

Presenting a live 90-minute webinar with interactive Q&A

NFTs and Fractional NFTs: Legal and Regulatory Concerns for Creators and Investors

NFT as a Commodity, Securities Requirements, AML and Cybersecurity Issues

WEDNESDAY, AUGUST 25, 2021

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Mark H. Wittow, Partner, **K&L Gates LLP**, Seattle

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Non-Fungible Tokens (NFTs) - Legal and Regulatory Concerns

Andrew Lom
Partner
New York

August 25, 2021



What is an NFT?

- Could represent a physical asset
- Could be tied to another digital asset
- Could be the asset in and of itself
- Initial major use case: Art



by Ivy J Jewelers

Expanding NFT use cases

- Collectibles
- Gaming
- Event tickets
- Physical goods



Virtual assets in virtual worlds





24 hours

7 days

30 days

All-time

Click Here

NFT Collectible Rankings by Sales Volume (All-time)



Top NFT Collectible Sales (All-time)

	Product	Sales	Buyers	Txns	Owners
1	NBA Top Shot	\$561,778,596.38	271,526	4,495,823	473,749
2	CryptoPunks	\$284,880,717.37	2,629	12,900	2,255
3	Hashmasks	\$49,370,051.01	3,125	11,214	4,238
4	Sorare	\$38,262,423.17	15,764	217,592	17,401
5	CryptoKitties	\$33,211,545.02	100,486	762,310	
6	Axie Infinity	\$19,532,731.77	29,546	171,288	45,802
7	Art Blocks	\$18,405,049.61	2,012	10,690	4,365
8	Alien Worlds	\$14,628,279.36	126,781	1,790,958	791,178
9	Topps MLB	\$8,688,101.74	11,813	316,411	37,013
10	MyCryptoHeroes	\$4,638,996.77	2,888	42,662	5,554

	NFT
1	CryptoPunk 7804 Alien, Small Shades, Pipe, Cap Forward Sold: 1 month ago
2	CryptoPunk 3100 Alien, Headband Sold: 1 month ago
3	CryptoPunk 3011 Male, Small Shades, Earri Vampire Hair, Normal Be Frown Sold: 5 days ago
4	CryptoPunk 6965 Ape, Fedora Sold: 2 months ago

Business in virtual worlds

- Real estate
- Property development
- Virtual events and “transactions”
- Other value building activities

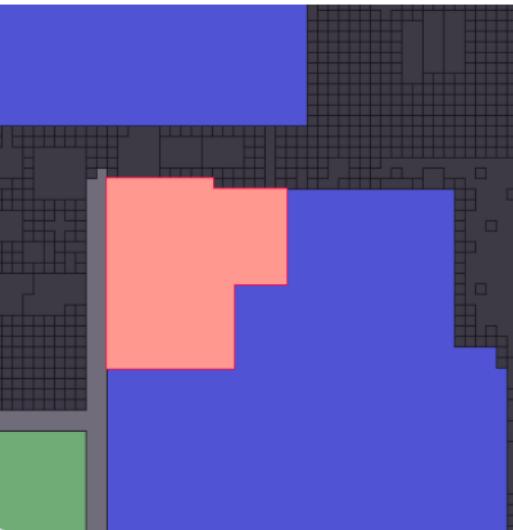
 Republic Realm
@joinrepublic_RE 

Republic Realm just closed on the largest land acquisition in [@decentraland](#) history! We can't wait to announce our big plans for this estate.

Our commitment to building and developing the metaverse is stronger than ever.

 LAND Bot @dclandbot
Bid accepted!

Estate Id: 4247
Estate Size: 259 parcels
Price: 1,295,000 MANA (\$913,228.2 USD)
market.decentraland.org/estates/4247/d...



1:34 PM · Jun 17, 2021 

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NRF



Overview of an NFT ecosystem

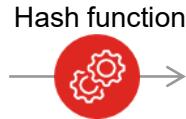


© Beeple

Digital Asset
Rights Owner

NFT Creator / “minter”
/ first seller

Platform /
Marketplace



NFT

- Blockchain based
- Smart Contract
- Hash of image file
- URI for location of image file

CHRISTIE'S



Terms of sale



OpenSea

Buyer(s) / Resellers

NFTs present unique issues with respect to establishing ownership and security interests

- Key issue is link between the token, which is being purchased, and the underlying asset
 - Where is underlying asset housed?
 - What are terms of the smart contract itself? (e.g. royalties for subsequent sales) What terms are coded into the smart contract?
 - What are terms of related license agreement?
 - How do we enforce the terms of the agreement?

“Few platforms seem to be doing the legal legwork necessary to convey valuable rights together with their tokens. My suspicion is legally enforceable copyrights and hard-coded, on-chain monetization mechanisms will be a valued feature for NFT platforms, and the platforms with the most effective monetization schemes will attract the most in-demand content creators (and therefore the best content).”

Electronic agreements

Blockchain's use of private keys and encryption fits well with existing law on electronic agreements.

- [A] signature, contract, or other record relating to such transaction may not be denied legal effect, validity, or enforceability solely because it is in electronic form
- [A] contract relating to such transaction may not be denied legal effect, validity, or enforceability solely because an electronic signature or electronic record was used in its formation
- 15 U.S.C. § 7001(a)
- The term "electronic" means relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities.
- The term "electronic record" means a contract or other record created, generated, sent, communicated, received, or stored by electronic means.
- The term "electronic signature" means an electronic sound, symbol, or process, attached to or logically associated with a contract or other record and executed or adopted by a person with the intent to sign the record.
- 15 U.S.C. § 7006 (3)-(5)

Myriad potential legal and regulatory issues

- Consumer protection laws – both federally and at the state level
- UCC Article 2 governs sale of goods or “tangible, moveable property”
 - Do the default provisions apply?
- UCC Article 9 governs security interests
- Interplay between UCC and other rights in physical goods and IP rights
- Inadvertent general partnership and/or joint venture issues
- Securities law treatment
 - *Howey* test: “investment contract”
 - *Gary Plastic* case: the way an asset is packaged, sold or offered could also make it a security
 - Fractionalized ownership
 - Basket of rights with different ownership
 - Basket of rights with different control persons and principal/agent relationships
- Commodities law treatment

Questions



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**NFTs and Fractional NFTs: Legal and Regulatory
Concerns –
Derivatives and Securities Law Issues**

Anthony R.G. Nolan, K&L Gates (New York)

PROLOGUE

- Bitcoin vs. Ether
- ICO vs. IEO vs. STO
- ERC-20 vs. ERC-721 token protocol
- NFT Use Cases:
 - In-game assets
 - Other virtual assets
 - Land on Mars
 - Virtual Art
 - Real-world assets
 - Tweets
 - Artworks
 - Next???
 - Royalty rights management

NFTS AND THE COMMODITY EXCHANGE ACT

- CFTC Jurisdiction Over Virtual Currency
 - *In Re Coinflip*
 - *In Re Bitfinex*
 - CFTC OGC Letter Re: SEC v. Telegram
- CFTC Regulatory Oversight of Products
 - Anti-fraud and Anti-manipulation
 - Leveraged or Margined Retail Transaction
 - Commodity Pools

NFTS AND THE COMMODITY EXCHANGE ACT

- CFTC Regulation of Digital Asset Intermediaries
 - Commodity Pool Operator
 - Commodity Trading Advisor
 - Futures Commission Merchant
 - Introducing Broker
 - Swap Dealer
 - Swap Execution Facility
 - Designated Contract Market

NFTS AND THE FEDERAL SECURITIES LAWS

- Regulatory Framework and SEC Jurisdiction
- Definition of Security
- Howey Test:
 - investment in
 - a common enterprise
 - with an expectation of profits
 - from entrepreneurial or managerial efforts of others.
- Utility Tokens?
 - *In Re Munchee*
 - *TokenJet NAL*
 - *Pocketful of Quarters NAL*
- Decentralization?
 - Hinman Speech: When Howey Met Gary (Plastics)
 - SEC Commissioner Peirce's Token Safe Harbor Idea
 - Upcoming Rippl Labs trial

NFTS AND THE FEDERAL SECURITIES LAWS

- Are NFTs and Fractionalized NFTs Securities?
 - Single ERC-721 token sold to a single investor
 - Collectibles
 - Royalty rights
 - Fractionalization models
 - Multiple ERC-721 tokens on a single asset / asset class
 - One ERC-721 token represented by many ERC-20 tokens
- Some Analogues for a Digital Age:
 - Custodial receipt for gold bars? One? Many? How sold?
 - Bill of lading for art in transit?
 - Actively managed orange grove?
 - Country club membership?
 - Retail gift card?

NFTS AND THE FEDERAL SECURITIES LAWS

- SEC Regulatory Impact if an NFT is Security
 - Sponsors / Issuers / Investors
 - Registration of offers and sales
 - Exemption from registration
 - Initial Sale
 - Resales
 - Intermediaries
 - Securities Exchange Act
 - Broker-Dealer
 - National Security Exchange / Alternate Trading System
 - Investment Advisers Act
 - Investment Company Act

LAST WORD: CFTC VS SEC AS MAIN REGULATOR

- Coming jurisdictional tussle between SEC and CFTC
 - SEC Chair Gensler recent comments
 - CFTC Commissioner Stump recent comments
- Cf. prior jurisdictional debates
 - Commodity Futures Modernization Act (2000)
 - Dodd-Frank Act (2010)
- Practical impact for NFTs:
 - Potential demarcation of types of NFTs
 - Potential joint regulation of certain NFT products
 - Model: mixed swaps
 - Model: security futures

Questions?
Thank you.

Anthony.Nolan@KLGates.com

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**NFTs and Fractional NFTs: Legal and Regulatory
Concerns –
Intellectual Property Issues**

Mark H. Wittow, K&L Gates (Seattle)

KEY INTELLECTUAL PROPERTY (IP) RIGHTS CONSIDERATIONS FOR NFTs

- If you are the NFT creator or distributor, do you have all of the IP rights you need (via ownership or license) to:
 - Create the NFT?
 - Issue (distribute/sell) the NFT?
 - Sell fractional shares?
- ***Ownership of the “material object” is NOT the same as ownership of IP rights in that object***
 - 17 USC 202 (copyright)
 - Brand owners and individuals control rights to commercial exploitation of their use in images

WHAT IP RIGHTS MATTER FOR NFTs?

- Copyright -
 - Who created, who owns the work that is basis for the NFT?
 - If the creator/issuer doesn't have the rights to the work, is the use a fair use?
 - Can fractional shares be created?
 - Moral rights – does the Visual Artist's Rights Act (VARA) apply?
 - How does the first sale doctrine impact resale and use of NFTs?
 - Unauthorized use = infringement, subject to statutory penalties (up to \$150,000 per work), or actual damages, and injunctive relief (including destruction of infringing item)

WHAT IP RIGHTS MATTER FOR NFTs?

- **Publicity Rights** – Does a person (living or dead) appear in the NFT?
 - limited fair use rights (state-specific)
 - Unauthorized use -> statutory penalties, damages, injunctive relief
- **Trademark Rights** – Does a brand/logo/slogan appear in the NFT?
 - limited fair use, nominative use without permission
 - Unauthorized use = infringement, subject to injunctive relief and actual damages
- **Patent Rights** – Does the NFT platform conflict with a patent?
 - User liability for patent infringement
 - See Appendix 1 – Examples of NFT Patents

COPYRIGHT – EXCLUSIVE RIGHTS:

- (1) to reproduce the work
- (2) to prepare derivative works
- (3) to distribute copies ... to the public ...
- (4) to perform the work publicly;
- (5) to display the publicly; and
- (6) in the case of sound recordings, to perform ... publicly by means of a digital audio transmission.

17 U.S. Code § 106

- *These rights are held exclusively by the copyright owner, not the owner of the “material object”*

COPYRIGHT – FRACTIONAL SHARES

- Yes – see 17 USC 201:
 - “[O]wnership of a copyright may be transferred in whole or part by any means of conveyance or by operation of law ...”
 - Must be in writing unless by operation of law – 17 USC 204
 - “[A]ny of the exclusive rights comprised in a copyright, including any subdivision of any of the rights specified in section 106, may be transferred ... “
 - Similarly, any subdivision may be licensed, exclusively or non-exclusively
 - Transfers may be terminated by grantor after 35 years – 17 USC 203

COPYRIGHT – WHO IS THE OWNER?

- The creator of a work owns it, unless –
 - It is a work made for hire by:
 - An employees within scope of employment
 - A contractor, in certain categories, via a written contract
 - If WMFH, employer owns it and is deemed author
 - Creator assigns all right, title and interest in **writing**
 - Creator remains author, but assignee is copyright owner
 - Subject to 35-year termination right
 - Joint creation = joint ownership
 - Joint ownership default rules/ issues
 - Music – two sets of rights
 - Composition is distinct from Sound Recording

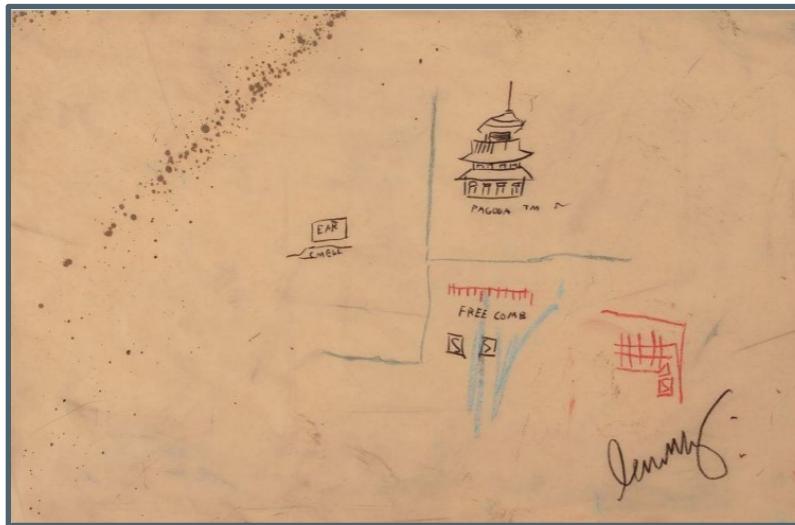
COPYRIGHT - FAIR USE

- “[T]he fair use of a copyrighted work … for purposes such as criticism, comment, news reporting, teaching (including multiple copies for classroom use), scholarship, or research, is not an infringement of copyright.”
- In determining whether the use made of a work in any particular case is a fair use the factors to be considered include—
 - (1) the purpose and character of the use, including whether such use is of a commercial nature or is for nonprofit educational purposes;
 - (2) the nature of the copyrighted work;
 - (3) the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and
 - (4) the effect of the use upon the potential market for or value of the copyrighted work.

17 U.S. Code § 107

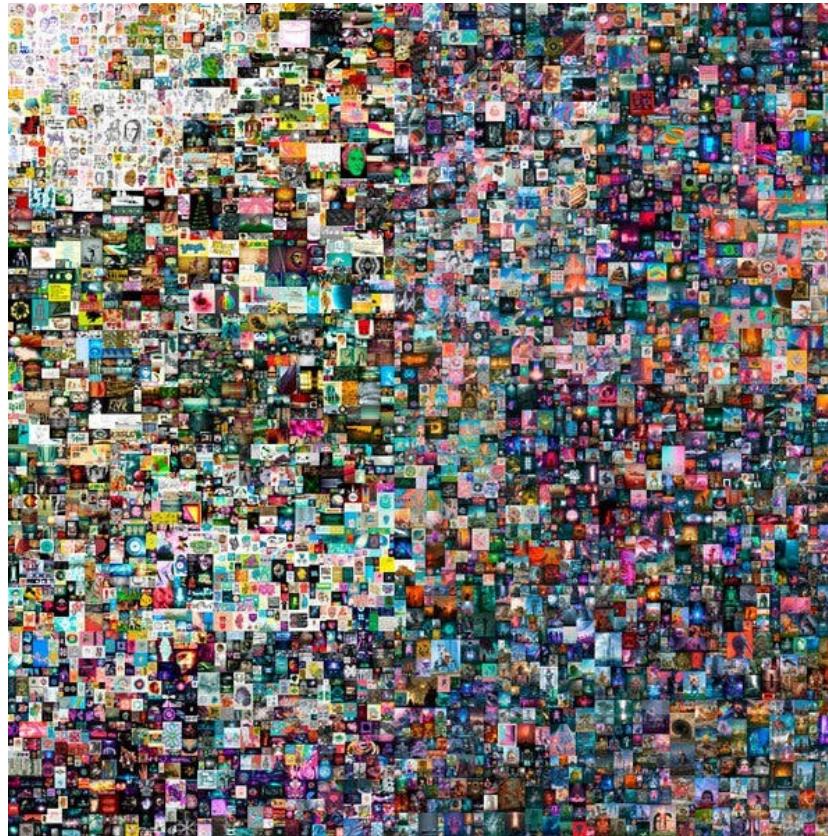
IP RIGHTS ISSUES IN RECENT NFT TRANSACTIONS

- In April 2021, an NFT of a 1986 drawing (“Free Comb with Pagoda”) by Jean-Michel Basquiat was withdrawn from sale on OpenSea after the artist’s estate confirmed the NFT seller did not own a license or rights to the work, just the drawing itself.
- NFT seller also offered to destroy the physical original – VARA violation?



IP RIGHTS ISSUES IN RECENT NFT TRANSACTIONS

- Beeple, a digital artist (aka Mike Windelmann), sold an NFT called *Everydays: the First 5000 Days*, a collage of 5,000 separate items, for \$69.3 million.
 - Copyright, publicity rights, trademark issues?
 - Ownership of NFT vs. ownership of IP rights in underlying work?



- Any issues with this one - “Disney Plus Content Generation”?
 - This is one of the 5000 posts included in “Everydays”
 - Posted Nov. 15, 2020



IP RIGHTS ISSUES IN RECENT NFT TRANSACTIONS

- Aug. 6, 2021— Mintable sale of limited-edition NFT collection featuring Stan Lee
 - Includes 3 paintings by artist Rob Prior
 - “The Infinity Gauntlet”
 - “Introducing Stan Lee, Master of Magic”
 - “I am Iron Man”
 - “Only one copy and NFT of each painting will be available for sale.”

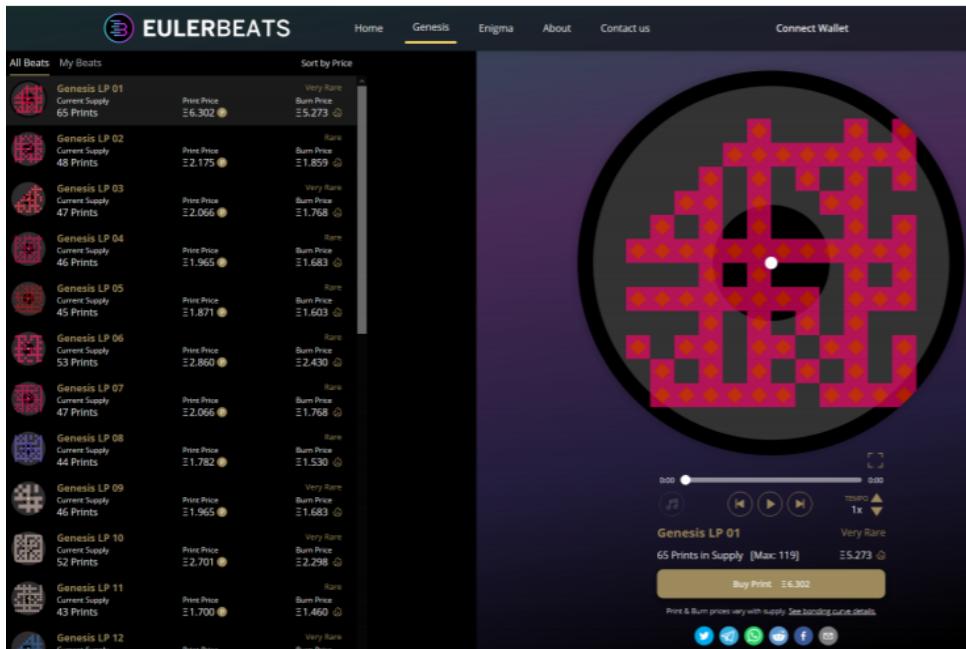


FIRST SALE DOCTRINE

- **§ 109. Limitations on exclusive rights: Effect of transfer of particular copy or phonorecord**
 - The **owner** of a particular **copy** or phonorecord **lawfully made** under this title, or any person authorized by such owner, is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy or phonorecord.
 - **How does this apply to digital goods, such NFTs?**
 - The Non-Fungible Token is **purchased**
 - The underlying IP Rights are **licensed**, not purchased
 - Restrictions may be imposed on those license rights
 - *No reproduction, distribution, public display, public performance or creation of derivative works without explicit authorization*
 - For discussion of case law in US and EU, see Appendix 2

NFTs – First Sale vs. License Rights

Eulerbeats Terms of Service - “When you purchase an Original NFT, and so long as you retain ownership of that Original NFT, you will hold an exclusive, worldwide, royalty-free, sublicensable **license** to the Artwork, subject only to the following limitations: ...”



Questions?
Thank you.

Mark.Wittow@KLGates.com

APPENDIX 1 - EXAMPLES OF NFT PATENTS

Blockchain Cross-Chain Non-Fungible Token Exchange

US 20210133700 A1

(19) United States

(12) Patent Application Publication

Williams et al.

(10) Pub. No.: US 2021/0133700 A1

(43) Pub. Date: May 6, 2021

(54) BLOCKCHAIN CROSS-CHAIN
NON-FUNGIBLE TOKEN EXCHANGE(71) Applicant: Forte Labs, Inc., San Francisco, CA
(US)(72) Inventors: Josh Williams, San Francisco, CA
(US); Raymond A. Chiapuzio, Eugene,
OR (US)

(21) Appl. No.: 17/067,167

(22) Filed: Oct. 9, 2020

Related U.S. Application Data(60) Provisional application No. 62/913,559, filed on Oct.
10, 2019.(52) U.S. Cl.
CPC G06Q 20/065 (2013.01); G06Q 20/3829
(2013.01); H04L 9/3213 (2013.01); G06Q
2220/00 (2013.01); H04L 9/3247 (2013.01);
H04L 2209/38 (2013.01); H04L 2209/56
(2013.01); H04L 9/0643 (2013.01)**ABSTRACT**

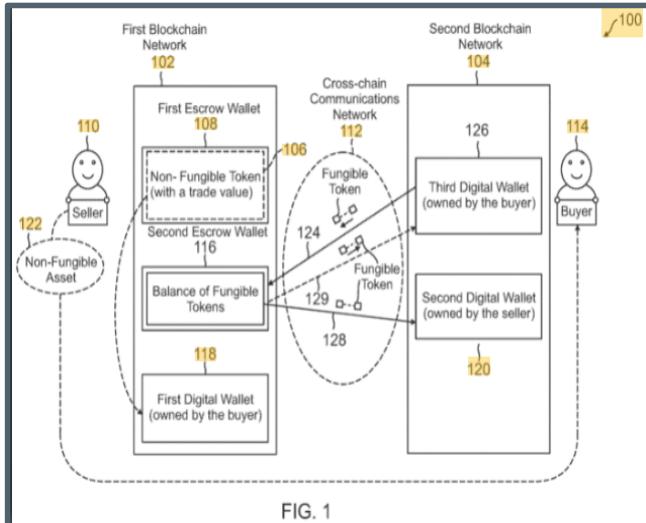
A system and corresponding method exchange a nonfungible token (NFT) via blockchain cross-chain fungible token transfers. The system comprises first and second blockchains. The first blockchain holds the NFT in a first escrow digital wallet. The NFT is available for trade by a seller and is associated with a trade value. The first blockchain monitors a balance of fungible tokens, owned by buyer, that are transferred from a second blockchain to a second escrow digital wallet of the first blockchain. In response to detecting that the balance monitored represents the trade value, the first blockchain transfers, simultaneously, (i) the NFT from the first escrow digital wallet to a first digital wallet of the first blockchain, the first digital wallet owned by the buyer, and (ii) the balance of fungible tokens from the second escrow digital wallet to a second digital wallet of the second blockchain, the second digital wallet owned by the seller.

Publication Classification

(51) Int. Cl.

G06Q 20/06	(2006.01)
G06Q 20/38	(2006.01)
H04L 9/32	(2006.01)
H04L 9/06	(2006.01)

Blockchain Cross-Chain Non-Fungible Token Exchange



- Uses two blockchains and wallets to monitor NFTs and where they are to make sure that there is safe transfer between wallets.
- This patent is to help increase the ease of transferring NFTs between wallets.

Blockchain Cross-Chain Non-Fungible Token Exchange

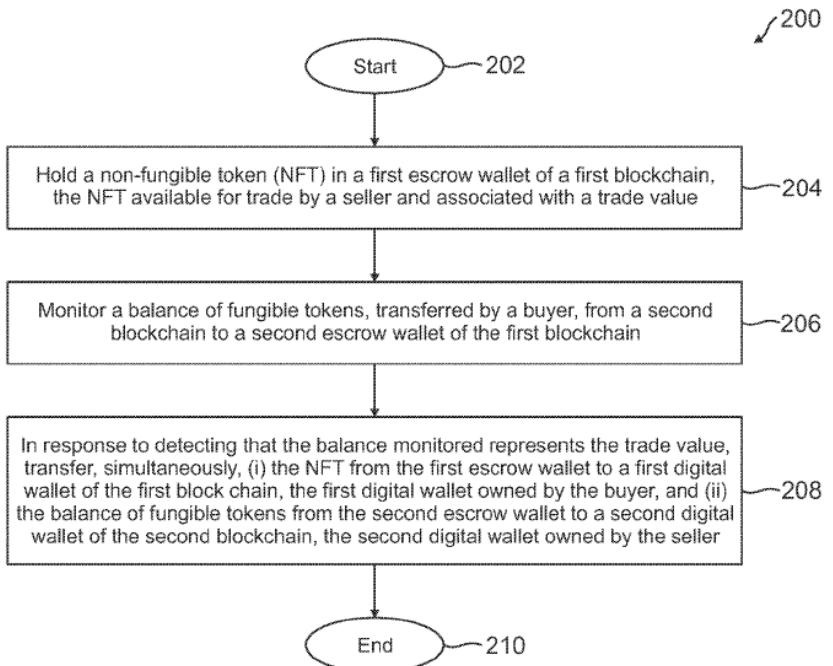


FIG. 2

System and method for creating, tracking, and transferring non-fungible tokens in the Ethereum blockchain

US 20210097508A1

[19] United States

(12) Patent Application Publication (10) Pub. No.: US 2021/0097508 A1
Papanikolas (43) Pub. Date: Apr. 1, 2021

[54] SYSTEM AND METHOD FOR CREATING,
TRACKING, AND TRANSFERRING
NON-FUNGIBLE TOKENS IN THE
ETHEREUM BLOCKCHAIN

Publication Classification

(51) Int. Cl.
G06Q 20/06 (2006.01)
G06F 16/27 (2006.01)

(71) Applicant: **Sean Papanikolas**, Mill Valley, CA
(US)

(72) Inventor: Sean Papanikolas, Mill Valley, CA
(US)

(57) ABSTRACT

21) Appl. No.: 17/061,254

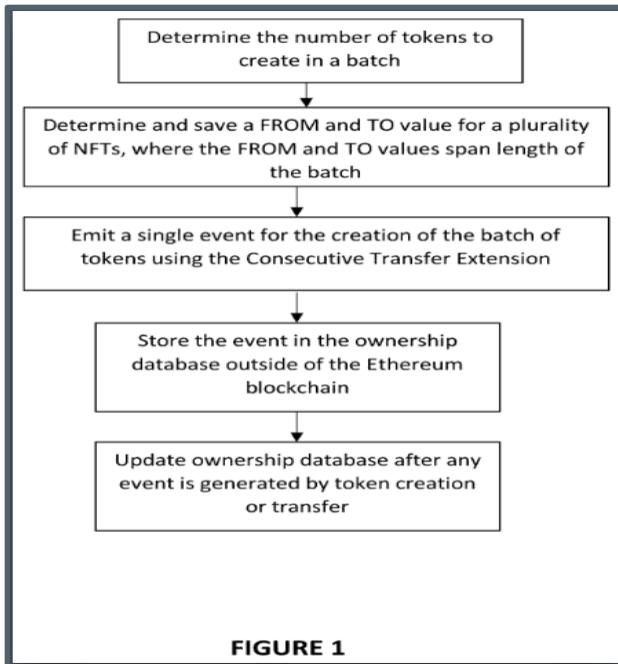
(22) Filed: Oct. 1, 2020

Related U.S. Application Data

[60] Provisional application No. 62/909,054, filed on Oct. 1, 2019.

A method for creating a large number of non-fungible tokens on the Ethereum blockchain, wherein the method includes the steps of determining the number of tokens to create in a batch, minting a batch of non-fungible tokens by identifying a token identifier of the first token in the batch (the FROM value) and the last token in the batch (the TO value), emitting a single event for the creation of the batch of non-fungible tokens, and saving the event in an ownership database that is external to the blockchain in order to determine ownership of tokens in the Ethereum blockchain.

System and method for creating, tracking, and transferring non-fungible tokens in the Ethereum blockchain



- System for creating a large amount of NFTs
- Determines the number of tokens to create in a batch, mints them, and creates IDs for them
- Saves the IDs in the ownership database
- Allows for tracking NFTs between sales to maintain royalties

APPENDIX 2 – First Sale Cases

IF THE DIGITAL WORK IS LICENSED AND NOT SOLD ...

- In *Vernor v. Autodesk*, 621 F.3d 1102 (9th Cir. 2010), the Ninth Circuit held that the first sale doctrine does not apply to the resale of software by users that are licensees of a copy, rather than owners.
- Autodesk indicated that its software was licensed and not sold, and required purchasers to accept license terms before using the software.
- Autodesk restricted, via the license, its software licensees from transferring the software.
- Vernor purchased and then resold used copies of the Autodesk software.
- After receiving cease and desist letters and DMCA takedown notices from Autodesk, Vernor sought a declaratory judgement that his resale was non-infringing, citing the first sale doctrine.

IF THE DIGITAL WORK IS LICENSED AND NOT SOLD ...

- The Ninth Circuit held that the first sale doctrine did not apply to works that are licensed and not sold:
 - “We hold today that a software user is a licensee rather than an owner of a copy where the copyright owner (1) specifies that the user is granted a license; (2) significantly restricts the user's ability to transfer the software; and (3) imposes notable use restrictions. Applying our holding to Autodesk's SLA, we conclude that [Vernor] was a licensee rather than an owner of copies of Release 14 and thus was not entitled to invoke the first sale doctrine or the essential step defense.”
 - In sum, in the US, the distinction between a sale and a license is important because the Ninth Circuit has held that a resale of a licensed copy of the software is not protected by the copyright first sale doctrine, and therefore may be prohibited in the license.

IF THE DIGITAL WORK IS LICENSED AND NOT SOLD ...

In *Capitol Records, LLC v. ReDigi Inc.*, 910 F.3d 649 (2d Cir. 2018):

- ReDigi offered a resale service for digital downloads, which were licensed, not sold by the original providers (e.g., iTunes, eMusic).
- ReDigi's technology worked as follows:
 - A user would download a "media manager" program that would analyze the user's computer to identify each digital music file that might be eligible for sale through ReDigi.
 - Once a user decided to sell an eligible track and initiated an upload process, the end result was a new copy of the digital music file on ReDigi's server and the deletion of the corresponding file from the user's computer.

If the digital work is licensed and not sold ...

- ReDigi's first sale argument failed because at the end of the process there was a digital music file on ReDigi's server and not on the user's computer, so reproduction occurred
- Under the laws of physics, it was simply impossible that the same material object, *i.e.*, the same "copy or phonorecord," could be transferred over the Internet.
- Therefore, because first sale is only a defense to violation of the distribution right, first sale did not immunize ReDigi's violation of the plaintiff's reproduction right.
- The district court observed that "[t]he first sale defense does not cover this any more than it covered the sale of cassette recordings of vinyl records in a bygone era."
- The Second Circuit held: "We conclude that the operation of ReDigi version 1.0 in effectuating a resale results in the making of at least one unauthorized reproduction. Unauthorized reproduction is not protected by 109(a)."

UsedSoft GmbH v. Oracle International (Court of Justice of the European Union 2012) (C-128/11)

- Oracle licensed its software on a non-transferable basis.
- UsedSoft offered sale ‘used’ Oracle licenses, which were ‘current’ in that the maintenance agreement between the original licensee and Oracle was in force.
- ECJ ruled that the owner of copyright in software cannot prevent a perpetual licensee who has downloaded the software from the internet from selling the ‘used’ license.
- The ECJ pointed to Article 4(2) of the EU Software Directive, which provides that the first sale of a copy of a program by the rights holder or with their consent in the EU exhausts the distribution right of that copy within the EU (such that the rights holder loses its right to rely on its copyrights to oppose the resale of that copy).

UsedSoft GmbH v. Oracle International (Court of Justice of the European Union 2012)

- The ECJ reasoned as follows:
 - Where a customer downloads a copy of Oracle's software and enters into a license agreement under which it receives the right to use that copy for an unlimited period in return for payment of a fee, such a transaction amounts to a 'sale' for the purposes of Article 4(2) and involves a transfer of the right of ownership in that copy.
 - This broad interpretation of Article 4(2) is necessary as otherwise the effectiveness of the rule of exhaustion would be undermined since suppliers would merely have to call the contract a license rather than a sale in order to circumvent it.
 - The ECJ said that the term 'sale of a copy' in Article 4(2) encompasses all situations in which there is a grant of a right to use a copy of a computer program for an unlimited period in return for payment of a fee, and any such 'sale' would trigger the exhaustion provisions of the Software Directive. Therefore, even if the license agreement prohibits further transfer, the copyright holder can no longer oppose the resale of that copy.
 - It is immaterial whether the computer program is made available in some physical form (e.g. a CD or DVD) or by way of internet download; in either case the transaction is a 'sale' of the relevant copy of the software.

UsedSoft GmbH v. Oracle International (Court of Justice of the European Union 2012)

- Significantly, the ECJ also noted:
 - In order for a resale not to infringe, the original licensee must render its own copy unusable at the time of its resale.
 - It would be permissible for the copyright holder to make use of technical protective measures (e.g. product keys) to ensure that this is the case.