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IMPOSING LIABILITY ON DATA PROCESSING SERVICES—SHOULD CALIFORNIA CHOOSE FRAUD OR WARRANTY?

The bright promise of economy and efficiency that computers suggest, coupled with the mystery that surrounds their operation, makes the businessman ripe for exploitation by the charlatan and legitimate data processor alike. During the decade of the 1960’s, the growing data processing services industry was aided by the “mystique of the computer.” Due to their lack of knowledge about computers in general, many businessmen had false hopes that they would solve all of their decisionmaking problems. Those businesses which could not justify a computer “in house” turned to computer service bureaus. A blind faith in the capacities of the computer made it easy for the customer to tolerate the difficulties that arose. The situation was analogous to the early days of the railroad, the automobile, and the airplane, when the consumer wanted only to take a ride and did not ask for guarantees.

Today the situation is changing and the service bureaus are taking a long overdue look at their role in providing commercially useful services. Their customers, in turn, will predictably begin

1. Data processing service companies that offer their services to the general public virtually did not exist prior to 1960. By 1969 they had grown into a $2 billion segment of the economy, employing 120,000 persons and serving 220,000 customers. DATAMATION, Mar. 1, 1971, at 50-51.
5. Spangenberg, Torts, in LAW AND COMPUTERS IN THE MID-SIXTIES 58 (1966) [hereinafter cited as Spangenberg], discusses parallels between the impact of railroad technology on law and what might be expected from computer technology.
6. Roy, supra note 2; Bigelow, Contract Caveats, 16 DATAMATION, Sept.
to demand a more businesslike and less venturesome attitude; these customers will undoubtedly turn increasingly to their attorneys for advice on how to ensure that they get the benefits they seek from data processing services.7

The recent Eighth Circuit decision in *Clements Auto Company v. Service Bureau Corporation*8 demonstrates that at least some courts will hold commercial data processors liable for failing to work the magic they claimed their machines were capable of producing. The thrust of this decision strongly suggests that data processing services will be required to live up to a level of expertise which they are probably not prepared to assume. More significantly, the form of liability announced in *Clements* precludes contractual limits of liability. If this decision is widely followed, it may stifle the beneficial application of data processing techniques to as yet unexamined problems in the business community by placing the entire risk of failure on the service bureau operator.

This comment will study the problems presented by *Clements* and the small group of pertinent computer industry cases to date, and suggest how California can be expected to rule on the same issues. First, it will show that California could easily extend its own definition of fraud to encompass the innocent misrepresentation that made Service Bureau Corporation (SBC)9 liable in *Clements*. Second, it will discuss how facts which support a finding of liability for innocent misrepresentation will also tend to substantiate a cause of action based on implied warranty. Furthermore, it will demonstrate why implied warranty is the prefera-

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9. Service Bureau Corporation will be referred to hereinafter as SBC.
ble legal theory upon which to base computer service bureau liability. A brief analysis of the applicability of products liability and negligence theory to data processing situations is included. Finally, the author will suggest how a proliferation of Clements-like situations may be forestalled in California.

**THE PROBLEM—CLEMENTS AUTO COMPANY**

The facts involved in *Clements Auto Company v. Service Bureau Corporation*¹⁰ are not atypical of the computer service bureau industry's relationship with its clients.¹¹ A data processing salesman approaches a company and suggests that his firm's service can solve the company's management problem; contracts are signed providing for the performance of specific calculating, summarizing, decisionmaking or reporting services. The specific services are performed in accordance with the contracts, but the company's management problem remains unsolved. Not surprisingly, the customer feels shortchanged—he has paid for a solution; that was his only reason for entering into the contracts. However, the service bureau believes that it has done exactly what contracted to do—provide specific services.

In *Clements*, the plaintiff operated four wholesale supply houses in Minnesota and Wisconsin. In 1962, Clements sought and SBC proposed to perform data processing services which would eventually make possible computerized inventory control of warehouse merchandise.¹² Clements negotiated three series of contracts which obligated SBC to produce specified accounting and inventory status reports in a special format which were designed to provide Clements with the desired information. However, the contracts did not specifically obligate SBC to "control" Clements' inventory.¹³ SBC wrote the requisite computer programs,¹⁴ produced the reports that were contracted for,¹⁵ and made modifications to the programs in order to increase the usefulness of the reports.¹⁶ Thus, according to SBC, it performed its

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¹¹. The writer of this comment has nine years of experience in service bureau management. His research is confirmed by his own experience.
¹³. *Id.* at 140.
¹⁵. *Id.*
contractual obligations diligently at a considerable loss on the contracts.\textsuperscript{17}

Viewed from Clements' position, however, the facts take on a different coloration. In 1961, Clements became familiar with an SBC product that "provided excellent control"\textsuperscript{18} of Clements' subsidiary's inventory. A year later, Clements proposed that SBC provide a "similar data processing system"\textsuperscript{19} for Clements' wholesale supply houses; SBC indicated that it could do so. However, whatever SBC's system may have accomplished, it did not provide the inventory control that SBC repeatedly asserted it would. Finally, Clements sued on alternative theories of (1) misrepresentation, (2) breach of implied warranty, (3) contract reformation,\textsuperscript{20} and (4) rescission or breach of contract.\textsuperscript{21}

\textbf{Solution 1—Fraud and Deceit}

Relying on a theory of misrepresentation, the trial court in \textit{Clements} awarded the plaintiff damages amounting to substantially all of its out of pocket costs for nearly the entire duration of the contract period.\textsuperscript{22} The alternative theories of recovery were held either not to be maintainable on the facts\textsuperscript{23} or to add nothing to the recovery.\textsuperscript{24} The Eighth Circuit Court of Appeals affirmed on the liability issue but reduced the damages on the ground that the plaintiff's duty to mitigate arose earlier than had been determined by the trial court.\textsuperscript{25}

Whereas the district court had focused its attention on specific misrepresentations,\textsuperscript{26} the court of appeals concentrated on the "one central actionable misrepresentation . . . that the pro-

\begin{footnotesize}
\begin{enumerate}
\item[17.] \textit{Id.}, at 132, n. 13. The trial court notes that SBC lost $115,000 in performing the contracts, and that while there were breaches of contract, one involved "relatively minor errors". \textit{Id.} at 140. The other two, \textit{id.} at 124, 140, may be ignored in the light of the circuit court's finding that the duty to mitigate arose before they occurred. 444 F.2d 169, 186 (D. Minn. 1971).
\item[19.] \textit{Id.}
\item[23.] \textit{Id.} at 139, implied warranty, reformation and rescission.
\item[24.] \textit{Id.} at 140, breach of contract.
\item[25.] \textit{Clements Auto Co. v. Service Bureau Corp.}, 444 F.2d 169, 186 (8th Cir. 1971).
\end{enumerate}
\end{footnotesize}
posed data processing system would, when fully implemented, be capable of providing [Clements] sufficient information in a form such that when properly utilized, it would constitute an effective and efficient tool to be used in inventory control."27 However, both the district court and the court of appeals made it clear that they were relying on the Minnesota tort of innocent misrepresentation.28 A comparison of current California tort law reveals that a similar result would be likely there.

The California Law of Fraud and Deceit

Two separate areas of the California Civil Code state the law of tortious misrepresentation.29 The two code sections which are particularly applicable to a situation in which a proposal to perform data processing services is made in good faith are sections 157230 and 1710.31 These two sections have been held to be interchangeable and the same rules of law apply to both.32

The elements of tortious misrepresentation in California are:

1. that a material misrepresentation was made;

28. The elements of fraud in Minnesota are: "1. There must be a representation; 2. That representation must be false; 3. It must have to do with a past or present fact; 4. That fact must be material; 5. It must be susceptible of knowledge; 6. The representer must know it to be false, or in the alternative, must assert it as of his own knowledge without knowing whether it is true or false; 7. The representer must intend to have the other person induced to act, or justified in acting upon it; 8. That person must be so induced to act or so justified in acting; 9. That person's action must be in reliance upon the representation; 10. That person must suffer damage; 11. That damage must be attributable to the misrepresentation, that is, the statement must be the proximate cause of the injury." Id. Compare these with the requisite elements in California, which are given in the text accompanying note 33, infra.
29. CAL. CIV. CODE §§ 1571-1574 (fraud); §§ 1709-1711 (deceit) (West 1971).
30. "Actual fraud . . . consists in . . . [t]he positive assertion, in a manner not warranted by the information of the person making it, of that which is not true, though he believes it to be true . . . [or] [t]he suppression of that which is true, by one having knowledge or belief of the fact . . . ." Id. § 1572.
31. "Deceit . . . is either: . . . [t]he assertion, as a fact, of that which is not true, by one who has no reasonable ground for believing it to be true . . . [or] [t]he suppression of a fact, by one who is bound to disclose it, or who gives information of other facts which are likely to mislead for want of communication of that fact . . . ." Id. § 1710. Sections 1572(1), (4) and (5) and 1710(1) and (4) apply where the representer is not acting in good faith and would require proof of belief or intent not to carry out promises. Section 1573, constructive fraud, applies where there is a breach of a fiduciary relationship, without fraudulent intent. There might be situations where section 1573 would be useful, e.g., where a data processing system was recommended by a CPA firm.
that it was false;
[3] that the defendants knew it to be untrue or did not have sufficient knowledge to warrant a belief that it was true;
[4] that it was made with an intent to induce plaintiff to act in reliance thereon;
[5] that plaintiff reasonably believed it to be true;
[6] that it was relied on by plaintiff;
[7] and that plaintiff suffered damage thereby."

These elements agree generally with the elements under Minnesota law, leaving in dispute (1) to what extent the defendant must be aware of the falsity of his representations, (2) whether material representations include statements of opinion or intention as well as representations of past or present fact, (3) what justifies reliance by the plaintiff, (4) the proper measure of damages, and (5) the duty to mitigate.

**Scienter**

California law remains somewhat unsettled as to whether or not scienter—the representer's knowledge of the falsity of his representations—is required for proof of fraud. A recent case, *Black v. Shearson, Hammill & Co.*, states unequivocally that scienter is an essential element of fraud, but dictum in *A. Teichert & Son, Inc. v. State* maintains that misrepresentation may be innocent as well as fraudulent.

*Gagne v. Bertran,* a 1954 California Supreme Court case, seemingly put the issue to rest. In that case, plaintiff hired Bertran to perform soil tests on a lot which he planned to buy for an apartment building site. Defendant performed the tests and informed plaintiff that there was no more than 16 inches of soil fill; in fact there was significantly more. In reliance on the defendant's report plaintiff purchased the lot. He subsequently had to spend substantially more on the foundation than he had

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34. Cf. note 28, supra. Elements 1, 2, 4, 7, 9, 10, and 11 under Minnesota law are in accord with elements 1, 2, 4, 6, and 7 in California.
35. See elements 3, 5, 6, and 8 in note 28 supra.
39. Accord, Stone v. Farnell, 239 F.2d 750 (9th Cir. 1956).
planned because of the inaccurately reported filled subsoil condition. The California Supreme Court upheld the trial court in finding deceit by the defendant.\textsuperscript{40} Justice Traynor emphasized that, due to the defendant's negligently performed test sampling, his assertions were "made without reasonable ground for believing"\textsuperscript{41} them to be true, and no more knowledge of falsity than that was required to find liability. In a footnote, Justice Traynor specifically declared that "statements in a number of cases, contrary to . . . the cases cited in the text, that scienter is an essential element of every cause of action for deceit are erroneous and are therefore disapproved."\textsuperscript{42}

\textit{Gagne} should have settled the issue except that \textit{Wishnick v. Frye},\textsuperscript{43} one of the cases in the text of the Traynor opinion, holds that scienter is a necessary element of fraud.\textsuperscript{44} \textit{Wishnick} was not expressly overruled. However, cases subsequent to \textit{Gagne} have not found the \textit{Wishnick} inconsistency particularly bothersome. \textit{Stowe v. Fritzie Hotels, Inc.}\textsuperscript{45} supports \textit{Gagne} and \textit{Stone v. Farnell}\textsuperscript{46} broadened the scope of the \textit{Gagne} rationale to include sections 1572 and 1573 (fraud) as well as section 1710 (deceit). \textit{Sixta v. Ochser}\textsuperscript{47} cites \textit{Stone} with approval. Thus, despite some questionable authority to the contrary,\textsuperscript{48} a substantial number of cases hold that scienter is not required for a finding of fraud.\textsuperscript{49}

There are three classes of actionable misrepresentations: in-

\textsuperscript{40} The court also found negligence on the part of the defendant. \textit{Gagne} is especially interesting with regard to data processing services because the finding of deceit rests upon the negligent sampling technique. Many data processing proposals are based upon a preliminary fact gathering which often proves to be misleading. \textit{See}, e.g., Clements Auto Co. v. Service Bureau Corp., 444 F.2d 169, 182-83 (8th Cir. 1971), but note that the preliminary facts in that case were furnished by Clements.

\textsuperscript{41} \textit{Gagne v. Bertran}, 43 Cal. 2d at 488, 275 P.2d at 20.

\textsuperscript{42} \textit{Id.} at 487, 275 P.2d at 20.

\textsuperscript{43} 111 Cal. App. 2d 926, 245 P.2d 532 (1952).

\textsuperscript{44} \textit{But see} \textit{Stone v. Farnell}, 239 F.2d 750, 754 (9th Cir. 1956), which states that "the \textit{Wishnick} decision is not the law of California."

\textsuperscript{45} 44 Cal. 2d 416, 282 P.2d 890 (1955).

\textsuperscript{46} 239 F.2d 750 (9th Cir. 1956).

\textsuperscript{47} 187 Cal. App. 2d 485, 9 Cal. Rptr. 617 (1967).

\textsuperscript{48} \textit{Wishnick v. Frye}, 111 Cal. App. 2d 926, 245 P.2d 532 (1952); \textit{Robinson v. Robinson}, 187 Cal. App. 2d 677, 10 Cal. Rptr. 130 (1960); \textit{Black v. Shearson, Hammill & Co.}, 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1968); 2 B. \textit{Witkin, Summary of California Law, Torts} § 198, at 1383 (7th ed. 1960). Had the disapproval of the scienter requirement been more forcefully stated in \textit{Gagne}, much confusion about this area of California law could have been avoided. \textit{See}, e.g., \textit{Strand v. Librascope, Inc.}, 197 F. Supp. 743, 755 n. 13 (D. Mich. 1961), where it is noted that California requires scienter but that \textit{Gagne} marks a tendency to ameliorate the requirement. \textit{See also note 51, infra.}

tentional, negligent, and innocent.\textsuperscript{50} The \textit{Clements} holding turns on innocent misrepresentation\textsuperscript{51} and therefore imposes strict liability on the representer.\textsuperscript{52} California clearly allows recovery for intentional and negligent misrepresentation,\textsuperscript{53} as the statutes and the \textit{Gagne} line of cases indicate. However, California would seem to go further, for in \textit{Gagne} the court held that an expert's "unequivocal statement necessarily implied that he knew facts that justified his statement,"\textsuperscript{54} thereby indirectly imposing strict liability in fraud for innocent misrepresentation by experts.\textsuperscript{55} Therefore, within narrow bounds, California courts appear willing to label a seller's innocent misrepresentations fraudulent.

\textit{When Does Salesmanship Become Lying—Fact versus Opinion}

When bringing suit for fraud in California it is necessary to distinguish between expressions of fact and expressions of opinion. The law allows some room for "puffing"; a salesman may make extravagant claims for his product provided they are understood to be no more than hyperbole.\textsuperscript{56} Similarly, predictions of

\begin{footnotesize}
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\item \textsuperscript{50} W. Prosser, \textit{Law of Torts} 713 (3rd ed. 1964).
\item \textsuperscript{51} "There is no proof that anyone at SBC knew this statement was false when it was uttered, but deliberate deception or scienter is not a necessary element . . . ." Clements Auto Co. v. Service Bureau Corp., 298 F. Supp. 115, 126 (D. Minn. 1969). "It is important to emphasize that, in Minnesota, the element of scienter, or intent to deceive, or even recklessness, is not necessary to actionable fraud." Clements Auto Co. v. Service Bureau Corp., 444 F.2d 169, 176 (8th Cir. 1971).
\item \textsuperscript{52} W. Prosser, \textit{Law of Torts} 726 (3rd ed. 1964), does not include California among the states which impose strict liability, but does cite Edwards v. Sergi, 137 Cal. App. 369, 30 P.2d 541 (1934), as an example of the fiction of presuming scienter, and notes a trend towards strict liability in fraud.
\item \textsuperscript{53} Deceit involves a statement by one who has "no reasonable ground for believing it to be true." Cal. Civ. Code § 1710(2) (West 1971) (emphasis added). See also the text accompanying note 41, supra. Compare with this the Minnesota standard: "of his own knowledge without knowing whether it is true or false." \textit{See note 28, supra.}
\item \textsuperscript{54} 43 Cal. 2d 481, 489, 275 P.2d 15, 21 (1954).
\item \textsuperscript{55} The presumption of knowledge was used to support a fraud cause of action in Edwards v. Sergi, 137 Cal. App. 369, 30 P.2d 541 (1934), which involved the sale of land by an agent who innocently asserted that it contained a wooded section when it did not. \textit{See also} the text accompanying notes 66-72, infra.
\item \textsuperscript{56} Lathrop v. National Sugar Co., 16 Cal. App. 350, 116 P. 982 (1911), holds that some puffing is permissible. \textit{See also} Williams v. Lowenthal, 124 Cal. App. 179, 12 P.2d 75 (1932); W. Prosser, \textit{Law of Torts} 739 (3rd ed. 1964) ("The 'puffing' rule amounts to a seller's privilege to lie his head off, so long as he says nothing specific, on the theory that no reasonable man would believe him . . . "). The question of what is puffing and what is fraud is one of fact [Cal. Civ. Code § 1574 (West 1971)] and allows the plaintiff to get to the jury in any event. Herzog v. Capital Co., 27 Cal. 2d 349, 352, 164 P.2d 8, 9 (1945).
\end{itemize}
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product performance must be shown to infer assertions of past or present fact to be actionable.\footnote{57} In Clements, the specific representations made by SBC were phrased in terms of what the system would do when it was properly functioning at some time in the future.\footnote{58} These assertions were made about a system which was a present fact only in the sense that it was a present conception. Nevertheless, these representations were held to be more than mere predictions. The court in Clements found that the proposed system was a product,\footnote{59} notwithstanding the fact that it was clearly not an off-the-shelf item and might never exist in a tangible state unless Clements signed the contracts.\footnote{60} Treating the concept of a system as a finished product made it possible to treat descriptions of its proposed characteristics as statements of fact rather than design objectives.

Because no California court has yet dealt in detail with the special problems of representations associated with the sale of untested data processing systems, the search for a rule of law must necessarily proceed by analogy.\footnote{61} There are cases which discuss representations about anticipated product performance; if a data processing system is a product, then these cases are useful ana-


\footnote{58} The language in question is "the only way [Clements] would ever get", Clements Auto Co. v. Service Bureau Corp., 298 F. Supp. 115, 125 (D. Minn. 1969); "program will provide", id. at 127; "no additional personnel would be required", id. at 128; "would allow", id. at 130; "it would constitute", id. (emphasis added).

\footnote{59} "We believe the trial court was correct in finding that the representations as a whole were more than mere predictions. . . . We have previously stated the central representation to be 'that the proposed data processing system would, when fully implemented, be capable of providing [Clements] sufficient information in a form such that when properly utilized, it would constitute an effective and efficient tool to be used in inventory control.' While this statement is in a sense a prediction of what the system will do, it is also, under existing Minnesota law, a statement of the inherent capabilities of a particular product." Clements Auto Co. v. Service Bureau Corp., 444 F.2d 169, 181 (8th Cir. 1971).

\footnote{60} One of the contracts signed by Clements "provided for the programming necessary to produce the reports." Clements Auto Co. v. Service Bureau Corp., 298 F. Supp. 115, 121 (D. Minn. 1969). The computer that was going to make the system possible had not yet been delivered to SBC's offices at the time the proposals were presented.

\footnote{61} "Until there is a large volume of decided cases on the new mechanisms, decisions in cases involving them will be made by drawing analogies to ostensibly comparable situations in other fields." Freed, Some Legal Aspects of Computer Use in Business and Industry, 12 JOURNAL OF INDUSTRIAL ENGINEERING 289, 290 (1961). "The most feasible solution therefore appears to be to examine the law in closely related areas and try to reason by analogy to computers wherever possible." Banzhaf, When a Computer Needs a Lawyer, 71 DICKINSON LAW REV. 240, 241 (1967).
logues. Ordinarily, where prior experience is definitely lacking or where the court wishes to ignore it, predictions of future performance are dismissed as mere opinion; however, where a product which is not new is put to new uses, California regards statements of predicted performance in those untried uses as statements of fact. For example, in Kolberg v. Sherwin-Williams Co. the plaintiff bought an insecticide spray from the defendant, relying on the defendant's assertions that it would kill scale without damaging his orange trees or crop. However, use of the spray resulted in substantial damage to plaintiff's orange crop. The plaintiff sued and won on a fraud theory by showing that the defendant knew of previous instances of defoliation resulting from the use of the spray. Thus, because the defendant knew of risks associated with his product's use, his representation that the spray could be used safely in plaintiff's circumstances was actionable. Similarly, in Cornell Tractor Co. v. Humphrey, a case involving a harvester which did not harvest grain as fast as the seller had indicated it would, the plaintiff buyer succeeded on a fraud theory. From these precedents it is clear that, to the extent that a proposed system may be treated as a product, the seller's predictions about its potential are actionable where the seller knows how his product has worked previously in similar situations.

**Expertise: Salesmanship in Disguise**

The seller cannot always be shown to have specific knowledge of adverse results in prior situations. For that reason, another line of analogous cases bases liability on the expertise of the representer. For example, Barron Estate Co. v. Woodruff involved an architect who represented to his client that the total construction cost of the designed building would not exceed $300,000. On the basis of that estimate, the architect was retained to make the necessary plans at a retainer of 15% of each week's cost of construction. After construction costs surpassed the $300,
000 limit and it became obvious that there would be a great deal of additional expense required, the client sued on the basis of fraud. The Supreme Court of California held that the plaintiff properly relied on the architect's cost estimate because it was a representation of fact and, moreover, because the architect's superior knowledge and skill justified such reliance. Thus, where the seller makes predictions which are within the scope of his own specific field of expertise, such predictions become actionable as statements of fact.

The distinction between statements of fact on the one hand and predictions or opinions on the other depends largely on the relative degree of expertise between the parties. For example, in Bank of America v. Hutchinson, the bank's branch manager vouched for the credit of one of the bank's depositers to a third party. On the basis of this information the third party made a loan to the depositer in question which was subsequently found to be uncollectible. Although no fiduciary relationship between the bank and the lender was found, the court held the bank liable for its employee's misrepresentations. The rule of Hutchinson is, therefore, that a cause of action for fraud can be maintained where an unsubstantiated opinion is offered by a representer who is in possession of superior knowledge. Thus, if an expert speaks at all, he must speak truthfully.

The expertise differential may likewise be augmented by buyer ignorance and gullibility. For example, in Harazim v. Lynam the defendants ran a confidence game which took the form of an instructional course in the "science of money," representing among other things that President Kennedy had been a member. The object of this scheme was to get the course enrollees to turn over money for "investment" purposes. In reversing the trial court's dismissal the court of appeals held that the plaintiff's gullibility, as well as the defendant's superior knowledge, can be a determinative factor in a finding of fraud.

However, the balance of knowledge between the parties may also tilt in the defendant's favor. One recent case denied re-

67. 163 Cal. at 572, 126 P. at 356. Cf. Clements Auto Co. v. Service Bureau Corp., 444 F.2d 169, 184 (8th Cir. 1971) regarding "statements upon which [Clements], with its limited knowledge of computers and data processing systems, could reasonably rely, given the superior knowledge of SBC."

68. 212 Cal. App. 2d 142, 27 Cal. Rptr. 787 (1963). See also Custodio v. Bauer, 251 Cal. App. 2d 303, 59 Cal. Rptr. 463 (1967), where a misrepresentation cause of action was sustained against a doctor who represented that a sterilization operation on a woman would work when he knew of instances to the contrary. The woman subsequently became pregnant.


covery to a plaintiff who invested in a duplex on the basis of the defendant builder's claims as to rental value. The court ruled that the defendant's estimates of rental value did not justify plaintiff's reliance because the builder had no experience in renting duplexes and both parties had comparable knowledge in real estate matters.

A case which involved an innocent misrepresentation in the sale of computer components also rested its decision on the relative expertise of the parties. In *Strand v. Librascope, Inc.*, the expertise differential was at first glance insubstantial, but because of the rapid development then taking place in the state of the art, the court held that the seller's superior knowledge of the product involved required full disclosure. Plaintiff Strand bought magnetic reading and recording devices from the defendant for use in a computer that he was building. The defendant not only failed to inform Strand of an improved version of the devices, but also failed to disclose the troubles that it was having in its own use of the devices, and the necessary modifications needed to make them function. Although both parties were pioneers in a very specialized area of technology, the court found that "[t]he transaction entered into between Librascope and Strand did not thus present the classic common-law situation of parties 'bargaining at arms length'", because "[i]n the area of electronic digital computers [in 1961], research and development [were] advancing at an almost unbelievable pace." Thus, on the frontiers of knowledge, where experimentation is still taking place, those who are perhaps only days ahead may be liable for their statements. The rapid discovery and development of new uses for data processing often gives the "expert" data processor only slightly more knowledge about the difficulties inherent in a particular application of data processing techniques to a customer's problems than the customer himself has, and yet that slight advantage is apparently enough to make him liable for his prognoses of product performance.

California is on the verge of imposing a rule of innocent misrepresentation on experts. Cases such as *Barron Estate Co.* and *Strand* illustrate how courts have made the disparity of knowledge between the seller and the buyer a basis for treating assertions about future performance as statements of fact in order to find fraud. Data processing skill is clearly a species of expertise

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39 (1970). This case would be useful in defeating the fraud claim of a service bureau against a software firm, if both parties had an equal degree of expertise in the subject area.


72. 197 F. Supp. at 752.
and cases such as *Gagne* hold such expertise a basis for strict liability. Thus, there is a strong likelihood that statements similar to SBC's in *Clements* will incur fraud liability in California. Assuming that liability is imposed, it is probable that damages will be greater than under Minnesota law.

**The Measure of Damages under a Fraud Theory**

The trial court in *Clements* awarded damages equal to substantially all of Clements' out of pocket expenses attributable to the fraud, including sums for clerical costs, increased supplies required, executive salaries, and losses due to distressed inventory as well as the sums outlayed to SBC and the equipment lessor.\(^7\)

The court held, furthermore, that no duty to mitigate arose until some three years after the service contracts were negotiated\(^7\) because Clements was justified in relying on SBC's continuing assurances that the system would work after certain recommended improvements were made.\(^7\)

Had this holding withstood attack on appeal, it would have had dramatic consequences for the service bureau industry by making data processors liable for all losses incurred while the data processor and his customer worked jointly to improve the system. Service bureaus would understandably become reluctant to bear strict liability for customer losses attributable to working the "bugs" out of the system, particularly when all of the benefits would flow to the customer.

On appeal, SBC vigorously argued that the limit of liability provisions in the contracts between the parties should govern in a case of innocent misrepresentation just as they would for breach of contract.\(^7\)

Had this argument prevailed, there would be too little constraint on service bureau claims of system performance; a service bureau would be able to minimize its risk of damages without expressly specifying for which of those assertions of quality it was limiting its damages. The Eighth Circuit held, however, that the issue was controlled by Minnesota tort law and

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73. *Clements Auto Co. v. Service Bureau Corp.*, 298 F. Supp. 115, 142 (D. Minn. 1969). Looking at the results from SBC's viewpoint, SBC was liable for $480,811.33, *id.* at 142, on a gross sale of $216,596.90, *id.* at 215, which represented a net loss even without the damage award, *id.* at 132 n. 13. The ""Third Court's award . . . [turned] . . . three years of loss into years of profit of over $100,000 per year at SBC's expense." SBC's Appellant's Brief at 51, *Clements Auto Co. v. Service Bureau Corp.*, 444 F.2d 169 (8th Cir. 1971). A copy of Appellant's Brief is on file in the office of the SANTA CLARA LAWYER [hereinafter cited as Appellant's Brief].


75. *id.* at 137.

76. Appellant's Brief, *supra* note 73, at 45.
hence any contractual limit of liability was inapplicable, even where the misrepresentations were innocent.\textsuperscript{77} Thus, the service bureau in Minnesota has no means by which it can minimize its risk other than exercising extreme caution when moving into new areas of data processing services.

SBC also contended that Clements was obligated to refuse offered services once it determined that the system was not functioning as it had anticipated.\textsuperscript{78} However, the Eighth Circuit held that the duty to mitigate arose not at the first sign of error nor after an excessive experience of failure, but only after Clements and SBC had made a reasonable effort to make the system perform to the customer's satisfaction.\textsuperscript{79} This ruling, therefore, takes a pragmatic approach to the mitigation problem by allowing data processors to attempt to apply their techniques to new problems without bearing the risk of unlimited liability should failure ultimately result.

The circuit court also brushed aside SBC's attempt to require evidence as to the cost of pre-computer inventory methods\textsuperscript{80} on the ground that the trial court was "allowed considerable leeway in arriving at the amount of damages."\textsuperscript{81} This refusal to insist on proof of pre-service bureau costs is unfortunate because all too often the costs before data processing consist of the largely invisible part-time efforts of a number of clerical personnel, which could easily escape the court's attention, while the costs of data processing are evidenced by a highly visible monthly bill.

California statutory law on the subject of damages for fraud likewise follows the "out of pocket rule." Civil Code § 3343,\textsuperscript{82} which states the rule of damage recovery for actions in fraud, awards the difference between what the defrauded party has expended and what he has received in value, plus additional damages arising from the transaction.\textsuperscript{83} Section 3343 clearly allows

\textsuperscript{77} Clements Auto Co. v. Service Bureau Corp., 444 F.2d 169, 188 (8th Cir. 1971).

\textsuperscript{78} Appellant’s Brief, supra note 73, at 47.

\textsuperscript{79} Clements Auto Co. v. Service Bureau Corp., 444 F.2d 169, 185 (8th Cir. 1971).

\textsuperscript{80} Appellant’s Brief, supra note 73, at 49.

\textsuperscript{81} Clements Auto Co. v. Service Bureau Corp., 444 F.2d 169, 190 (8th Cir. 1971). It cut the award to $247,745.17. Id. at 191.

\textsuperscript{82} CAL. CIV. CODE § 3343 (West 1971).

\textsuperscript{83} Id. It is difficult to see the distinction between this section and section 3333 covering tort in general, and the Supreme Court of California apparently shares in the confusion. In Gagne v. Bertran, 43 Cal. 2d 481, 490, 275 P.2d 15, 22 (1954), the majority cites section 3333, but, as pointed out by the dissent, actually applies section 3343. For the rule that, Gagne v. Bertran notwithstanding, section 3343 applies in cases of fraud, see Garrett v. Perry, 53 Cal. 2d 178, 346 P.2d 758 (1959); Sixta v. Ochsner, 187 Cal. App. 2d 485, 9 Cal.
consequential damages, and if intent to defraud can be shown, exemplary damages can be awarded.

The primary statutory measure of damages for fraud is clear, but three secondary factors cloud the picture. The first of these is the "benefit of the bargain" measure of damages which would be applicable to fraud in sales covered by the Uniform Commercial Code. The second is the lessening, in recent cases, of the inflexibility of the rule limiting damages to "out of pocket" losses. Coleman v. Ladd Ford Co. declared the existence of exceptions to the exclusive measure of damages decreed by section 3343 and the rationale of Coleman is sweeping enough to reach many other cases. Finally, the third factor tending to ameliorate the impact of section 3343 is the courts' liberality in applying it. Examples are Lawson v. Town & Country Shops, Inc., where punitive damages were awarded under section 3343, and Sixta v. Ochsner which misread Lawson as allowing recovery of loss of profits and held that any loss arising from the transaction is recoverable.

The Duty to Mitigate

Mitigation of damages may not be stringently required of the defrauded party in all cases. For example, in Gagne, where


85. CAL. CIV. CODE § 3294 (West 1971). In Brockway v. Heilman, 250 Cal. App. 2d 807, 58 Cal. Rptr. 772 (1967), the defendant sold a bar and promised to deliver a liquor license, which he had no intent of doing. $5,000 exemplary damages were awarded.

86. CAL. COMM. CODE § 2721 (West 1971). The California annotation to section 2721 indicates that it would change the measure of damages to the more generous standard applicable to breach of contract.

87. "Remedies for material misrepresentation or fraud include all remedies available under this Article for non-fraudulent breach." Id. (emphasis supplied). The disjunction of "material misrepresentation" and "fraud" suggests that applicability to innocent as well as fraudulent misrepresentation might be intended. See also Note, Fraud: Measure of Damages, 11 U.C.L.A.L. REV. 876, 883 (1964).

88. See notes 118-33 and accompanying text, infra, for an analysis of to what degree a service bureau's activities are subject to the Uniform Commercial Code.


94. Id. at 491, 9 Cal. Rptr. at 620.
property was purchased for an apartment building in reliance upon soil tests, it was held unreasonable to require the purchaser to cease construction in order to mitigate damages.\textsuperscript{85} Moreover, authority exists for the proposition that where the seller has superior knowledge a defrauded buyer is not prevented from maintaining an action because he abandoned his investigation of the facts after his suspicions were aroused.\textsuperscript{86} Thus, although the court's reasoning in \textit{Clements} that the plaintiff was not entitled to rely on SBC's representations after it became apparent that they were false is persuasive, it could be argued that the inextricable involvement of the data processing system in the customer's business considerably prolonged justifiable reliance. In any event, reliance would not be negated by mere suspicion of falsity.\textsuperscript{87}

The measure of damages for fraud in California is at least as generous as that applied in \textit{Clements} and the trend in California is towards greater generosity. Likewise, California is no less liberal than the \textit{Clements} court in allowing the plaintiff to prolong reliance and delay mitigation.\textsuperscript{88} In short, \textit{Clements} would have fared as well if not better in California. However, beyond the generosity of California courts there lies a sounder basis for anticipating an increased measure of damages for fraud in data processing cases. The \textit{Clements} trial court perceived the great dependence on data processing services that the user quickly develops.\textsuperscript{89} This dependence makes it very difficult for the user to

\textsuperscript{86} Hobart v. Hobart Estate Co., 26 Cal. 2d 412, 435, 159 P.2d 958, 971 (1945).
\textsuperscript{89} "Furthermore, the representations made by SBC were not ones which the ordinary laymen eventually could easily determine to be true or false. SBC presented to [Clements] new techniques involving a new technology and a new language. This system was represented to have the potential for great benefit to those who used it. It was to permit the managers of this business to retrieve and compare information about their business with a degree of accuracy and at a speed which was unheard of before the computer was developed. But this system also had a potential for great harm to those who adopted it, when the system was improperly designed. This businessman, who decided to automate his accounts receivable and attempted by that to obtain the information necessary for inventory control, took a step down a path from which there was no turning back without great cost. He abandoned his previous accounting system. He discarded his old method of inventory control. His whole business was wrapped around a spool of magnetic tape which was not in his possession and was not even his property. To the extent that the
abandon even faulty data processing systems and revert to manual methods. The circuit court relied upon Minnesota precedents which it interpreted as cutting off justified reliance after discovery of signs of fraud and for that reason reduced damages. However, the court's ruling pointedly ignores the presence in that authority of justification for not requiring mitigation in certain situations. The trial court's findings of fact indicate that Clements' "discovery" of the fraud, on the date that the circuit court holds that justifiable reliance ended, was mere suspicion. Furthermore, a finding of seller expertise which justified Clements' reliance on SBC's representations in the first place should provide a basis for continuing reliance on assurances that the system would work as soon as the "bugs" were worked out. These considerations in concert—the generosity of California law on fraud damages, the unavailability of contractual limitations of liability, and the extreme dependence inherent in reliance upon data processing services—would tend to result in unjustifiably large damage awards.

Excessively large damage awards could have a crippling effect on the fledgling data processing services industry. The circuit court in Clements probably recognized this because it resorted to a strict concept of justifiable reliance which does not accord with the facts in order to avoid too large a damage award. If California courts rely on fraud as a basis for imposing liability in similar cases, they too may be forced into being overly restrictive in determining where justifiable reliance ends and the duty to mitigate starts. For that reason, it is desirable that a basis of liability be recognized that allows a contractual form of limitation. It is evident that implied warranty will satisfy that goal.

**SOLUTION 2—IMPLIED WARRANTY**

*The Nexus Between Fraud and Warranty*

The concept of implied warranty developed from the tort of

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100. Perkins v. Myerton, 190 Minn. 542, 251 N.W. 559 (1934); L'Evesque v. Rognrud, 254 Minn. 55, 93 N.W.2d 672 (1958), cited by Clements Auto Co. v. Service Bureau Corp., 444 F.2d 169, 184 (8th Cir. 1971).

101. Id.

102. The passage quoted at Clements Auto Co. v. Service Bureau Corp., 444 F.2d 169, 184 (8th Cir. 1971), to the effect that a defrauded party must mitigate upon discovery of the fraud, concludes with the statement that the stated rule is "not without limitations", Perkins v. Myerton, 190 Minn. 542, 251 N.W. 559, 560 (1934). Perkins also states that "the defrauded party is not required to abandon [an ongoing business] in order to obtain relief." Id. at 561.

however, it shows some of the characteristics of both tort and contract law. In California, actions for fraud or deceit have become virtually interchangeable. Had the scope of fraud theory remained within its original bounds, actions for fraud and deceit would lie for intentional misrepresentations while warranty would lie for innocent ones. However, many jurisdictions have extended the fraud concept to impose strict liability for innocent misrepresentations.

In *Clements* SBC contended that finding liability for innocent misrepresentations is tantamount to finding liability under an implied warranty. SBC reasoned that the disclaimers of implied warranties which were effective to bar a cause of action for breach of an implied warranty should also have barred the fraud cause of action because, in the face of such disclaimers, Clements was no more justified in relying on the statements as representations of fact than as warranties. However, the Eighth Circuit rejected this contention and ruled that "a general disclaimer clause is ineffective to negate reliance on even innocent misrepresentations." If this position is adopted by other courts, data processing services may not be able to contractually avoid liability for statements of product quality except where those statements are adjudged implied warranties.

California has statutorily extended fraud to cover misrepresentations which are negligently made, and judicial construction has nearly resulted in recognition of strict liability for representations made in conjunction with sales. Because California courts will not expressly impose liability for innocent misrepresentations as a subspecies of fraud, they have not directly ruled on the effect of a disclaimer on sincere but false claims that are not found to be warranties. However, as discussed earlier, California courts could impose liability for fraud on a data processor in SBC's position without acknowledging that it was basing its decision on innocent misrepresentation. Since the same utterances

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105. *Id.* at 651-52.
108. "SBC contends that liability in Minnesota today for innocent misrepresentation in a case involving the sale of either goods or services cannot exist in the absence of a parallel finding of liability for breach of warranty." Appellant's Brief, note 73, *supra*, at 29.
111. See text accompanying notes 30, 31 and 38-49, *supra*.
112. See text accompanying notes 55-72, *supra*.
113. *Id.*
frequently give rise to both fraud and breach of warranty causes of action, particularly in data processing cases, there is a strong likelihood that California courts will eventually have to squarely face this issue. Furthermore, if the few computer industry cases to date are indicative of a trend, the unique requirements of data processing may provide opportunities to avoid disclaimer clauses.

When the first *Clements* -like case arises in California, the courts will have authority for finding liability on the basis of either fraud or warranty, and will be in a position to decide the case on the basis of public policy. Before the relative merits of the two can be weighed, it is necessary to examine the nature and extent of warranty liability.

*The California Law of Warranty*

The law with respect to goods. A common source of warranty liability in California is that portion of the Uniform Commercial Code governing sales which has been incorporated into the California Commercial Code. Generally, these provisions apply only to goods, not services, but it may not be assumed

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115. Landy, *supra* note 4, at 139, indicates that there are three cases other than Clements either decided or pending which include both fraud and warranty causes of action.

116. *See text accompanying notes 143-9, infra.*

117. *CAL. COMM. CODE §§ 2312-2317 (West 1971).* Section 2312 covers warranties of title and against infringement which would be of interest especially in the sale of computer programs. Section 2313 provides that express warranties are created by the seller's affirmation of fact or opinion, description of goods, or *sample* or *model*, provided they are part of the basis of the bargain. With regard to warranties that arise by virtue of advertising, see note 131 and accompanying text, *infra.* With regard to samples, it should be noted that service bureaus frequently furnish sample reports as part of a proposal for data processing services. And as to models, the flowcharts that are often placed in formal proposals often bear little resemblance to the system being sold. Section 2314 deals with the implied warranties of merchantability and usage of trade which would tend to impose a minimum level of quality on the service bureau. Section 2315 deals with the implied warranty of fitness for a particular purpose, which requires the seller to take into account the buyer's purpose in choosing the product. Section 2316 allows all warranties to be excluded by appropriate, conspicuous language in writing. However, in California disclaimer clauses are to be construed strictly against the seller. Lindberg v. Courtches, 167 Cal. App. 2d 828, 334 P.2d 701 (1959); *Burr v. Sherwin Williams Co.*, 42 Cal. 2d 682, 268 P.2d 1041 (1954). Section 2317 states in what order inconsistent warranties shall be considered. It is important to note that implied warranties of fitness for a particular purpose may survive even contrary express warranties in the form of a sample. *Id.* § 2317(c); *L & N Sales Co. v. Stuski*, 188 Pa. Super. 117, 146 A.2d 154 (1958); *Frigidinners, Inc. v. Branchtown Gun Club*, 176 Pa. Super. 643, 109 A.2d 202 (1954).

118. *CAL. COMM. CODE § 2102 (West 1971).*
that the activities of data processing services are thereby excluded.\textsuperscript{110} Computer programs may be goods;\textsuperscript{120} reports printed at a remote location may be goods.\textsuperscript{121} While the law is at best uncertain, at least one California court has refused to dismiss a cause of action which claimed that computer-produced reports were goods under the Uniform Commercial Code.\textsuperscript{122} If data in the form of a report may be subject to warranties, it seems only logical to assume that the information contained on the surface of a magnetic disk or tape may also come under the Uniform Commercial Code's warranty provisions.\textsuperscript{123} If the data stored in the service bureau's magnetic files bears warranties, then inaccuracies in printed reports will subject the service bureau operator to liability unless he can demonstrate inaccuracy in the "input" information that he originally received from his customer. Having guaranteed all the intermediate stages of information storage, the operator can hardly deny responsibility for the end-product.

\textit{The law with respect to services.} The other basis of liability for implied warranties lies in the common law.\textsuperscript{124} Twenty-five years ago the California Supreme Court found a warranty-like

\textsuperscript{119} Freed, \textit{Computers and the Work of Lawyers}, 76 CASE & COMMENT, Aug. 1971, at 46-47, notes "[t]he true legal nature of the activities of suppliers of software programs frequently has been mistaken. Suppliers of goods tend to be considered to be rendering services."


\textsuperscript{121} Freed, \textit{Computers and the Work of Lawyers}, 76 CASE & COMMENT, Aug. 1971, at 50.

\textsuperscript{122} 15 DATAMATION, July 1969, at 115, which reports Southern California Retailer's Credit Service Co. v. Statistical Tabulating Corp., (Superior Court, Los Angeles County, Docket number 98690, March 1968), lists the contentions of both parties, and states that in May 1969 the court denied motions to dismiss. Like many similar suits (see Landy, supra note 4) it may have been settled. The article reports that the plaintiff customer of the service bureau was relying on a definition of goods that would include computer printed reports.


\textsuperscript{124} "For historical reasons warranties have become identified primarily with transactions involving the sale or furnishing of tangible chattels . . . but they are not confined to such transactions." Gagne v. Bertran, 43 Cal. 2d 481, 486, 275 P.2d 15, 19 (1954).
obligation to warn of possible dangers in the sale of a service in Dam v. Lake Aliso Riding School. In that case a child was thrown from a hired horse. The court held that the bailor of a horse impliedly warrants that it does not have an especially vicious temperament when it is offered for use in a riding class. This implied duty to point out concealed unsuitability has direct application to a Clements situation. Another useful exemplar is the changing status of warranties in building construction. A data processing service constructs a system of programs in much the same way a building contractor constructs a building. Any warranties that attach to a finished building, therefore, may be relevant to data processing systems. For example, Kuitems v. Covell held that an implied warranty of fitness for an intended use arose in a contract to install roofing material. Likewise, Dow v. Holly Mfg. Co. held a building contractor liable on an implied warranty for his faulty installation of a heater. And the court in Aced v. Hobby-Sesack ruled that a warranty of merchantability could be implied in a contract to install radiant heat tubing. In all three cases, the contracts were for installation services, and the finished product was held to carry a warranty that the labor had been properly done. Although these cases involved the installation of goods, the logical extension of their rationale would create implied warranties where the goods installed were of nominal value and the contract was primarily for services rendered. Data processing systems tend to be just such compositions.

The attractiveness of the implied warranty theory to the buy-

125. 6 Cal. 2d 395, 57 P.2d 1315 (1936). See W. Prosser, Law of Torts 655 (3rd ed. 1964), where the author notes the “tendency to extend the strict liability of an implied warranty beyond cases involving the sale of goods.”

126. This implied duty was “not a warranty in that sense which insures the suitableness of the horse”. Dam v. Lake Aliso Riding School, 6 Cal. 2d 395, 400, 57 P.2d 1315, 1318 (1936). Recovery was denied in this case because the horse was found to be safe.


128. 104 Cal. App. 2d 482, 231 P.2d 552 (1951). “The contract here under consideration involves a construction job and not a mere sale of roofing material ... [and includes an] ... entirely reasonable obligation implied in all contracts to the effect that the work performed 'shall be fit and proper for its said intended use'. Id. at 485, 231 P.2d at 554.


130. 55 Cal. 2d 573, 360 P.2d 897, 12 Cal. Rptr. 257 (1961). “[W]e conclude that the contract is one for labor and material. There may nevertheless be an implied warranty ... There is no justification for refusing to imply a warranty of suitability for ordinary use merely because an article is furnished in connection with a construction contract rather than one of sale.” Id. at 582-83, 360 P.2d at 902, 12 Cal. Rptr. at 262.
er of data processing services is that warranties can be implied by advertising.\textsuperscript{131} In light of the frequently extravagant claims about software products,\textsuperscript{132} this could have a strong impact on the data processing industry.\textsuperscript{133}

Evidently California is close to extending warranty to the sale of services as well as goods. This wider ambit for warranty, together with a broadened conception of what constitutes goods, will provide a rationale by which the sale of data processing systems can be brought under the law of implied warranty. The buyer will benefit from such a development, for it will tend to ensure that he gets what he wants from the system. In addition, the seller will benefit, because, if data processing systems are subject to implied warranties of fitness and merchantability, the representations which will make the data processor liable will be subject to the other negotiated terms of the contract. Thus, a negotiated disclaimer, for example, may determine the protection afforded the seller.

\textit{Escaping the Disclaimer}

Commercial service bureau operators would be well advised to consult the disclaimer guidelines set forth in California Commercial Code § 2316 in order to exclude undesired contract warranties.\textsuperscript{134} Apparently many do not.\textsuperscript{135} However, even when they comply with section 2316, there are means by which their disclaimers can be avoided.

\begin{footnotes}
\footnote{131. E.g., Lane v. C. A. Swanson & Sons, 130 Cal. App. 2d 210, 278 P.2d 723 (1955), held that the words "boned", "boneless", and "no bones" in an ad warranted that there would be none. See also Thomas v. Olin Mathieson Chemical Corp., 255 Cal. App. 2d 806, 63 Cal. Rptr. 454 (1967).}
\footnote{132. See, e.g., the advertisement in 17 DATAMATION, Aug. 15, 1971, at 57. "Any existing data file may be converted into \textit{any} user-defined format . . . ." (emphasis added).}
\footnote{133. Spangenberg, supra note 5, at 72. \textquoteleft The advertising department now makes most of the warranties that get involved in litigation.\textquoteright \ Cf. Bigelow, \textit{Contract Caveats}, 16 DATAMATION, Sept. 15, 1970, at 42.}
\footnote{135. See Survey, supra note 134. 14\% of service bureaus do not use formal, written contracts for data processing services, 23\% do not use formal written contracts for programming services, and 56\% do not use formal, written con-}
\end{footnotes}
First, the disclaimer may be voidable by reason of its unconscionability. Voiding the express disclaimers in the written contract between the parties results in the creation of implied warranties of merchantability and fitness for a particular purpose by operation of law. Thus, where disclaimers in data processing contracts are unconscionable, buyers of data processing services will find themselves protected. Furthermore, since Clements suggests that service bureau operators will be assumed to possess superior technological expertise, it is probable that courts in the future will be quick to find unequal bargaining power because of the knowledge disparity between the local businessman and the sophisticated purveyor of data processing services.

In addition to the unconscionability escape mechanism, California has a policy of construing disclaimers strictly against the seller. In fact, this often appears to operate as a public policy against disclaimers. A case in point is Burr v. Sherwin Williams Co., where a small quantity of weed killer was inadvertently mixed into the insecticide which defendant sold to the plaintiff, damaging the latter's cotton crop. The California Supreme Court held that the disclaimer in the contract was effective to negate an implied warranty of fitness for the particular purpose of killing specified pests, but was not effective to negate the implied warranty of merchantability as a pesticide. Thus, the court was able to honor the disclaimer clause and still grant relief to the plaintiff.

tracts for sale or lease of program packages. Furthermore, the tendency of service bureaus is to copy each other's poorly written contracts, which may leave them open to liability even when using a contract. Freed, Computers and the Work of Lawyers, 76 CASE & COMMENT, Aug. 1971, at 46.


141. "Seller makes no warranty of any kind, express or implied, concerning the use of this product. Buyer assumes all risk in use or handling whether in accordance with directions or not." Id. at 693, 268 P.2d at 1047 (emphasis supplied).
without the pretense of finding fraud, to which the *Clements* court was forced to resort.

*Lindberg v. Coutches* demonstrates even greater judicial ingenuity at circumventing the validity of a disclaimer. In that case a used airplane was sold “as is” although the aircraft engine had a hidden defect. The court held that a warranty of airworthiness could be implied because the “as is” disclaimer was rendered ineffectual when the seller permitted the buyer to purchase subject to an inspection which would not have revealed the defect. Thus, the court defeated the seller’s patent effort to avoid liability other than that for which he specifically contracted by finding a fatal flaw in the disclaimer itself. *Burr* and *Lindberg* do not hold that disclaimers are invalid per se, but they do indicate how easily a court can brush aside the disclaimer to reach a just result.

The degree of avoidability of disclaimer clauses is important if implied warranty is to be a commercially relevant legal tool. Where courts uniformly uphold disclaimers in favor of the seller implied warranty serves little purpose; fraud must be established before the overreaching seller can be made to pay for his excessive pretensions. However, in jurisdictions such as California where the courts are willing to view disclaimers with an eye to equity, implied warranty becomes a useful means of balancing technological risk against economic risk. This is particularly true of data processing sales. The risk that particular data processing techniques will not be adequate to solve the complex business problems to which they are applied can be offset by an appropriate distribution of the risk of loss between the parties. Although the parties in such situations frequently bargain at arm’s length and—recognizing the possibility of failure—include liquidated damages provisions in their contracts, the buyer is at the seller’s technological mercy in defining the scope and attributes of the data processing system involved because of the seller’s superior knowledge. In those cases where the seller has dictated a definition of a system in technical terms, but has defined it so inadequately that it will not in fact solve the problem at which it is aimed, implied warranties may incorporate minimal protections for the buyer into the contracts by guarantying that the system must solve at least these problems. However, by expanding the specifics of the definition of the seller’s data processing task to include the ultimate goal for which the buyer entered into the contract, implied warranty theory leaves the risk of failure subject to

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the parties' fairly negotiated business judgment as to risk distribution. In *Burr* the court's decision meant that chemicals sprayed on plants must at least not damage the plants and in *Lindberg* it meant that airplanes must at least be airworthy, notwithstanding disclaimers. Similarly, using *Clements* as an example, inventory control systems should be required to control inventory, not withstanding the seller's efforts to spell out less demanding goals. However, in none of these situations should the seller who has failed be liable for damages beyond those contracted for.

**Warranties in Data Processing**

Contracts for data processing may offer unique opportunities for warranty disclaimer avoidance. In *Clements* the Eighth Circuit held that SBC had represented that the data processing system as a whole, irrespective of any specific misrepresentations, would be an effective tool for the purpose for which it was intended.\(^{143}\) In *Sperry Rand Corp. v. Industrial Supply Corp.*,\(^{144}\) the Fifth Circuit reached a similar conclusion with regard to the manufacturer's representations concerning its system of tabulating machines. Industrial Supply had bought a system comprised of ten punched card tabulators for use in performing certain accounting functions. However, the machines did not adequately perform their task. Each one of the machines had been sold by its trade name,\(^ {145}\) each had express warranties and there was an integration clause which purported to exclude liability for representations not included in the contract for sale. Nevertheless, an implied warranty of fitness for the system as a whole was found.\(^ {146}\)

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144. 337 F.2d 363 (5th Cir. 1964).
145. *Cf. Lindberg v. Coutches*, 167 Cal. App. 2d 828, 334 P.2d 701 (1959), which said that "Cessna 195" was not a trade name so as to infer anything, but was only a convenient shorthand between the parties to identify the contract subject.
146. "The transaction between Sperry Rand and Industrial Supply was not the sale of a single item. It was of the ten items... incorporated into a system intended to be tailored to the needs of Industrial Supply. The operational functions of these ten machines were keyed together in a manner intended to meet the accounting and record-keeping requirements of the buyer. They were tailored by Sperry Rand's 'know how' for the particular needs of Industrial Supply. There is no difference in principle between the incorporating of specifically described machines into an integrated system and the building of a specifically designed single piece of equipment for a like purpose. The sale of a group of specifically described machines, which have been combined into an integrated system, specially arranged for the purchaser, is not to be exempted from the otherwise applicable operation of the doctrine of implied warranty on the ground that the machines comprising the system are patented and have been designated by trade names," *Sperry Rand Corp. v. Industrial Supply Corp.*, 337 F.2d 363, 371 (5th Cir. 1964).
A variation of the Sperry Rand rationale was recently utilized as a defense in Security Leasing Company v. Flinco, Inc.,\(^\text{147}\) where Flinco leased a Computyper\(^\text{148}\) from the plaintiff. Although the contracts made no mention of programming services, the Utah Supreme Court held that the parol evidence rule was not violated by admitting testimony of promises to provide programming because it was obvious that the Computyper "could not perform the intended service for Flinco unless it was programmed into [Flinco's] business..."\(^\text{149}\) Beyond the narrow holding with respect to the parol evidence rule, Flinco suggests that at least some courts are ready to distinguish between a bare electronic device and the data processing system which the buyer believes he is getting.

Sperry Rand and Flinco suggest two ways in which disclaimers of implied warranties can be avoided. First, the system is a product separate from the sum of its components and can bear implied warranties separate from those applicable to or excluded from its components. Second, a computer with programming must be distinguished from the computer hardware alone. Taken together these conclusions suggest that because data processing systems have a designed purpose, the systems themselves bear an implied warranty that they will effectuate that purpose. Thus, it may be proper to hold that any disclaimer clause that does not specifically disclaim liability for failure to accomplish the intended overall purpose of the system is ineffective, and, as a corollary, that an implied warranty of fitness for the designed purpose attaches by operation of law despite any broad, generalized disclaimer.

**ALTERNATIVE SOLUTIONS TO ACTIONS BASED ON FRAUD OR WARRANTY**

**Products Liability\(^\text{150}\)**

A system such as the one designed by SBC in *Clements* could have made either SBC or some third party strictly liable in tort under products liability theory.\(^\text{151}\) Products liability requires

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148. A small desk-type computer, made by Friden, Inc.


150. With regard to the implications of products liability to the data processing industry, see generally Freed, *Legal Questions in a Computer Society*, 7 TRIAL, Jan. 1971, at 39.

151. Southern California Retailer's Credit Service Co. v. Statistical Tabulating Corp. (Superior Court, Los Angeles County, March 1968, Docket number 98690) is an action based in part on a strict liability theory. "As the legal brief puts it, 'defendant designed and manufactured a system to process plaintiff's information so as to produce a final product defined as a series of weekly and monthly reports. . . .'" 15 DATAMATION, July 1969, at 117.
neither representations about the product nor reliance thereon, and in a proper case would greatly reduce the plaintiff's burden of proof. Furthermore, whereas an action based on innocent misrepresentation requires privity and is, therefore, of use only between the immediate parties to a sale, an action based on products liability is available to anyone in the product distributive chain. Although the range of potential plaintiffs may be restricted to those with personal injuries or property damage, there is some authority for extending the reach of this tort concept to commercial injury. But even with these restrictions, products liability may have applicability to at least two data processing situations. In one, a third party is damaged by the reports generated by the system. For example, if the system is a docket control scheme for a law firm, there may be liability to a litigant whose date for appeal is missed because of poor system design. A remedy for this situation could be based on either products liability or implied warranty.

Another situation in which products liability theory would apply is one, as in the Ford Motor Credit Co. v. Swarens case, where the court blamed mistakes on the computer. Trust in the infallibility of a computer is hardly a defense...
be relevant is damage to a plaintiff because of a commercially available "canned" program, purchased by a data processor from a supplier.\textsuperscript{160} The gist of products liability is placing a product on the market with knowledge that it will be used without inspection and consequential injury to person,\textsuperscript{161} property\textsuperscript{162} or (possibly) profits\textsuperscript{163} due to a defect in the product. Historically, most data processing systems have been custom designed; increasingly, however, they are standard packages intended to be used or installed into larger systems without inspection. As the use of off-the-shelf program products grows, so will the usefulness of products liability theory. For example, if the inventory control system in \textit{Clements} had been designed by another firm and merely installed by SBC, Clements might have been able to hold the supplier jointly liable with SBC.

\textit{Negligence}

Where services alone are involved and neither fraud nor warranty provide a possibility of relief, negligence is the most likely avenue of recovery for an injured data processing customer.\textsuperscript{164} The early data processing cases have indicated that liability is to some degree predicated on the seller's expertise.\textsuperscript{165} California has enunciated a standard of care for experts generally\textsuperscript{166} and a few standards are available to guide the attorney seeking to prove negligence in data processing.\textsuperscript{167} However, not all the requisite measures of competence in the data processing industry have yet surfaced.\textsuperscript{168}

\textsuperscript{162} Seely v. White Motor Co., 63 Cal. 2d 9, 19, 403 P.2d 145, 152, 45 Cal. Rptr. 17, 24 (1965).
\textsuperscript{164} The customer, plaintiff in Computer Credit Systems, Inc. v. Control Data Corp. (D. Ga. June 15, 1971) (reported in Computerworld, July 7, 1971, at 1) is proceeding on a malpractice theory \textit{inter alia} in its suit against a time-shared data processing service. \textit{See also} Landy, \textit{supra} note 4.
\textsuperscript{166} Experts have "a duty to exercise the ordinary skill and competence of members of their profession". Gagne v. Bertran, 43 Cal. 2d 481, 489, 275 P.2d 15, 21 (1954).
\textsuperscript{167} \textit{See}, e.g., \textit{Bigelow, Some Legal and Regulatory Problems of Multiple Access Computer Networks}, \textit{11 JURIMETRICS JOURNAL} 47 (1970); Hicks, \textit{ANSI COBOL}, 16 \textit{DATAMATION}, Nov. 1, 1970, at 32.
\textsuperscript{168} 'The computer industry is still in its infancy and is one of the fastest
CONCLUSION

California courts will soon confront the questions raised by Clements Auto Company v. Service Bureau Corporation. When they do, they should base liability on an implied warranty theory, rather than the Clements fraud rationale because implied warranty will be more conducive to promoting proper negotiations between the parties. There may be a disparity in technological skills which forces the buyer of data processing services to rely on the computer expert; such disparity is consistent with either fraud or warranty. There is no disparity in business acumen. A businessman buyer of data processing services may not be able to judge whether the specifics of a proposal will in fact accomplish the desired purposes, but he is able to gauge what cost will accrue to him from failure to accomplish them. He can, then, negotiate a limitation to the seller's liability which expresses his judgment. The Clements solution to the problem of an insufficiently precise definition of the purpose of a system—liability for tortious innocent misrepresentation—is too tough on the data processing services industry; it leaves service bureaus liable for unlimited damages. Worse yet, it places none of the responsibility for defining the purpose on the customer. Implied warranty, on the other hand, enables the parties to split the risk of loss through limitation of liability clauses and thereby encourages the buyer as well as the seller to specify precisely what he wants the system to accomplish. Where the seller has intentionally or negligently misrepresented, fraud is the proper basis for relief. But where the untrue representations are innocently made, a public policy in favor of open and thorough negotiation of contracts would demand that necessary relief be afforded on the basis of implied warranty.

It will not be enough to treat injuries after they have occurred. Prophylaxis too is needed. The justifiable reliance in Clements rested on the expertise of the data processor. Expertise is regulated by license in other professions. The legislature growing and changing industries, with few generally accepted standards of conduct." Scaletta, The Legal Ramifications of the Computer Age, 8 DATA MANAGEMENT, Oct. 1970, at 12; accord, Banzhaf, When a Computer Needs a Lawyer, 71 DICKINSON LAW REV. 240, 242 (1967).


171. See generally CAL. BUS. & PROF. CODE (West 1971). Id. §§ 2141, 2142.5 and 2142.10 make it a misdemeanor to practice medicine without a license. Id. §§ 2191 and 2192 set minimal educational standards for a license to practice. Similarly, id. §§ 6002, 6125 and 6060 guarantee a minimum
should look for standards for licensing data processing services and salesmen. A tentative start has been made, but if this new industry is to perform a useful function in the commercial world, the California Legislature must follow up on its early efforts before a number of Clements-like situations arise.

Jerry A. Philpott

level of expertise in attorneys; id. §§ 5055, 5081 and 5083 apply in a similar fashion to certified public accountants. Some other professions which the legislature has seen fit to regulate are: barbers, id. §§ 6500-6636, engineers, id. §§ 6700-6799, collection agencies, id. §§ 6850-6956.2, contractors, id. §§ 7000-7058, and yacht and ship brokers, id. §§ 8900-8975.


173. CAL. BUS. & PROF. CODE § 9984.5 (West 1971) specifies that employment agencies that would advertise their reliance on computers are limited to a $15.00 fee, must keep applicants on their files for one year, and must process their applications at least weekly and report to them within 48 hours after matching them to a job. See also 16 DATAMATION, November 1, 1970, at 97.