for defects, the buyer has a period of one year from the conclusion of the notarial deeds referred to in article 2 to verify the condition of the furniture and software sold. (…) ".

The original French version provided as follows:

"ARTICLE PREMIER

Le vendeur s'oblige à livrer l'ensemble du mobilier et des logiciels de gestion d'entreprise entreposés dans les locaux sis [street address] à [city], selon inventaire annexé pour faire partie intégrante du présent contrat, à l'acheteur et à lui en transférer la propriété.

ARTICLE 2 – PRIX DE VENTE

L'acheteur s'oblige à payer au vendeur le montant de CHF 500'000.- (…) pour l'acquisition du mobilier et des logiciels précités.

ARTICLE 8 – GARANTIE EN CAS D'EVICTION ET GARANTIE EN RAISON DES DEFAUTS

Le vendeur certifie que l'ensemble du mobilier et des logiciels visés à l'article premier sont sa propriété et libres de tout engagement.

(…)

S'agissant (…) de la garantie en raison des défauts, l'acheteur dispose d'un délai d'un an à partir de la conclusion des actes notariés visés à l'article 2 pour vérifier l'état du mobilier et des logiciels vendus. (…)".

By a handwritten addition to the Sales Contract, the period of "one year" in Art. 8 was changed to "one month", upon A's request, who wished to avoid bearing a full year's worth of costs for the computer equipment.

Contrary to what was agreed in Art. 1 of the Sales Contract, no inventory was attached to the Sales Contract.

On October 2, 2014, A and X signed two notarial deeds for the sale of the two parcels of real estate housing the garage and parking lot, for a total price of CHF 2,700,000.

On the same day, Z presented A with a cheque for CHF 500,000 in payment of the purchase price agreed in the Sales Contract.

However, it turned out that the Software sold by A to Z in the Sales Contract actually belonged to a third-party company (S AG, "S") and that A only held a license to use the Software.

In this respect, on October 13, 2014, S invited A to sign a document entitled "Confirmation of Transmission", whose terms read namely as follows (unofficial translation from French to English):

"Transmission of the license and service agreement for the programs to company Y SA. By means of signature, A confirmed the transmission of the licenses and services agreement for the above programs to company Y SA."

The original French version provided as follows:

"Transmission de la licence et de la convention des services pour les programmes à l'entreprise Y. SA. A. confirme avec la signature de cette lettre la transmission des licences et la convention des services pour les programmes ci-dessus à l'entreprise Y. SA".

This document was signed by A and representatives of Y.

On January 22, 2015, Z. invalidated the Sales Contract on the grounds of fraud (Art. 28 SCO) or, alternatively, mistake (Art. 24 SCO). Z then summoned A to refund the payment of CHF 500,000 within ten days of receipt of the letter, which A refused to do.

Z thus commenced debt-collection proceedings against A. Moreover, Z and Y had also initiated criminal proceedings against A for fraud (but these proceedings were closed in September 2018).

The dispute was brought before the local courts which ordered a financial assessment by an expert in order to assess the value of the assets that were sold in the Sales Contract. In its report, the court-appointed expert estimated the value of the furniture between CHF 1,450 and CHF 10,000 and added that, through a process of deduction, the Software had to be valued at least CHF 490,000 to justify the agreed sale price of CHF 500,000.

When ruling on the matter, the cantonal courts found that A and Z were bound by a contract for the sale of movable property (Art. 184 SCO), whose specific purpose could not be ascertained by means of subjective contract interpretation.

According to the objective method of contract interpretation that the courts applied, and thus the principle of trust, the Sales Contract was intended to transfer ownership of the furniture and of the Software, but not to transfer the computer installations (i.e. the hardware) in the garage.

The cantonal courts thus held that A had intentionally misled Z by representing that it owned the Software, when in fact it only held a license for its use. Notwithstanding its gross negligence in failing to verify this point, Z was entitled to invalidate the Sales Contract on the grounds of fraud under Art. 28 SCO (which provides that "A party induced to enter into a contract by the fraud of the other party is not bound by it even if its mistake is not fundamental"), a right that Z had exercised in a timely manner (Art. 31 SCO).

The cantonal courts thus decided that Z was entitled to claim reimbursement of the purchase price of CHF 500,000 on the grounds that A had committed fraud against Z.

Issue

The Federal Supreme Court was called upon to review the cantonal courts' interpretation of the Sales Contract and, in particular, to assess the parties' intentions when concluding the sale of the Software specifically.

Decision

The Federal Supreme Court confirmed the reasoning and the ruling of the cantonal courts, in particular the finding that the Sales Contract covered the sale of the Software but not the sale of the physical IT infrastructure (hardware) of the Business (computer equipment/"*installation informatique*", para. 3.2), an argument made unsuccessfully by A.

Indeed, in the cantonal court proceedings, A pointed to the parallel conclusion of the two contracts (i.e. the Sales Contract and the Other Contract), claiming that the Sales Contract concerned the sale of *tangible* goods (and thus of the physical IT infrastructure) and the Other Contract concerned the sale of *intangible* goods (clientele, etc.). This argument was rejected by the courts.

In order to interpret the Sales Contract, the cantonal courts relied on the *objective* method of contract interpretation, based on the principle of trust, because they could not establish the true and common intent of the parties through the application of the subjective method of contract interpretation. Under the objective method of contract interpretation, the court must ascertain what meaning, as per the rules of good faith, each party could and should reasonably attribute to the other party's expressions of intent.

On this basis, the cantonal courts concluded that the sale concerned title over the Software and not over the hardware. The Federal Supreme Court confirmed this interpretation. While it noted that the text of the Sales Contact referred to the *physical location* of the Software (under Art. 1, "[t]he seller undertakes to deliver all the furniture and business management software *stored at the premises located at* [street address] in [city], […]" [italics added]; in the French original version "Le vendeur s'oblige à livrer l'ensemble du mobilier et des logiciels de gestion d'entreprise *entreposés dans les locaux sis* [street address] à [city], […]"), the Federal Supreme Court did not consider that this wording had any material impact on the interpretation of the Sales Contract.

In addition to the wording of the Sales Contract, the cantonal courts took into account other factors, such as the fact that the statutory purpose of the Buyer (Z) included the supply of software.

Having said that, the Federal Supreme Court found it somewhat surprising that Z had agreed to pay such a substantial purchase price (i.e. CHF 500,000) given such scarce information ("*renseignements étiques*") and an accounting value that it could not verify prior to the purchase (para. 4.3).

The Federal Supreme Court also expressed its surprise at the fact that the Sales Contract would even include the sale of a tailored software product, as it seemed unlikely that a car dealer (such as A) would have contracted out the development of a software product to operate its business (and that it would have agreed to pay a steep price for it, knowing that this type of software was readily available on the market) (para. 4.3).

In fact, the Federal Supreme Court went as far as to question whether the parties had entered into a sham transaction (para. 4.3), under which the real object of the Sales Contract and thus the reason for the payment of CHF 500,000 differed from what the Sales Contract provided. It noted however that no evidence had been brought forward to establish a sham in this case.

Finally, the Federal Supreme Court also noted the relatively long delay (i.e. over three months) between the moment when Z learned that the Seller held a mere license to use the Software (October 13, 2013) and the moment it formally notified the Seller of its intention to invalidate the Sales Contract (January 22, 2014).

Despite raising these points, the Federal Supreme Court ultimately confirmed the finding of the cantonal courts, according to which Z was entitled to invalidate the Sales Contract for fraud (Art. 28 para. 1 SCO). The fraud consisted in A claiming to own the Software when in reality it held a mere license granted by a third-party licensor (i.e. S). Moreover, the right to invalidate was upheld despite the Seller's negligence; indeed, the Federal Supreme Court held that the negligence on the part of the victim did not prevent it from invoking fraud committed by the other party because the fraud outweighed the negligence of the victim (para. 4.2).

Key takeaway

Contracting parties negotiating the sale of business assets in an asset deal that includes software should precisely identify the object as well as the legal nature of the transaction that they wish to conclude with respect to software. Thus, if they wish to sell a software product that is used to operate the business of the seller, they should precisely identify what will be the object of the sale transaction and whether they agree, alternatively, on the sale of the IP rights on the software or the sale of a copy of the software (with a transfer of the license agreement for the use of the software), and whether the transaction shall cover the physical IT infrastructure used to run the software.

Comments

This case is rather peculiar as noted by the Federal Supreme Court and many gray areas regarding the facts remain (the Federal Supreme Court expressly referred to the anomalies that characterized this case – "anomalies qui caractérisent cette affaire", para. 4.3). Indeed, based on the very limited record of the case (including the judgment of the cantonal court of the Canton de Vaud (Civil court of appeal, cour d'appel civile) of August 16, 2021 [ref. HC / 2021 / 572]), it appears quite difficult to grasp the various facets of the transaction and hence to analyze their legal consequences. Moreover, the interposition of different companies (Z as the Buyer in the Sales Contract and Y as the Buyer in the Other Contract) adds to the complexity of the matter.

Despite its specificities, this case serves as an important warning of the challenges which can arise in asset deals that include software if the parties do not precisely define the object of the transaction. In this case, the Buyer apparently expected to buy the intellectual property rights (IPRs) on the Software (i.e. the copyrights) while the Seller wanted to sell the physical IT infrastructure on which the Software had been installed. The discord between the parties' expectations could not be reconciled.

This case illustrates the confusion that can arise between a transaction on an *intangible* asset (i.e. IPRs on a software) and a transaction on a *tangible* asset (i.e. the sale of a tangible copy of the software that can belong to a party similar to the ownership of other types of physical goods incorporating IPRs/copyrights, such as a book or a painting, which can be coupled with the sale of the physical IT infrastructure on which a copy of the software runs). Unfortunately, none of the courts clarified nor discussed this distinction in this case. In this sense, this case can be compared to another recent decision handed down by the Federal Supreme Court (judgment of 11 July 2023, ref. 4A_372/2022) – that will also be presented and commented on our Swiss Contract Law platform – where the parties to a complex IT contract were in dispute about the nature of the rights (i.e. full transfer *or* mere license of the copyrights on the software) that the client had over the software product at issue.

As a matter of principle, it is generally admitted that the sale of a tangible good does not imply the sale of the IPRs (and specifically of the copyrights) that are incorporated in that good (e.g. the sale of a book or a painting does not imply the sale of the copyrights on the book or the painting, unless otherwise agreed upon by the contracting parties). This stems from Art. 16 para. 3 of the Swiss Copyright Act (SCA) which provides that "[t]he assignment of the ownership of a copy of a work does not include the right to exploit the copyright, even in the case of an original work". A tricky legal issue that can arise in this context (which was apparently not debated in this dispute) relates to potential application of the principle of exhaustion which applies under Swiss copyright law (which corresponds to the "first sale" doctrine under US copyright law). Pursuant to this principle (which is regulated in Art. 12 (for all copyrighted works in general) and specifically for software in Art. 12 para. 2 SCA and under Art. 17 para. 1 of the Ordinance on Copyright and Related Rights), the owner of a copy of work has the right to resell that copy without infringing on the copyrights of the author of the work. The application of this principle of exhaustion to software products may be complex in certain circumstances (particularly when dealing with digital copies of the software).

In this case, it seems that the parties (and particularly the Seller) did not have a clear understanding of the type of transaction they intended to conclude with regards to the Software. The courts decided that the Seller had to ultimately bear the consequences of the resulting lack of clarity, and it was held that the Seller had fraudulently misled the Buyer into believing that it was purchasing the IPRs on the Software. This finding appears quite harsh on the Seller who did not appear to be an expert in IT/software (he was a car dealer). By contrast, it seems rather lenient on the Buyer whose very statutory purpose – as noted by all instances including the Federal Supreme Court – included the supply of software. From this perspective, one could argue that the Buyer ought to have known or at least to have clarified what rights it was expecting to buy with respect to the Software in the Sales Contract.

One can contrast this finding (which is quite harsh on inexperienced clients who rely on external IT solutions for their business activities) with the above-mentioned recent decision handed down by the Federal Supreme Court (judgment of 11 July 2023, ref. 4A_372/2022). In that case, the Federal Supreme Court held that the client did not have the same level of expertise as compared to the expertise possessed by its IT service provider, and thus deserved to be protected against the integration and application of unusual and onerous contractual terms that were contained in the general terms and conditions of the IT service provider (para. 3.6). A comparison between these two decisions reveals a possible inconsistency regarding the degree of protection afforded to inexperienced clients of IT service providers under Swiss contract law.

In any event, in the case at hand, the Federal Supreme Court highlighted that the Buyer had accepted a price of half a million Swiss francs to buy the Software without clarifying precisely what the Software entailed, who owned the IPRs/copyrights on the Software nor what rights relating to the Software would be transferred to the Buyer under the Sales Contract. And yet, as the financial expert report ordered by the court in the cantonal proceedings revealed, the purchase price of CHF 500,000 under the Sales Contract consisted almost exclusively of the price of the Software given that the value of the other tangible assets that were sold (i.e. furniture) was very low (only a few thousand Swiss Francs).

Based on the wording of the Sales Contract, it would not have been unreasonable to hold that the Sales Contract included the sale of a copy of the Software that the Seller had acquired from the third-party company (S) but did not include the sale of the IPRs on the Software (in part because it was a standard software product and not a tailored software product that had been developed exclusively for the Seller's Business). Based on the wording of the Sales Contract, the Seller had indeed agreed to "deliver all the furniture and business management software *stored at the premises* at [street address] in [city]" (italics added). Contrary to the finding of the Federal Supreme Court, one could have reasonably considered in good faith (based on the objective method of contract interpretation) that the reference, in the contractual provision, to the physical location of the Software at the premises of the Business meant that the parties intended to sell a *copy* of the Software that had been acquired and used by A to operate the Business. Had the parties wished for the sale of the IPRS/the copyrights on the Software, they would not have referred to the physical location of the IPRS/the copyrights on the Software because IPRs have no physical location as such. This illustrates the distinction that must be drawn between a transaction over physical goods versus a transaction over IPRs.

In this case, the transfer of the copy of the Software from the Seller to the Buyer was connected to the transfer of the license agreement relating to the use of the Software from the Seller to the Buyer. Unfortunately, given the very limited information about the facts of the case, it is not possible to ascertain how the Software was initially made available by S (the Software provider) to A and whether the content of the license agreement was covering the use of the Software that was entered into between S as licensor and A as licensee.

However, what the records show is that some six weeks after the signing of the Sales Contract (i.e. on October 13, 2014), S (the Software Provider) invited A to sign a document entitled "Confirmation of Transmission" by which A was requested to confirm the transmission to Y of the license and the service agreement relating to the Software. This document was signed by A and two representatives of Y. Interestingly, this document did not refer to Z (the Buyer under the Sales Contract) but rather to Y (who was the Buyer under the Other Contract). No clear explanation is given as to why (and the Federal Supreme Court considered this fact as being insignificant, given its narrow scope of review on appeal, see para. 4.3). In any event, the subsequent behavior (i.e. post-signing) of the parties could not be taken into account under the objective method of contract interpretation, and is therefore of no relevance in the objective interpretation of the Sales Contract.

Ultimately, Z was entitled to invalidate the Sales Contract for fraud (on January 22, 2014) even though the representatives of Y had previously agreed to the aforementioned transfer of the license agreement (in October 2013). This may appear surprising, as by agreeing to this transfer, Y (via its representatives, one of whom was also a representative of Z) seemingly confirmed that the transaction relating to the Software in the Sales Contract was not a sale of the IPRs/copyrights on the

Software but rather the sale of a copy of the Software (the use of which was governed by the aforementioned license agreement).

One cannot help but wonder whether it is justified for a corporate buyer, whose very statutory purpose includes the supply of software and who should, at the very least, be deemed more expert in software products than the Seller (the latter being an individual operating a car dealership) to invalidate a sales contract for fraud (or even for mistake, which was the fallback ground for invalidation claimed by the Buyer) on the ground that the buyer supposedly thought that it was buying the IPRs on the Software and not a mere copy of the Software.

As duly noted by other commentators (Helene Tasman / Dario Galli / Markus Vischer (cited below), para. 16), this case does not adequately reflect the balancing test that must be performed when deciding whether a contract can be invalidated for fraud. Indeed, the behavior of the alleged victim (in this case, the Buyer) must also be taken into account because the negligence of the victim of the alleged fraud can play a role in assessing whether the victim can successfully invalidate the contract for fraud under Art. 28 para. 1 SCO.

Based on the case law of the Federal Supreme Court (see e.g. judgment 4A_437/2020 of December 29, 2020, para. 4.1), the parties have a certain duty to inform each other in good faith about facts which are likely to influence the other party's decision to enter into the contract or to enter into it under certain conditions. The extent of the parties' duty to inform cannot be determined generally, but depends on: the circumstances of the case, in particular the nature of the contract; the way the negotiations were conducted; and the intentions and knowledge of the parties. The duty to inform imposed on the seller ceases if, in view of concrete circumstances, the seller can in good faith assume that the buyer will become aware of the information on its own. In this respect, it is in principle sufficient if the buyer has the *possibility* to discover the information by exercising the care required under the circumstances. In this particular case, one could reasonably assume that the Buyer *had* the possibility to discover the nature and extent of rights over the Software that it intended to purchase from the Seller, had it exercised the care that was required by the circumstances.

Other comment(s) of this judgment

Helene Tasman / Dario Galli / Markus Vischer, Verhältnis von Art. 28 Abs. 1 OR zu Art. 146 Abs. 1 StGB, *in* digitale Rechtsprechungs-Kommentar (dRSK), published on June 9, 2023, (https://www.walderwyss.com/user_assets/publications/Verhaltnis-von-Art.-28-Abs.-1-OR-zu-Art.-146-Abs.-1-StGB.pdf).

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