

## Second Life – the legal implications of a virtual world

SECOND LIFE IS A 'VIRTUAL ONLINE COMMUNITY' that was created in 2003 by Linden Labs, a technology company based in San Francisco. It is a virtual world that is growing at an astonishing rate, with the number of users having soared from approximately 700,000 last autumn to its current level of over 8,500,000 residents.

Residents create online characters, called 'avatars', who can travel and mingle with others anywhere on Second Life by walking, flying or teleporting to their destination.

The world has its own currency known as the Linden dollar. Using Linden dollars residents can buy and sell virtual items such as virtual clothing, virtual land and even virtual planes. Linden dollars can be freely converted into US dollars in the real world. At the present time, on average, \$1.5m is spent a day on Second Life.<sup>1</sup>

Huge sums of money can now be made in Second Life and several residents have claimed to have become millionaires in the real world through buying virtual land cheaply on Second Life and selling or renting the land to other avatars.

### COMMERCIALISATION OF SECOND LIFE

There has been an increased interest from businesses in the sudden growth of the number of residents on Second Life. International companies such as Nike and IBM have begun to recognise the potential of Second Life and have opened virtual stores there to try to cash in on the ever-growing virtual world marketplace.

Businesses are seeing several advantages of entering Second Life, including the opportunity:

- to market their real-life goods to the younger market who form the majority of Second Life users;
- to hold meetings with other offices or clients throughout the world through Second Life – this will become increasingly appealing to companies

as Linden is soon to introduce sound into the virtual world;

- to carry out job interviews with potential employees throughout the world; and
- to test out potential new brands in the virtual world before introducing them to the real world.

However, companies considering entering Second Life should be warned that this is very much a developing world with numerous uncertainties.

In particular, Second Life lacks a comprehensive regulatory framework. Governments throughout the world have yet to take action over the potential dangers that may arise if Second Life remains unregulated.

In addition, there is uncertainty as to how any litigation with regard to Second Life will be handled, due to the cross-border nature of many of the transactions.

Linden's terms and conditions include a dispute resolution clause stating that any disputes should be taken to arbitration in San Francisco. However this has already been challenged in the US courts, which ruled in *Bragg v Linden Research Inc and another* that this clause was 'unconscionable'. Therefore, as matters currently stand, there are several ways in which criminals and fraudsters can use Second Life, as set out below.

### INTELLECTUAL PROPERTY RIGHTS

Intellectual property rights in Second Life are currently an area of some uncertainty and should be of concern to both businesses operating in Second Life and to those who have chosen to remain outside Second Life in the real world.

Linden's terms and conditions state that the resident retains any copyright and other intellectual property rights with respect to any digital content that the resident may create in Second Life. This includes avatar characters, clothing, scripts, textures, objects and designs. As Linden's website states: 'You create it, you own it – and it's yours to do with as you please.' However, lawyers believe that there is little precedent for Linden's terms and conditions and this has left the door open for potential abuse of IP rights.

As in the real world, businesses in Second Life suffer from trademark infringement. It has been estimated that there is a trademark infringement in at least 1% of Second Life transactions (there are currently approximately 1.5 million transactions per year). In a

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recent search of the classifieds on Second Life there were 99 hits for Gucci and 101 hits for Nike. None of these virtual products have been endorsed by the relevant company.

Leading IP lawyers have suggested that as the economic transactions on Second Life are real, this distinguishes it from a video game. Hence many of the same issues are at play as when a person sells counterfeit items on a street corner, as in both cases the vendor is using the company's brand name to market a product.

Linden's current policy with regard to breach of trademark is that if an abuse report is filed against a trademark infringement, then it will investigate the complaint and remove the product if it is found to be in breach of a trademark. Its official policy states:

'Linden staff generally removes content that uses trademarks without apparent authorisation, with or without giving notice to the object owner. This generally includes all real-life corporate logos and brand names.'

At present it appears that Linden has not actively tried to seek out trademark violators and the onus is therefore on companies to log into Second Life to ensure that their trademarks are not being infringed. As the number of users of Second Life continues to grow, this will become an increasingly important issue.

In addition, in July 2007 the first case regarding breach of copyright on Second Life was filed in the US. The complaint was filed by Eros LLC accusing a Second Life avatar 'Volkov Catteneo' of copying and selling one of its most popular Second Life products.<sup>2</sup> Eros LLC now faces the problem that it has no knowledge as to the real-world identity of Volkov Catteneo. Lawyers representing Eros have confirmed that they will subpoena Linden to force it to disclose his real-world identity. However, perhaps of more concern is the claim made by Volkov Catteneo, in an interview with Reuters, that he does not fear a subpoena as Linden does not have accurate real-world personal information about him.

#### **FRAUD IN SECOND LIFE**

The Fraud Advisory Panel, a UK-based independent watchdog, has recently warned that web-based virtual communities such as Second Life are under serious threat from potential fraudulent activity. As early as 2003, police in South Korea reported that over 50% of cyber crime occurred in virtual worlds.<sup>3</sup>

Although all Second Life residents are anonymous (avatars use false names, which in itself is a

concern), new Second Life users must provide contact details and at least one credit or debit card number when registering. This poses several risks.

#### **Hacking**

The information stored on Linden's databases is an obvious target for hackers and identity thieves who wish to obtain residents' personal information and credit/debit card details.

In September 2006 it was reported that hackers did indeed break into the Second Life user database gaining access to Second Life account names, real-life names, account passwords and payment information. Linden has never confirmed exactly how much information was stolen.

This would appear to be a continuing problem. In May 2007 Linden requested that all users change their passwords without explaining why this was necessary.

#### **Credit card fraud**

The lack of regulation of Second Life by authorities throughout the world leaves genuine customers and businesses, who are supplying goods and services on Second Life, wide open to potential crimes such as credit card fraud.

#### **Ponzi schemes**

It has also been suggested in the press that potential scams are already taking place on Second Life. In-game banks have begun to appear on Second Life including Ginko Financial, which, as of the beginning of February 2007, claimed to have deposits of L\$114,398,068 and offered a daily interest rate of 0.10% which is an annual return of approximately 44%.<sup>4</sup>

The chief executive of Ginko has refused to reveal his true identity or how Ginko is achieving such high returns for its customers. This has led to suggestions that Ginko is nothing more than a Ponzi scheme, ie a scheme where the promoter promises huge returns to investors on short-term investments. The scheme works by paying older investors interest from new funds received. These schemes normally collapse as they generate no money and require an increasing number of new investors to keep up the interest payments owed.<sup>5</sup>

Of particular concern is that where fraudulent schemes exist, it may be very hard for depositors to track down the people behind the schemes, especially if they have used false identities. In these circumstances, one can foresee depositors focusing their attention on Linden, whose terms

and conditions would have to be scrutinised by the courts. On 9 August 2007 Ginko Financial ceased trading. At the time it was believed that the bank had 18,000 accounts worth a total of L\$190m (\$700,000). It remains to be seen if depositors will attempt to trace the owners of the bank.<sup>6</sup>

Linden has already been the target of litigation where it has sought to protect residents of Second Life. An attorney from the US, Marc Bragg, has filed a complaint against Linden. He discovered a loophole in the virtual land auction system that allowed him to buy property cheaply before other residents could make a bid for the land. Linden eventually discovered the scheme and threw Mr Bragg out of Second Life. Mr Bragg is now suing Linden, claiming that the company is blocking him from \$8,000 worth of assets (the land that he bought).

#### THREAT OF MONEY LAUNDERING ON SECOND LIFE

Concerns are also growing about the potential use of Second Life and other virtual worlds by criminals and terrorists for money laundering.

There are three steps: set up an account using false personal details; fund the account with the proceeds of crime; and have an associate on the other side of the world who can withdraw the funds as profits or even as capital for further criminal schemes.

The scheme would work as follows:

- The criminal opens 15 to 25 accounts on the virtual world with false identification. The accounts are funded by criminal activity with proceeds deposited by smurfs (couriers).
- The criminal then purchases some virtual real estate from a co-conspirator and all the virtual purchase money is transferred into the conspirator's account.
- The conspirator can then transfer the funds out of the virtual world into the real world without any regulation of the transaction.

In April 2007 Interpol commented that an additional threat is that criminals can use foreign exchanges on virtual worlds which allow residents to trade virtual currency just as if they were trading in the real world. Interpol's report stated that 'as a matter of urgency' law enforcement must learn how to investigate crimes involving virtual money and legislators must grant them power to recover data stored in jurisdictions where the crimes took place.<sup>7</sup>

#### THREAT OF TERRORISM ON SECOND LIFE

According to a recent article for *The Australian*,<sup>8</sup> there are currently three jihadi terrorists and two elite jihadist terrorist groups registered on Second Life. The thinking is that Second Life enables terrorists to rehearse and refine their plans without the risks inherent in doing so in the real world. By way of example:

- 1) They can build training camps on Second Life to use for training rather than risk arrest in countries such as Afghanistan.
- 2) They can practise for future attacks, such as crashing planes into buildings.
- 3) There is a group called the Second Life Liberation Army, which has set off a number of atomic bombs at targets in the virtual world. There is concern that this group and others are being used to rehearse future attacks because increased security means they can no longer practice in the real world.
- 4) Second Life can be used to recruit individuals to join terrorist cells and to spread propaganda.
- 5) There are weapons armouries in Second Life where access to guns such as AK47s can be purchased to practise with.
- 6) Funds can be transferred around the world to fund terrorism.

Security experts do not view these incidents as computer games; they believe they may have a much more sinister purpose.

#### TAXATION OF PROFITS ON SECOND LIFE

Second Life is also coming to the attention of the tax authorities in the US and around the world. A congressional committee in the US is currently investigating how virtual assets and incomes should be taxed. With on average \$1.5m in transactions taking place per day, it is not surprising that the tax authorities are investigating virtual worlds.

Currently, if a Second Life resident cashes funds out of Second Life into a real world currency, then the resident should report any income to the national tax authorities. However, there is uncertainty over dealings that occur solely in Second Life. Currently tax authorities seem to be ignoring such transactions but, with the huge growth in the size of transactions in Second Life, tax lawyers await with interest the report from the Joint Economic Committee of Congress which is due shortly.

**CONCLUSION**

Many businesses may wish to take advantage of the opportunities that Second Life offers. In particular, as Second Life continues to grow at such a fast rate the potential opportunities to both win new customers for goods and services in the real world and the opportunities to try out new products are huge. However, businesses considering whether to enter Second Life should be aware that this is very much a developing virtual world with no legal system or financial regulation.

John Zdanowski, chief financial officer of Linden, recently commented that there is 'no indication anyone is using Second Life for money laundering or real-world terrorism'. One matter is certain, however. Criminals are forever looking for new opportunities to commit crimes, to exploit loopholes and to take

advantage of systems where there is less robust regulation. They will therefore try to do so in Second Life, just as they have done on the internet.

A virtual world where some residents have already claimed to have become millionaires through their activities on Second Life, and where there are enormous opportunities to commit crime, will be too tempting a target for them to miss. This will remain the case until governments are prepared to take action to introduce a regulatory framework to Second Life.

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**NOTES**

- 1) For the number of dollars spent in the last 24 hours on Second Life go to: [www.secondlife.com](http://www.secondlife.com)
- 2) A copy of the complaint in this case can be found at: [www.secondlife.reuters.com/media/SDOC1202.pdf](http://www.secondlife.reuters.com/media/SDOC1202.pdf)
- 3) For further information on the Fraud Advisory Panel's comments on virtual communities see: [www.fraudadvisorypanel.org/newsite/PDFs/pressreleases/Government%20Should%20Extend%20Legislation%20into%20Virtual%20World%20010507.pdf](http://www.fraudadvisorypanel.org/newsite/PDFs/pressreleases/Government%20Should%20Extend%20Legislation%20into%20Virtual%20World%20010507.pdf)
- 4) For further information see 'Virtual Bank, Real Scam', published by *The Journal of the Business Law Society*: [www.iblsjournal.typepad.com/illinois\\_business\\_law\\_soc/2007/02/virtual\\_bank\\_re.html](http://www.iblsjournal.typepad.com/illinois_business_law_soc/2007/02/virtual_bank_re.html)
- 5) See 'Ginko Financial - Pioneer or Pyramid?' by Adam Reuters: [www.secondlife.reuters.com/stories/2006/10/15/ginko-financial-pioneer-or-pyramid/](http://www.secondlife.reuters.com/stories/2006/10/15/ginko-financial-pioneer-or-pyramid/)
- 6) For more about the Ginko collapse see 'Unable to pay depositors, Ginko ceases banking operations' by Adam Reuters: [www.secondlife.reuters.com/stories/2007/08/09/unable-to-pay-depositors-ginko-ceases-banking-operations/](http://www.secondlife.reuters.com/stories/2007/08/09/unable-to-pay-depositors-ginko-ceases-banking-operations/)
- 7) See 'Virtual Worlds "Clear and Present Danger" for Money Laundering' by Brian Monroe: [www.world-check.com/media/d/content\\_pressarticle\\_reference/Virtual\\_Worlds\\_Clear\\_and\\_Present\\_Danger\\_for\\_Money\\_Laundering.pdf](http://www.world-check.com/media/d/content_pressarticle_reference/Virtual_Worlds_Clear_and_Present_Danger_for_Money_Laundering.pdf)
- 8) See 'Virtual Terrorists' by Natalie O'Brien, *The Australian*, 31 July 2007: [www.theaustralian.news.com.au/story/0,25197,22161037-28737,00.html](http://www.theaustralian.news.com.au/story/0,25197,22161037-28737,00.html)

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***Bragg v Linden Research Inc and another  
Civil Action No 06-4925 in the United  
States District Court For the Eastern  
District of Pennsylvania***

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***Eros LLC v John Doe, a/k/a Volkov  
Catteneo, a/k/a Aaron Long filed in the  
United States District Court Middle  
District of Florida Tampa Division***