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Scope of the Uniform Commercial Code; Survey of Computer Contracting Cases

By Amelia H. Boss* and William J. Woodward**

The Ad Hoc Subcommittee on the Scope of the Uniform Commercial Code ("Ad Hoc Subcommittee"), the youngest subcommittee of the Uniform Commercial Code Committee, was formed only three years ago, and the following article represents its first contribution to the annual survey. For this reason, the article is divided into two parts. The first is a foreword containing a general description of the Ad Hoc Subcommittee, its formation, organization, and achievements. The second is a review of the law governing computer contracting.

FOREWORD: THE AD HOC SUBCOMMITTEE ON SCOPE OF THE UNIFORM COMMERCIAL CODE

Over the years the Committee on Uniform Commercial Code ("U.C.C. Committee"), through its subcommittees on the various articles of the Uniform Commercial Code ("U.C.C." or "Code"), has monitored legal and legislative developments that affect the Code. In carrying out this work, the U.C.C. Committee did not rigidly restrict its inquiry to cases and developments directly implicating the existing provisions and structure of the Code. Instead, it interpreted its mandate more broadly, recognizing that many developments at the periphery of the Code needed attention.

Thus, over time the U.C.C. Committee involved itself in subject areas beyond the existing scope of the Code. For example, leasing contracts have long been recognized as hybrid transactions that have some of the attributes of a sale and some of a secured transaction. For many years, the Subcommittee on General

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The following members of the Ad Hoc Subcommittee on Scope of the Uniform Commercial Code contributed to this article: Denis K. Abercrombie; Herbert L. Ash; Roger D. Billings, Jr.; David M. Bosko; Patricia Brumfield Fry; Samuel W. Gordon; Richard Harbus; Michael S. Khoury; Ann Lousin; Veryl V. Miles; Raymond T. Nimmer; Hugh E. Reynolds, Jr.; and Gary M. Schober.
Provisions, Sales, Bulk Transfers and Documents of Title monitored the application of article 2 to leasing contracts, and the Subcommittee on Secured Transactions monitored the application of article 9 to leasing transactions. In 1981, however, recognizing the need to deal specifically with leasing transactions, a Subcommittee on Personal Property Leasing was formed and became a vital force in the drafting of the new article 2A. Similarly, electronic funds transfers were outside the ambit of the Code, not being covered in the original provisions of articles 3 ("Commercial Paper") and 4 ("Bank Deposits and Collections"). Yet the U.C.C. Committee has been active in efforts that include developing possible amendments to articles 3 and 4 and drafting a possible additional Code article dealing specifically with wire transfers.

Other issues continue to surface that involve the possible application of U.C.C. provisions to transactions traditionally excluded from Code coverage. In a survey conducted by the Subcommittee on Sales concerning problems under article 2, respondents repeatedly raised scope issues. Frequently mentioned were whether the Code applied, or should apply, to contracts (both those with sales components and those without) for services and for computer software. Because of the U.C.C. Committee's perception that these two areas raised important problems in their interaction with the U.C.C., a new subcommittee was created to deal with those tangential but nonetheless extremely important issues.

The Ad Hoc Subcommittee on the Scope of the Uniform Commercial Code had its first organizational meeting in April 1986. At the outset, the Ad Hoc Subcommittee identified for study and exploration two general areas that are not the subject of any comprehensive uniform law: (i) services contracts and (ii) "intangibles," such as computer programs and intellectual property.

Commercial services contracts represent an important segment of modern commerce, and the volume of services contracts, both in number and in value, probably exceeds the volume of sales transactions. Despite that fact, there is no comprehensive statutory law governing services contracts. Although article 2 of the Code is occasionally applied to such contracts by analogy, or even directly when services are a portion of a larger sale-of-goods contract, such application


4. See Worrell v. Barnes, 87 Nev. 204, 484 P.2d 573, 9 U.C.C. Rep. Serv. (Callaghan) 76 (1971) (applying article 2 to sale of water heater where installation was defective).
has been far from consistent and has raised additional problems. Transactions relating to intangibles have also become significant, especially in light of the substantial growth of the computer industry. As the number of transactions involving hardware and software have greatly increased, issues ranging from contract formation, enforcement, damages, and warranties to the financing of such mixed transactions have taken on importance.

In the study of these general areas, the Ad Hoc Subcommittee's inquiry was not limited to questions of the "scope" of the Code (i.e., where sales contracts end and services contracts begin). Rather, the Ad Hoc Subcommittee undertook a broader examination of the commercial law problems encountered in those areas to see whether any type of statutory treatment was feasible or desirable. The Ad Hoc Subcommittee structured its inquiry by posing three questions: (i) Is the present case law and statutory law relating to such topics functioning satisfactorily; (ii) Should any of these areas be the subject of uniform statutory treatment; and (iii) If uniform statutory treatment is desirable, should any of these areas be included within the scope of the Code?

The Ad Hoc Subcommittee initially created two working task forces, one on services and another on the computer industry. As the Ad Hoc Subcommittee's work progressed, two additional task forces were created: a Task Force on Electronic Mail Services in April 1987, and a Task Force on Intellectual Property Financing in August 1987.

Each task force was expected to review and analyze the statutory and case law applicable to the area under consideration, review the legal literature, and canvass the problems encountered by practitioners. At that point, one of several initial decisions could be made. First, the task force might decide that the present law was adequately addressing all issues, eliminating any need for corrective action. Or, it could decide that clarification of the scope of the U.C.C. is needed (e.g., when does article 2 apply to a mixed sales/services contract), in which case the Ad Hoc Subcommittee could suggest appropriate clarifications for consideration by the sponsors of the Uniform Commercial Code (the National Conference of Commissioners on Uniform State Laws ("NCCUSL"), the American Law Institute ("ALI"), and the Permanent Editorial Board ("PEB")). Alternatively, the task force might decide that certain issues required more extensive statutory treatment, either by amendments to the existing provisions of the Code, by a new article within the U.C.C., or by a new uniform statute or federal legislation. The Ad Hoc Subcommittee further noted that there might be some legal issues which, though not amenable to statutory treatment, could nonetheless be dealt with by way of a symposium, scholarly article, sample documents, or additional commentary to the Code.

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6. For this reason, an attempt was made to recruit members from outside the U.C.C. Committee who were interested in and knowledgeable about the areas under exploration.
SERVICES TASK FORCE

As noted above, a frequent question under article 2 of the U.C.C. is its application to mixed sales/services contracts, i.e., contracts that involve both a sale of goods and the provision of services in varying proportion. The contract can be a pure sale of goods with only a minor services component (e.g., the sale of a hot water heater that the seller installs) or a services contract with a minor sale of goods (the commissioned painting of an original oil portrait that is then "sold" to the purchaser). The difficulty in delineating between sales and services contracts, and the absence of any clear, comprehensive, readily accessible body of law for services transactions, create a situation where the outright application of the Code to the entire transaction is very attractive. But this is exactly where courts often ignore important differences in the types of transactions involved, leading to inappropriate application of Code provisions.

The Services Task Force first sought to define the realm of services contracts with which it was dealing. The task force pointed out that it is difficult to define services contracts in any meaningful way, because the field of "services" is so large and variable. It is therefore difficult to approach services contracts as a generic form and to develop rules that can be applied across the board to such contracts. A constant problem is to distinguish between those mixed sales/services contracts which should be classified as "sales" contracts subject to the Code and those which should be outside the scope of the Code. Courts have historically approached the problem in a number of ways. Some have looked for the predominant feature of the contract; others have used a gravamen-of-the-

7. This is similar to the problems leading to the codification of personal property leasing law under article 2A. Leases were not directly covered by the pre-1987 official texts of the Code, while sales or secured transactions that might be "disguised" as leases were governed by articles 2 and 9 respectively, leading to extensive line-drawing litigation. Moreover, leases were not governed by any comprehensive or coherent body of law, making the application of articles 2 or 9 by analogy very attractive despite the problems inherent in applying that law to a unique form of transaction. See generally Mooney, Personal Property Leasing: A Challenge, 36 Bus. Law. 1605 (1981). The new 1987 official text of the Code clarifies the distinction between true leases and disguised leases by amending the definition of "security interest" in § 1-201(37), and it attempts to remove the temptation to apply articles 2 or 9 to lease transactions by providing a comprehensive, accessible body of leasing law in new article 2A.

8. A task force attempt to list the various types of contracts that might be classified as "services contracts" yielded approximately 100 types of services, ranging from actuarial services and astrologers, through cremation services, debt counseling services, and lobbyists, to public relations and tattooing! The list was merely illustrative and noninclusive, but it demonstrated the range of relationships falling under the rubric of services contracts. Discussion is continuing about the possibility of categorizing or grouping those contracts for further study.

9. On the other hand, the task force observed that certain types of services contracts might be appropriate subjects of legislation, on either a comprehensive or an ad hoc basis.


action test. Still others have tended to apply article 2 to even pure services contracts by analogy.

A report prepared by the Services Task Force set forth two conclusions: (i) there is a present need for some clarification about the applicability of article 2 to services contracts; and (ii) since the services area represents such a significant sector of our economy, there should be further exploration as to whether the law governing services contracts merits separate statutory treatment. With respect to possible codification of the law of services in general, the task force planned to continue its work and analysis; however, it recommended that the Code sponsors consider possible clarification of the scope of article 2. The report discussed the various ways such clarification might be provided (e.g., supplementary commentary,


14. On March 14, 1987, the PEB adopted its “PEB Resolution on Purposes, Standards and Procedures for PEB Commentary to the Uniform Commercial Code,” providing for the issuance of PEB supplementary commentary. Any commentary adopted by the PEB must serve one or more of the following purposes: (i) to resolve an ambiguity in the Uniform Commercial Code by restating more clearly what the PEB considers to be the legal rule; (ii) to state a preferred resolution of an issue on which judicial opinion or scholarly writing diverges; (iii) to clarify the application of the U.C.C. where the statute or the official comment leaves doubt as to the coverage of, or application to, particular circumstances or transactions; (iv) consistent with U.C.C. § 1-102(2)(b), to apply the principles of the Code to new or changed circumstances; (v) to clarify or elaborate upon the operation of the U.C.C. as it relates to other statutes (such as the Bankruptcy Code and various federal and state consumer protection statutes) and general principles of law and equity pursuant to U.C.C. § 1-103; or (vi) otherwise to improve the operation of the Code.

15. Section 2-102, the scope provision of article 2, could be amended to state when the article applied to mixed contracts. Alternatively, individual sections of article 2 that could appropriately be applied to mixed contracts could be cross-referenced in § 2-102 or specifically amended to include coverage of these types of contracts. The Services Task Force recognized that, although many provisions of article 2 could be applied to mixed contracts, application of other provisions could prove difficult or inappropriate. One forward-looking suggestion was that the universal contracting provisions—such as unconscionability, which theoretically can be applied to any contract—be moved to article 1 on General Provisions and that only those provisions that should be restricted to the sale of goods be left in article 2.
sections of article 2), and the content of that clarification but did not take any position on which course of action was preferable.

At its September 1987 meeting, the Permanent Editorial Board had before it the Services Task Force report from the Ad Hoc Subcommittee on Scope of the Uniform Commercial Code,16 other reports from the Ad Hoc Subcommittee (including one on electronic messaging services), and reports from the Subcommittee on General Provisions, Sales, Bulk Transfers and Bills of Lading recommending extensive amendments to article 2. The PEB resolved to seek authority from its parent organizations (the ALI and NCCUSL) to conduct a study, with assistance from appropriate persons, looking toward possible revisions of article 2. The study would address the scope of article 2 with respect to sales contracts involving services or other non-goods components such as real estate and intangibles.

**COMPUTER SERVICES TASK FORCE**

As its first project, the Computer Services Task Force confronted the definition of its own scope, recognizing that the common distinction between hardware and software is really elusive and that "computer law" questions ranged from commercial law issues such as contract formation, warranties, and damages to patent and copyright issues. The Computer Services Task Force began with computer contracting,17 examining the issues confronted on a day to day basis by parties negotiating an arm’s length computer contract (such as a custom software development contract or a bundled computer system sold on a turn-key basis), or by the parties involved in an over-the-counter purchase. It also reviewed the literature on computer contracting and the developing case law to determine what issues were being litigated and how they were being resolved.

As the task force reviewed pending and enacted legislation affecting computer contracting, it discovered that much of the legislation dealt with warranty

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16. Copies of that report may be obtained from the chair of the Services Task Force, Professor Ann Lousin, John Marshall Law School, 315 S. Plymouth Court, Chicago, Illinois 60604.

17. The issues discussed were wide ranging, including problems in detailing specifications; needs for testing and time for performance; warranties; licensing and resale; shrink-wrap licensing; sites for usage; custom and semicustom software; warranties of title; copyright protection; replication and back-up; limitations on damages; duty to cover or repair; direct, incidental, and consequential damages; overreaching and unconscionability; reclamation rights upon buyer’s insolvency; repossession rights; new options and configurations; delegation of performance; quality assurance; access to source codes; third party beneficiaries; new specifications; and changes in price.
protection on computer products and shrink-wrap licenses. These legislative efforts seemed to be hasty responses to pressure from certain interest groups, producing an ad hoc, nonuniform, and often contradictory patchwork of regulation which could have a potentially adverse effect on the computer industry nationwide. The burgeoning case law, moreover, seemed to demonstrate the need for a clear body of law to apply to computer contracting situations.

Given the size of the computer industry, the seriousness of the issues in computer contracting, the absence of any clear framework for resolving computer contracting disputes in the reported cases, and the potential for further confusion through the piecemeal adoption of state legislation, the Computer Services Task Force sensed that the development of the law relating to computer contracts could be significantly advanced through uniform legislation.

In a report authored by Professor Raymond Nimmer, the Ad Hoc Subcommittee concluded that the time is ripe for a consideration of a uniform software licensing law. While the Ad Hoc Subcommittee concluded that uniform legislation would be desirable, it reached no conclusions about the form or content of such legislation.

The Computer Services Task Force recommendation for a study of software contracting was favorably received by the Permanent Editorial Board at its September 1987 meeting. The PEB in turn recommended to NCCUSL that it create a study committee with NCCUSL and ALI representation to review, 18. In California, Assembly Bill No. 1507, Draft 6 (introduced Mar. 6, 1985), provided that every sale or lease of new computer products or parts would be accompanied by an implied warranty of merchantability if sold by a dealer, an implied warranty of fitness where the manufacturer or seller at the time of contracting had reason to know any particular purpose for which the product was required and that the buyer was relying on the skill or judgment of the manufacturer or seller, and an express warranty that the product conforms in all material respects with the technical specifications and performance capabilities of the product as set forth in the manufacturer's advertisement. Moreover, the bill would prohibit the disclaimer and limitation of duration of those warranties. Non-consumer sales at a purchase price exceeding $25,000 were excluded, as were sales of custom computer programs. Illinois and Massachusetts have also considered special legislation covering minimum warranties and warranty disclaimers in software agreements.


21. The uniform legislation could be a freestanding statute, separate from the Code; it could take the form of amendments to article 2 of the Code, or a new article within the ambit of the Code could be drafted, such as article 2A on personal property leasing.
with other appropriate persons, the Ad Hoc Subcommittee’s report. That study committee will determine what, if any, action should be taken by way of uniform legislation. The ALI Council and the NCCUSL Executive Committee are expected to react to this recommendation soon.

**ELECTRONIC MESSAGING SERVICES TASK FORCE**

The advent of electronic messaging system (“EMS”) is changing the way businesses negotiate and enter into contracts. In April 1987, the Electronic Messaging Services Task Force was formed to examine how well existing contract law, and particularly the contract formation provisions of U.C.C. article 2, accommodate these changes in business practice and whether reexamination of traditional contract rules for EMS is desirable.

On a very abstract level, it is easy to understand how EMS functions: A conveys a message to B, not by voice over telephone wires or by telegraph wire or United States Postal Service, but by means of an electronically generated message sent by a computer and received by a computer. A may type out the message on a computer terminal, specify the recipient of the message, who may have an “electronic mailbox” anywhere in the United States, and then “send” the message. The electronic message will travel over the telephone wires to the addressee’s electronic mail box, where it will be stored until the recipient “picks up” its mail by checking the contents of the box. A response will follow the same procedure in reverse.

In addition to the straightforward EMS transaction, there is a special type of EMS application called “electronic data interchange” (“EDI”). Assume B is a manufacturer who routinely orders parts from S in another state. The parties may agree to conduct all their business through electronic data interchange. If B finds its inventory of parts needs replenishing, a “purchase order” may be sent—not by mail but electronically. B fills in a predefined, formatted purchase order that is available on the EDI system and sends that order electronically to S. Upon receipt of that electronic purchase order, S may send a return acknowledgment, again on predefined electronic forms, and even an electronic invoice. Indeed, it is possible to conceive of a situation where B’s computer electronically monitors B’s inventory and automatically initiates the electronic purchase order when the inventory falls below some predetermined level, and where S’s computers upon receipt of the purchase order automatically issue electronic orders for the shipment of the requested items.

All this is done without paper. Indeed, one of the attractions of EMS and EDI is that communication can be quick and efficient without burdensome paperwork. But the lack of paper and indeed the entire way in which EMS

22. The elimination of paperwork was, of course, one factor leading to the use of uncertificated securities in place of negotiable stock instruments. This change in business practice prompted an ABA report calling for amendments to article 8. Committee on Stock Certificates, Section of Corporation, Banking and Business Law, Report of the Committee on Stock Certificates (1975). This in turn led to the 1978 amendments to the Code. See Aronstein, Haydock & Scott, Article 8 Is Ready, 93 Harv. L. Rev. 889 (1980); Aronstein, Security Interests in Securities: How Code Revision
proceeds raise numerous contract formation issues, such as the statute of frauds, the time of contracting, terms of the contract, and liabilities for errors in transmission.

In its draft report,\(^3\) the Electronic Messaging Services Task Force recommended that the PEB or NCCUSL begin a study on the impact of electronic messaging systems on the present contract formation provisions of article 2 and related provisions of other U.C.C. articles. In addition, the task force noted that electronic messaging services raise wider issues about the rights and obligations of both users and providers of those services. At its September 1987 meeting, the PEB responded to the task force by recommending a comprehensive reexamination of article 2.

**TASK FORCE ON INTELLECTUAL PROPERTY FINANCING**

At its April 1987 meeting, the Ad Hoc Subcommittee considered an area integrally related to computer software contracting: the area of intellectual property financing. The discussion began with consideration of how one acquires and perfects a security interest in intellectual property rights such as computer software, but the Ad Hoc Subcommittee quickly discerned that the issues raised were much broader than computer software. After consultation with the Subcommittee on Secured Transactions, the Ad Hoc Subcommittee approached the Subcommittee on Nonstandard Collateral Financing of the Commercial Financial Services Committee about coordinating work in this area. The Intellectual Property Financing Task Force of the Ad Hoc Subcommittee was formed and undertook preparation of a report detailing the problems involved and making suggestions for action.

In August 1987, the committees sponsored a program on Intellectual Property Financing.\(^4\) In addition, the Ad Hoc Subcommittee considered and tentatively approved a report prepared by G. Larry Engel on *Outline of Issues Involving Clarification on Reforms in Article 9 of the Uniform Commercial Code*. The Ad Hoc Subcommittee is now collaborating with the Patent, Trademark and Copyright Section of the ABA to present a unified proposal for action.

**SURVEY: COMPUTER CONTRACTING CASES**

It is against this background that the Ad Hoc Subcommittee makes its first contribution to the annual survey. This article is based on the work of the Computer Services Task Force but does not represent any position of that task

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\(^{23}\) People interested in the report and the work of the task force may contact the chair of the Electronic Messaging Services Task Force, Michael Baum, 25A Frost Street, Cambridge, Massachusetts 02140.

\(^{24}\) The speakers were G. Larry Engel, Mark Radcliffe, and Harry Sigman.
force or the Ad Hoc Subcommittee. Because the Ad Hoc Subcommittee considers areas at the periphery of the Code, the following survey is not limited to a discussion of cases applying the Code to computer contracts. Instead, the survey goes beyond, to the underlying problems—and solutions—in the computer area.

The following discussion does not purport to be an exhaustive review of computer law or even of the past year's developments. It highlights some of the important recent developments and analyzes them in a broader conceptual framework.

THE BARGAINING PROCESS: ESTABLISHING CONTRACTUAL RELATIONS

In contract cases involving the computer industry, as in other commercial contexts, one occasionally encounters contract formation questions. Courts address these questions in much the same way as they do in other contexts: by applying general common law principles. *Dataserv Equipment v. Technology Finance Leasing Corp.* is illustrative. The plaintiff in that case attempted to sell used "computer features." Technology, the prospective buyer, found the terms of the initial proposal unacceptable and demanded the deletion of three clauses in the offer. The seller agreed to delete two of the clauses but insisted that the third be retained. There matters stood, as the market value of the package dropped. Dataserv later notified Technology that the package was ready. When the buyer maintained there was no contract, Dataserv sold the "features" elsewhere and sued Technology for the difference.

The court deployed a classical offer and acceptance analysis to resolve the issues. As the court saw it, Technology’s proposed deletion of the three clauses was a counteroffer. Dataserv’s refusal to delete the third clause constituted a rejection of Technology’s counteroffer and prevented contract formation without further action by Technology. The court said "Dataserv's so-called 'acceptance,' when it offered to delete clause 8 . . . was without any legal effect whatsoever, except to create a new offer which Technology immediately rejected." As an alternative ground, the court held that, under the facts of this case, a contract could not be formed absent a signing. The court said, "[W]here the parties know that the execution of a written contract was a condition precedent to their being bound, there can be no binding contract until the written agreement [is] executed."

The central question in *Computer Systems of America v. International Business Machines* was whether contract formation can precede a formal signing. Defendant St. Regis wanted to lease a computer system from Computer Systems of America ("CSA"). Executives met to discuss the lease and agreed over the telephone on provisions including a four-year term, the monthly rental

26. *Id.* at 841, 40 U.C.C. Rep. Serv. (Callaghan) at 1631.
27. *Id.*
28. 795 F.2d 1086 (1st Cir. 1986).
payment, and the beginning date for the lease. At CSA's request, St. Regis also sent a confirming letter. A dispute later arose and St. Regis proceeded to buy the computer from another seller. CSA sued.

The confirming letter contained a provision that read: "This lease is dependent upon satisfactory contractual arrangements." The trial court seized upon this provision and awarded summary judgment to St. Regis, believing that the quoted language precluded a binding obligation between the parties. The appellate court reversed. Finding that, in context, the language had "neither a plain meaning nor only one possible meaning," the court rejected the trial court's "plain meaning" approach and found that summary judgment was improper.

Another classic contract formation problem appeared in *Konic International Corp. v. Spokane Computer Services.*29 Spokane was interested in purchasing a computer surge suppressor, and its investigation revealed that such devices sold for anywhere from $50 to $200. A Spokane employee then contacted Konic, talked with an engineer about his needs, and spoke with a salesman who told him the price of the unit he wanted was "fifty-six twenty." Spokane's employee thought this meant $56.20; Konic meant $5,620. Spokane telephoned in a purchase order for the unit, which was shipped, and Spokane's paperwork reflecting the low price followed the call and shipment. When the discrepancy was discovered, Spokane demanded removal of the equipment; Konic demanded $5,620 and later sued for it.

Because each side attached a materially different meaning to the same communication, each meaning was reasonable, and both parties were equally at fault in precipitating the problem, the appellate court held that there was no contract. Analogizing the situation to the famous *Peerless* case,30 the court said, "The mutual misunderstanding of the parties was so basic and so material that any agreement the parties thought they had reached was merely an illusion."31

The purported contract was also an illusion in *Sterling Computer Systems of Texas v. Texas Pipe Bending Co.*32 Sterling sued to enforce a contract to supply digitized cards and computer programs. Sterling's document contained the following provision:

> SCS [Sterling] shall not be liable for its failure to provide (sic) the services herein and shall not be liable for any losses resulting to the client [Texas Pipe Bending] or anyone else by reason of such failure.33

As the court interpreted the form, it exonerated Sterling from "even an outright refusal to perform the data processing services"34 to be supplied under

31. 109 Idaho at 530, 708 P.2d at 935.
33. *Id.*
34. *Id.* at 283.
the contract. As such, the court held the contract lacked mutuality, was without consideration, and thus was unenforceable by Sterling.

Formation issues of a different kind arose in several cases involving leases of computer equipment. Courts have had to determine whether a sublease with the lessor's consent impliedly released the original lessee from its obligations under the lease. In *Union Mutual Life Insurance Co. v. Chrysler Corp.*, Union Mutual sued Chrysler and Computer Systems of America for payments due under a computer equipment lease. Union Mutual had loaned Chrysler and CSA the money to buy equipment that CSA then leased to Chrysler. To secure the loan, Union Mutual took an assignment of Chrysler's lease promise and a security interest in the equipment itself and ensured that the lease agreement contained strong language barring Chrysler from asserting defenses against paying. Chrysler subsequently decided it did not want the equipment and subleased it back to CSA; the sublease agreement provided for payments to Chrysler identical to those Chrysler had been obligated to make to CSA. The net effect was that Chrysler gave up possession of the equipment and stopped paying CSA. When payments to Union Mutual also ceased, it sued both Chrysler and CSA.

Chrysler's position was that Union Mutual had released Chrysler from its obligation in connection with the sublease. Chrysler derived this position from Union Mutual's acceptance of payments from CSA and primary reliance on CSA for payment. The problem with the position was that the facts were not strong enough to show Union Mutual's intent to discharge Chrysler. Pointing to applicable precedent, the court inferred that, under the circumstances, nothing short of Union Mutual's explicit release of Chrysler would suffice to relieve it of its obligations under the lease.

*Bayou Acceptance Corp. v. Superior Hydraulics* presented the same issue. Superior, the lessee, argued that assignment of its lease with the consent of Bayou freed it of all obligations. The Louisiana Court of Appeals, citing provisions of the Louisiana Civil Code, held that Bayou's acceptance of the assignment of the lease did not release Superior because Bayou did not expressly declare its intent to discharge Bayou from its lease obligations.

Neither case involves a particularly innovative use of existing law. But the cases are important because this kind of issue can arise frequently in this volatile field. In a domain rife with technological breakthroughs, lease contracts can quickly change from mutually beneficial to bad from the lessee's perspective. When the lessee can get the same or better technology for less money, the lessee may attempt to extricate itself from the lease relationship. The "novation" defense in these cases is simply one such attempt. The cases confirm that

35. 793 F.2d 1 (1st Cir. 1986).
36. Id. at 12–14.
38. Indeed, the new proposed article 2A on personal property leasing transactions would yield the same results. See U.C.C. § 2A-303(5) (1987).
technological advance and the resulting riskiness in contracting are the driving forces behind the case law in this area.

**APPLICABLE LAW AND DECISIONMAKERS**

**Arbitrability of Disputes**

Several cases involve questions of the scope and applicability of arbitration clauses in the underlying contracts. In each, the computer seller drafted the contract and the decisions appear in accord with basic contract law rules. In *Monical v. NCR Corp.*, the buyers alleged fraud in the inducement. The contract contained an arbitration clause providing for arbitration of "any controversy or claim, including any claim of misrepresentation, arising out of or related to" the agreement. No claim of fraud was made as to the arbitration clause itself; accordingly, the court found that the "broad language of the arbitration clause" encompassed arbitration of the claim that the contract as a whole was induced by fraud.

The court in *NCR Credit Corp. v. Park Rapids Leasing Associates* came out the other way on identical language drafted by the same seller. The court found that the language was not clearly intended to cover an allegation of fraud in the inducement. That the party seeking to rely on the arbitration clause had actually commenced a lawsuit unquestionably influenced the court to find that the suit constituted a waiver of the right to arbitrate.

*Good(e) Business Systems v. Raytheon Co.* involved the same issue. This time, however, the arbitration clause applied to "all disputes arising in connection with" the agreement. Embracing that language, the court reasoned that it was broader than phrases such as "arising out of" or "arising under" and, hence, arbitration should resolve the disputed issues including alleged intentional misrepresentations and questions of fair dealing under Wisconsin law.

The court noted that the Federal Arbitration Act was paramount over state law and that the policy of that Act was strongly in favor of arbitration.

These three cases suggest that sellers may prefer arbitration to resolve their disputes and that courts will interpret arbitration clauses in favor of arbitrability in this industry. In addition, the cases suggest that misrepresentation claims are common in computer-related litigation.

Another case presents an arbitrability issue in a different context. In *International Talent Group v. Copyright Management*, the defendant entered into

40. *Id.* at 791, 467 N.E.2d at 645 (emphasis omitted).
41. *Id.*
42. 349 N.W.2d 867 (Minn. Ct. App. 1984).
44. *Id.* at 429.
46. For a discussion of fraud and misrepresentation claims, see infra notes 77–89 and accompanying text.
two contracts with the plaintiff. One was for computer hardware; the other was for the related software. The buyer alleged fraud with respect to both contracts. Only the software contract contained an arbitration clause, which applied to "any and all proceedings relation [sic] to the subject matter hereof." The court found that this was broader than simply "arising out of" and thus clearly covered the software claims. With respect to the hardware claims, the court said that "the inadequacies in the system may be caused by the hardware or the software or both. Thus it is not clear that the two agreements, if in fact separate, can be separated for purposes of resolving the claims raised in the complaint." Accordingly, the court found the hardware claims also to be arbitrable. As in the Good(e) case, the court referred to the federal policy favoring arbitration.

This last case raises another theme running through the computer industry cases: the interrelationship between hardware and software and the law's reaction to that interrelationship. In International Talent Group, the court found it necessary to merge what would normally be two separate contracts. Incorporating hardware and software into unitary contracts may well be a future industry trend as the line between them becomes legally indistinct.

APPLICABLE LAW

Application of Article 2 to Computer Contracts

Goods vs. Services

The major issue courts have faced in cases involving actions for breach of computer software contracts has been whether such contracts are for sales of goods or services. This determination is particularly important as the courts must consider whether the damages and remedies provisions of article 2 will govern the claims.

Although the court in Hartford Mutual Insurance Co. v. Seibels, Bruce and Co. does not provide any analysis as to whether computer software contracts are contracts for goods or services, it does illustrate that this issue involves a substantial question of fact. The seller developed and licensed computer software for insurance companies and had entered into a license agreement to provide the buyer/insurance company with a computer software product. Because of problems it encountered in implementing the computer software system, the buyer rescinded the contract and demanded reimbursement of the purchase price from the seller. The court denied summary judgment because of questions of fact as to whether the license agreement constituted a "contract for sale" and whether computer software programs were goods or services for purposes of applying the U.C.C.

The court also denied the seller's motion to strike the buyer's claims for actual and consequential damages in accordance with a limited repair and replacement remedy provision in the license agreement. The buyer raised

48. Id. at 592.
49. Id.
several arguments in opposition to the motion to strike: (i) The limited remedy failed of its essential purpose under section 2-719(2), so that the buyer was entitled to other remedies as provided by the U.C.C.; (ii) the limitation was intended for damage claims by third parties caused by the buyer's use of the system and not the buyer's own consequential damages; and (iii) the clause was unconscionable under section 2-719(3) of the U.C.C. and should not be given effect. The court denied the motion to strike because of questions of fact about the adequacy of the limited remedy, the intentions of the parties, and the interpretation of the limitation clause, and whether the totality of the circumstances in the case made the provision unconscionable under section 2-719(3) of the U.C.C.\(^5\)

Other courts have addressed the issue of the status of computer software contracts under article 2 and provide a more detailed analysis of such determinations. In \textit{RRX Industries v. Lab-Con, Inc.},\(^6\) the court affirmed an award of consequential damages for the buyer of a computer software system for use in medical laboratories, based on defects in the system. Under the contract, the seller agreed to correct any "bugs" that developed in the system and limited its liability under the contract to the contract price. In its award of consequential damages, the trial court relied on section 2-719(2) of the California U.C.C.\(^7\)

The primary question, on the appropriateness of the remedy, was whether the computer software system was "goods" as defined under section 2-105 of the U.C.C. and whether the contract was one for the sale of goods or services.\(^8\)

On the question whether the contract was one for the sale of goods or services, the court stated that it must look to the "essence of the agreement."\(^9\) That is, when the sale of goods predominates and incidental services are also provided under the contract, the provision of services does not alter the basic transaction. The court held that a case by case analysis must be made in these computer software contracts because the software packages vary depending on the needs of individual consumers. In this case, the court determined the sales aspect of the transaction to be predominant. The service aspect of the contract (i.e., employee training, repair services, and system upgrading) was incidental to the sale of the

51. The seller argued that because it did not agree to assume the risk of consequential damages the buyer was not entitled to them. The court held that this "tacit agreement test" for recovery of consequential damages has been rejected under the U.C.C. by virtue of \$ 2-715(2), which provides that the "seller is liable for any loss resulting from general or particular requirements for which the seller at the time of contracting had reason to know." Again, the court held that there was a question of fact as to whether reasonable men in the position of the seller would have foreseen the consequential damages claimed by the buyer. \textit{Id.} at 139.

52. 772 F.2d 543 (9th Cir. 1985).

53. Section 2-719 permits parties to a contract for sale to agree to limit damages. Subsection (2) of this provision regulates such limited remedies to the extent that, if the "exclusion or limited remedy [fails] of its essential purpose, remedy may be had as provided in this Act," thus allowing any other remedy that is available under the U.C.C., such as consequential damages.

54. The court's discussion of whether computer software is a "good" under the U.C.C. is very limited; it simply includes a reference to the U.C.C. definition of goods under \$ 2-105(1). \textit{RRX Indus.}, 772 F.2d at 546.

55. \textit{Id.}
software package and did not defeat the characterization of the computer software system as "goods."

As to the remedy, the seller argued that an award of consequential damages was not warranted because the contract limited the remedies to repairs and the contract price. The court noted that, although the failure of a repair remedy does not require that the damages limitations provision be totally voided under section 2-719(2) of the Code, the court may avoid the damages limitation and award consequential damages if the breach of contract is so fundamental that it causes a loss that is not a part of that contractual allocation. The court held that the trial court was not inconsistent with this rule in its finding that the seller was either unwilling or unable to provide a working system or to correct the problems with the system and that both limited remedies failed of their essential purpose. The court also held that the default was so total and fundamental that consequential damages were appropriate.

In Data Processing Services v. L.H. Smith Oil Corp., the court affirmed a judgment in favor of the buyer in a computer software contract. Under the contract, the seller agreed to develop and implement a data processing system and to develop an accounting system for the buyer. The buyer, dissatisfied, stopped making payments under the contract. The trial court held that the contract was for the sale of goods under article 2 and found that a computer program was specifically manufactured goods under sections 2-501(1) and 2-105(1) of the U.C.C.

On appeal, the trial court's finding was rejected. The appellate court held that in cases involving mixed goods/services transactions it had applied a bifurcated analysis, which requires that "cases involving actual goods as defined by [section 2-105(1)] fall within article 2 of the U.C.C., whereas cases not falling within that definition will be analyzed in accordance with principles of common law." The court noted, however, that one of its own districts did not follow this approach in mixed transactions but applied the "dominant thrust" test, which provides that the predominant thrust of the contract determines whether it is for goods or services. The court rejected this approach, referring to the principle of inclusio unius est exclusio alterius.

Under either approach, the court stated, the evidence would support a finding that the transaction was one for services and did not fall under article 2 as a contract for the sale of goods. This case was unlike those where the contract was found to be for sale of goods because there was no sale of hardware or prepackaged/standardized software. The seller was engaged primarily to de-

56. Id. at 547.

57. There was a dissenting opinion on the issue of the award of the consequential damages. The dissent argued that the failure of a repair remedy did not automatically entitle one to consequential damages or all other available remedies under the U.C.C. Rather, the dissent stated, the essence of § 2-719(2) is to assure that at least minimum adequate remedies be available under a sales contract. Therefore, so long as the limitation of remedies was not unconscionable pursuant to § 2-719(3), the limitation of damages provision should not have been disturbed. Id. at 547-52.


59. Id. at 318.
sign, develop, and implement an electronic data processing system. That is, the seller was contracted "to act" with respect to the buyer's needs; the buyer had essentially bargained for the seller's skills. The court stated that this type of contract was analogous to the services contracts between lawyer and client or physician and patient. Although a floppy disk, hard disk, punch card, and magnetic tape might result, these goods would be incidental to the transaction, which primarily involved the skill and knowledge of the seller. Although it disagreed with the trial court on this point, the appellate court did not reverse the trial court's decision because, it said, the findings of fact supported its judgment against the seller under common law principles.60

_Austin's of Monroe, Inc. v. Brown_61 also involved a breach of contract action against the seller and the manufacturer of computer hardware and software.62 Even though the case was decided under Louisiana law and not under the U.C.C., the court had to determine whether the contract was one "to give" or "to do." Under the contract, the seller agreed to provide the buyer with computer hardware, software, and programming to control and monitor cash register drawers, sales, inventory, and accounting, as well as training for the buyer's employees. Because of defects in the system that the seller was unable to cure, the buyer sued the seller for damages _in solido_. The court affirmed the trial court's decree for a reduction in the purchase price of the contract against the seller as opposed to damages _in solido_.

The court held that it is the dominant purpose of the contract that determines the nature of the contract as a whole. Although the defendant was obligated to design, program, install, and train the buyer's employees to operate the system, this was not the predominant or fundamental obligation of the contract, which was the sale of the computer system. The software and training charges represented the seller's "estimate of his cost and profit to place the system on line and amount[ed] only to about 1/5 of the total cost of the system."63 Accordingly, the contract was held to be a contract for sale, not a contract to provide services.

On the issue of the appropriateness of the damages awarded to the buyer, the court affirmed the trial court's decree for a reduction in the contract price rather than a rescission of the contract. This was because the buyer actually used the cash register function of the system for several years and had derived tax benefits from the total price of the system during that period. The court was

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60. The court stated that under common law, "[t]hose who hold themselves out to the world as possessing skill and qualifications in their respective trades or professions impliedly represent they possess the skill and will exhibit the diligence ordinarily possessed by well informed members of the trade or profession." _Id._ at 319–20. On the facts in this case, the seller had breached this promise. _Id._


62. The court affirmed the trial court's dismissal of the claims against the manufacturer, finding no "redhibitory vice" in its hardware and no liability under the dealership agreements it had with the seller. According to the court, the problems with the system were not in the manufacturer's hardware but in the seller's program and training. _Id._ at 1388.

63. _Id._
satisfied that the buyer's use of the system in its defective state was not so inconvenient to the buyer that the system was altogether unsuited to its purpose.

From these cases, it is clear that a computer software contract will typically be a mixed transaction, one that requires the seller to provide services as well as goods. A common method of classifying this type of contract for purposes of determining the applicability of article 2 of the U.C.C. is the use of the predominant or fundamental objective test. This can be determined by comparing the cost of services, such as training, computer programming, and the development of computer systems, with the cost of the goods that are being provided under the contract, such as computer hardware and standardized or prepackaged software. If the cost of the goods under the contract is so significant that the costs of the services are merely incidental to the value of the contract, then the court will likely classify it as one for sale.

Sale vs. Lease

In addition to having to determine whether article 2 applies to hardware or software contracts with services aspects, courts have also had to confront the application of article 2 to transfers of software and hardware by means of a lease rather than by means of a sale.

Two additional states appear to have accepted the reasoning of the New York court in *Hertz Commercial Leasing Corp. v. Transportation Credit Clearing House* by applying article 2 of the U.C.C. to equipment lease transactions by analogy only and only as to the lease terms that are the functional equivalent of terms found in sales contracts. In *J.L. Teel Co. v. Houston United Sales*, the Supreme Court of Mississippi adopted the rule of the *Hertz* case in finding an implied warranty of fitness for a particular purpose in a two-party lease of photocopying equipment. The court specifically limited its ruling to two-party leases because three months earlier the Mississippi Supreme Court held in *Briscoe's Foodland, Inc. v. Capital Associates* that article 2 of the U.C.C. should not be applied to a three-party equipment lease where the lessor did not supply the goods but was, in substance, a financing agent.

The *Teel* court reasoned that the underlying public policies that are reflected in the U.C.C. article 2 implied warranty of fitness for a particular purpose were present in two-party leases as well as in sales: The "lessee may have little opportunity or ability to detect a design or other characteristic inherent in the leased chattel that might render it unsuitable for a particular intended use."
The court noted that many sections of U.C.C. article 2 other than the warranty provisions have been and should be held applicable to leases by analogy. The court stated that its application of article 2 by analogy fulfilled the court's proper role as an interstitial lawmaker, and that common law rules may appropriately be crafted by applying analogous statutory forms (such as article 2) to cases before the court.

The Arizona Court of Appeals also used the *Hertz* reasoning in applying article 2 by analogy to a lease of computer equipment in *Pacific American Leasing Corp. v. S.P.E. Building Systems*. 68 The court adopted the oft-cited language of the *Hertz* case that "it would be anomalous if this large body of commercial transactions were subject to different rules of law than other commercial transactions which tend to the identical economic result." 69 The *Pacific American Leasing* court noted that U.C.C. section 2-102 provides that article 2 does not apply to a sale or contract that is "intended to operate only as a security transaction," 70 but the court said that the restrictive language "excludes those dealings designed to operate only as secured transactions but not the sales aspects of a combined sale-security agreement." 71

Such strained application of article 2 to leases of computer equipment should no longer be necessary with the final promulgation of article 2A on personal property leases. 72

"True" Lease vs. Disguised Security Interest

It would be surprising if the perennial issue of lease versus security interest did not arise in the computer industry, where vendees often lease equipment rather than purchase it or structure their purchase into the legal form of a lease. The question whether a given transaction is a true lease or one intended for security is important because a determination that the transaction is a security interest brings it within article 9 of the U.C.C.; this imposes filing requirements and other restrictions that do not apply to a true lease. When bankruptcy ensues, the lessor of a security leasehold may learn it does not have an ownership interest in the leased chattel (as would a true lessor), but rather a security interest subject to article 9 filing requirements. That security interest will inevitably turn out to be unperfected. The 1972 amendments to article 9 added a provision 73 allowing a true lessor to file a "no risk" financing statement

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69. *Id.* at 100, 730 P.2d at 277.
70. *Id.*
71. *Id.*
72. Under §§ 2A-212 and 2A-213 the lessor in a two-party lease would make implied warranties, as was the effect of the holding in *J.L. Teel*, while in a tripartite financing lease no implied warranties would be imposed on the lessor. Even in states where article 2A is not yet enacted, courts will likely look at the provisions of that new article to bolster the results previously reached by reasoning from the provisions of article 2.
to avoid later second-guessing by courts as to the "true nature" of the transac-

tion.

In Carlson v. Tandy Computer Leasing, the lessor apparently did not take
protective action under the section 9-408 provision. The lessor in Carlson
appealed the bankruptcy court's determination that the lease was actually an
installment sale and, therefore, one intended for security. The bankruptcy court
also held that the security interest was unperfected, entitling the trustee to the
leased equipment. On appeal, the Eighth Circuit concluded that the parties
intended "to create nothing more than a lessor-lessee relationship." The court
emphasized—as most courts do—the fact that the lessee had no duty or option
to purchase the equipment at the end of the lease. While stressing the intent of
the parties and claiming to look at all facts in the case, this court, like so many
others, ultimately focused on whether the lessee had a purchase option (and if
so, was the price nominal or did it approximate the anticipated market value
when the option was to be exercised), or whether the lessee was obligated to
purchase the equipment at the end of the lease.

While newly promulgated article 2A, with its conforming amendments to
section 1-201(37), promises some improvement in deciding this undying issue, as
long as lessors refuse or neglect to make protective filings, litigation of this
issue is unlikely to abate.

**THE BARGAINING PROCESS: REPRESENTATIONS WITHIN OR OUTSIDE THE CONTRACT**

A case seldom seems to arise involving a complaint about a computer product
that does not include a misrepresentation claim along with the breach of
warranty claim. The same case will inevitably also involve a disclaimer of
warranties and limitation of remedies. Perhaps the appearance of fraud and
misrepresentation claims is related to this industry's high rate of technological
change, which can alter the desirability of a contract that once seemed attractive.
Or that pace of industry change may manifest itself in sales people prone to
excessive "puffing" about their new products and what they will do for the
customer. Or it may be that computer sales personnel, like their paradigm used
car, encyclopedia, or aluminum siding counterparts, may contain more than a
normal proportion of bad apples. Since much of the litigation has focused on
misrepresentation rather than warranty claims, that will be the initial focus
here.

74. 803 F.2d 391, 2 U.C.C. Rep. Serv. 2d (Callaghan) 1052 (8th Cir. 1986).
75. Id. at 395, 2 U.C.C. Rep. Serv. 2d (Callaghan) at 1058.
76. C. Cooper, *Personal Property Leasing Under Article 2A*, in Equipment Leasing—Leveraged
Leasing (Practising Law Inst. 2d ed. 1988); Bayer, *Personal Property Leasing: Article 2A*, supra;
Cooper, *Identifying a Personal Property Lease Under the Uniform Commercial Code*, 49 Ohio St.
Fraud Claims

Any contract for the sale or lease of computer equipment or software is subject to the defense of fraud, variously referred to in reported cases as fraud, fraudulent inducement, or misrepresentation. The Code extends its remedies for breach of warranty to such claims even where purchasers want rescission due to the seller's fraud before contract formation. Fraud or misrepresentation may make the contract void or, more commonly, voidable at the aggrieved party's election.

While these principles vary little between ordinary commercial contracts for sale and computer contract cases, the facts involved in computer transactions provide fertile ground for the buyer's belief that misrepresentations were made by the seller. In the past, software vendors extended no warranties at all, providing the software license on an "as is" basis. Hardware contracts are often found with only general warranties against defects in material and workmanship, without any definition of the technical specifications according to which the hardware and software are expected to perform. Since purchasers generally base their selection of equipment and software on the sellers' representations as to the technical performance capabilities and reliability of equipment, the buyers often ignore the generally broad disclaimers of express and implied warranties in standard vendor contracts. When they become disappointed and discover that disclaimers foreclose their contract remedies, they turn to the law of misrepresentation for relief.

The cases seldom announce new principles; rather they simply show courts applying existing principles to a new and factually complex type of transaction. Misrepresentation cases will continue to proliferate until the industry more closely aligns its express warranties with the reasonable expectations of its customers, who assume that the hardware and software they buy will perform as described by the sellers' representatives who sold them the product.

Accusystems, Inc. v. Honeywell Information Systems involved a successful fraudulent inducement claim. After purchasing a computer and operating system to be used to provide data processing services to third parties, plaintiff sued on claims that included fraudulent inducement to contract, negligence or negligent misrepresentations, and breach of contract. The court had previously dismissed the breach of contract claims and dealt in this opinion with the tort claims.

As to negligent misrepresentation, the court held that without a special relationship of trust or confidence between the parties there was no such cause of action in New York. The court decided that the buyer-seller relationship in

77. See Annotation, Computer Sales and Leases: Breach of Warranty, Misrepresentation, or Failure of Consideration as Defense or Ground for Affirmative Relief, 27 A.L.R.4th § 2.0, at 110 (1984).
79. Restatement (Second) of Contracts, §§ 163, 164, ch. 7, Introductory Note.
the case before it was not such a special relationship. The court found, however, that the facts were sufficient for a cause of action for fraudulent inducement under New York law. That required a showing that the defendant "made a representation of fact which was known by [it] to be untrue or recklessly made, offered to deceive plaintiffs and to induce them to act upon the representation, causing injury."%

There seems little doubt that the plaintiffs met their enhanced burden to prove the facts by clear and convincing evidence. Prior to contracting, a Honeywell salesman had been present with plaintiff's representative in another company's offices and observed that company's payroll processing operations running on another Honeywell computer. In response to statements that plaintiff needed a system to perform similar operations on a larger scale, a system that would support thirty-two terminals on-line and that would perform many tasks simultaneously instead of one after the other ("multitasking"), the salesman represented that a particular Honeywell system was, in fact, capable of performing such functions. (The salesman did recommend, however, that the number of terminals be kept to twenty, to speed processing time.) In fact, the operating system plaintiff purchased could not support more than three terminals and caused numerous "crashes." In addition, Honeywell officials falsely stated that the operating system software and hardware had been extensively tested, was installed in a number of other locations where it was doing well, and was capable of multitask processing. Although plaintiff's representative had extensive computer experience, this did not preclude Accusystems' reliance on the misrepresentations: "[S]ince this is a dynamically growing industry [plaintiff's] reliance on Honeywell's representations with respect to the... operating system was reasonable."%

One effect of the fraudulent inducement claim in Accusystems was that the court sensibly declared many contractual terms ineffective. These included choice of law provisions in the contract, those limiting remedies, and a two-year contractual statute of limitations.

The argument that expertise in the computer field precludes reasonable reliance on misrepresentations was also raised in Olivetti Corp. v. Ames Business Systems, a factually rich intentional misrepresentation case involving the breakdown in the relationship between Olivetti, a distributor of word processing equipment, and Ames, one of its retailers. While most of the case dealt with the causal relationship between the misrepresentations and the damages claimed, the court rejected Olivetti's claim that Ames should not have relied on Olivetti's representatives but should have made independent inquiries and that trade rumors put it on notice. Rather, the court ruled that where a party intentionally misleads another for the purpose of inducing that misled party to enter into a

81. Id. at 480-81.
82. Id. at 482.
83. Id.
84. 356 S.E.2d 578, reh'g denied, 360 S.E.2d 92 (N.C. 1987).
contract, it cannot be heard to complain that the misled party should not have believed its misrepresentations.85

The court dismissed a fraud claim in Management Assistance, Inc. v. Computer Dimensions, Inc.66 Again, the claim was fraud in the inducement, coupled with claims for failure to act in good faith and for antitrust violations. The court rejected the fraud claim on the grounds that the claimant had the capacity and opportunity to read the written contract and had signed the contract when not under any special pressure, trick, or artifice. In the course of its opinion, the court held that the U.C.C. specifically governed the transaction.

Brignoli v. Balch, Hardy and Scheinman, Inc.87 shows a fraud claim used in a somewhat different context. Plaintiff apparently developed a software program specifically for defendant's use. Defendant drafted a short, and apparently legally insufficient, letter agreement, which the parties signed but which omitted provisions for compensating the plaintiff. Plaintiff alleged that the defendant intentionally had omitted the compensation term in order to frustrate plaintiff's enforcement of the contract. While the court did not appear to take the claim seriously, it did note that "one who makes a contractual promise with the undisclosed intention to breach it can be held liable for fraud" but that "proof of such intention must be based on more than a showing of nonperformance."88 The court refused to dismiss the fraud claim, concluding that if plaintiff's allegations regarding defendant's intentions at the time of drafting were true, they would provide more than a mere showing of nonperformance.89

**Confining Tort in the Contract Setting**

Courts deciding cases involving the computer business are struggling with the fuzzy line that separates contract claims from tort claims. Buyers who are frustrated with the product they purchased and barred from relief by their sales contract often attempt to recover under a tort theory such as misrepresentation or negligence. Surely, without strong policy justification, it is a mistake to permit a frustrated or disappointed business claimant to convert a losing case to a winning one merely by changing the pleading from contract to tort. Such strong policy support exists in the products liability field, which permits injured plaintiffs to recover from sellers in tort despite limitations in the sales contracts. If comparable policy support exists for avoiding contractual restrictions generally in computer-related situations, that support has not yet been articulated adequately.

Negligence and negligent misrepresentation are two common end runs around contract restrictions. Judging by the frequency with which the issues appear in computer cases, plaintiffs are exerting substantial pressure on courts

85. 356 S.E.2d at 584.
88. Id. at 1208.
89. Id.
to permit tort recoveries in cases where a contract otherwise bars or limits recovery. While it is too early yet to see a trend, these cases bear close monitoring.

_Eaton Corp. v. Magnavox Co._ illustrates one traditional approach to line drawing between tort and contract. In that case, a number of issues arose out of Magnavox’s sale of a minicomputer controller for installation in a truck antilock brake system manufactured by Eaton. Among other theories of relief, Eaton asserted negligence. But the court found that “Magnavox . . . has established an insuperable obstacle to Eaton’s claims under this theory. This obstacle is based not on Magnavox’s conduct, but on the very nature of the damages suffered by Eaton.” Under Michigan law, a plaintiff cannot make out a claim in negligence where there is a contractual relationship between the parties and no personal injury or damage to property (other than the subject goods). The court held that because the damages sought were for economic harm, plaintiff could not sustain a tort claim in negligence for such losses under Michigan law.

The _Eaton_ court’s approach to limiting the use of tort theories to avoid contract limitations seems to be the preferred approach. Different jurisdictions are currently debating whether one needs to show that a “catastrophic” incident actually caused serious bodily injury or damage to property or whether it is sufficient to show it could have caused such injury. The former view was adopted in _Consumers Power Co. v. Mississippi Structural Steel Co._, where the court applied the economic loss doctrine to all tort remedies, even though there were some commercial parties not in privity of contract and even though the occurrence could have (but did not) cause serious bodily injury or property damage. _Moorman Manufacturing Co. v. National Tank Co._ takes the more liberal approach. It seems reasonable to assume that the same point will emerge in the probably-rare cases involving physical damage or personal injury caused by a defective or nonconforming computer.

_Black, Jackson & Simmons v. International Business Machines_ shows comparable attempts at line drawing within misrepresentation theory. The court denied recovery to a frustrated purchaser of a computer system and software where the claim was solely one for negligent misrepresentation. Plaintiff’s action was against the equipment vendor and a third party software supplier, both of whom allegedly represented that the third party’s software products would operate on the IBM hardware recommended by the vendor.

91. _Id._ at 1536.
93. Although not involving the computer industry, the opinions in _Sanco, Inc. v. Ford Motor Co._, 579 F. Supp. 893 (S.D. Ind. 1984), _aff’d_, 771 F.2d 1081 (7th Cir. 1985), reflect the tendency for courts to confine contracting parties to contract remedies in economic loss cases.
After purchase, the plaintiff discovered that the software couldn’t operate on the computer. As framed by the court, the main issue was “whether the facts alleged in the case at bar state a cause of action for negligent misrepresentation which will enable [the plaintiff] to recover for purely economic losses.”97 The court relied on Moorman Manufacturing Co. v. National Tank Co.98 to deny the plaintiff relief.

As interpreted by the Black, Jackson court, Moorman permitted recovery for economic loss in only two situations: (i) where the defendant intentionally makes false representations or (ii) where the defendant is in the business of supplying information for the guidance of others in their business transactions and makes negligent misrepresentations. In the latter situation, which was the focus of the Black, Jackson court, the law required “that the defendant must supply the information in the course of its business” and that “the information must be supplied for the guidance of others and their business transactions.”99 Although a court could easily have concluded differently, this plaintiff lost on both grounds. The court construed neither IBM nor the software supplier to be in the business of supplying information; rather, both were selling merchandise. Further, the court interpreted the second element to require that the information be supplied to guide the recipient in its relations with third parties. In the case before it, defendants supplied the information only to guide plaintiff in its own business.100

Privity of contract sometimes limits recoveries in these cases as it does in other commercial settings. In Professional Lens Plan v. Polaris Leasing Corp.,101 the plaintiff acquired from Impact Systems (another defendant) a computer manufactured by Ohio Scientific that contained a hard disk manufactured by Okidata. The computer malfunctioned because of an alleged defect in the hard disk. The plaintiff sued Impact and Polaris Leasing, the financing agent, claiming lost profits and incidental expenses relating to the defect. Those defendants brought in Ohio Scientific and Okidata. Raising lack of privity, Okidata appealed a trial court order permitting Professional Lens to amend its pleadings to bring claims directly against Ohio Scientific and Okidata.

The appellate court examined in detail the Kansas decisions interpreting alternative B of U.C.C. section 2-318, which extends warranties to any natural person who may reasonably be expected to use, consume, or be affected by goods and who is injured in person by a breach of warranty. The court found no public policy reason to relax the privity requirement in cases where the damages sought were solely economic and the product did not pose a serious risk of physical injury, thus reversing the trial court.

97. Id. at 133, 440 N.E.2d at 283.
99. 109 Ill. App. 3d at 135, 440 N.E.2d at 284.
100. Id.
In accord with this decision is *Affiliates for Evaluation and Therapy v. Viasyn Corp.* A remote purchaser brought an action against a computer manufacturer for breach of implied warranty and negligence. The action was for costs of repairing mechanical breakdowns in the computer and for business loss suffered because of the computer's unavailability. One count charged the manufacturer with negligence in selecting an incompetent retailer who was unable to install or maintain the computer and in failing to take steps to repair the computer. Other counts were for breach of the implied warranty of fitness and implied warranty of merchantability.

The trial court granted the manufacturer's motion to dismiss based on existing Florida precedent. It concluded that the negligence count failed for lack of personal injury or property damage as an essential element. It also held that the breach of warranty counts required privity between the plaintiff and the defendant manufacturer. At the appellate level, plaintiff argued that the underlying precedent had been wrongly decided. The appellate court concluded that its immediate precedent was in full accord with the overwhelming weight of authority on this subject and supported its position with many citations. It also held, based on a binding Florida Supreme Court opinion, that an action for breach of implied warranty required a showing of contractual privity.

In *Ridge Co. v. NCR Corp.*, an Indiana federal district court in a comparable factual setting held that a plaintiff must show privity of contract in order to sue for breach of an implied warranty of merchantability.

In sharp contrast with the more traditional approaches in the foregoing cases, a federal district court applying Ohio law determined that a computer vendor's "ordinary negligence" in recommending its computer system and related software for the plaintiff's business needs is actionable as a tort outside the contract. The court reached that conclusion in *Invacare Corp. v. Sperry Corp.* by denying an equipment vendor's motion to dismiss the negligence claim. Without citing any Ohio precedent or statutes, the court determined that the conventional standard of ordinary care was applicable in any business context. "If machinists, electricians, carpenters, blacksmiths and plumbers, are held to the ordinary standard of care in their professions, the Court fails to see why personnel in the computer industry should be held to any lower standard of care." The *Invacare* court specifically considered as a precedent *Chatlos Systems v. National Cash Register Corp.*, where the court rejected an alleged tort of "computer malpractice" advanced by the plaintiff in connection with a com-

104. West v. Caterpillar Tractor Co., 336 So. 2d 80 (Fla. 1976).
108. 612 F. Supp. at 453.
puter sales and service contract. Distinguishing the earlier case, the Invacare court believed the Chatlos Systems court was

concerned with creating a new tort on a theory of elevated responsibility on the part of those who render computer sales and service. Such a concept is not before this Court. Rather, Invacare's claims allege a breach of the ordinary standard of care to which those in Sperry's industry are held.110

Invacare also had alleged fraud. The Invacare facts involved numerous contracts, including the first contract for installation of the computer and the initial order of software. According to the plaintiff, defendant represented that it would cure the defects in the system's operations through additional hardware and software purchases. Sperry therefore asserted that such representations went to the future performance of the system and did not qualify as "misstatements of existing fact upon which a cause of action for fraud can be based."111 Summarily rejecting this argument, the court stated that such representations did not relate to future performance but concerned the capabilities of the computer and its attendant software at the time of delivery and installation.

Buyers will occasionally mix consumer protection issues with their misrepresentation and breach of warranty claims. In Ellmer v. Delaware Mini-Computer Systems,112 the buyer of computer hardware sued the seller for breach of an express warranty, breach of an implied warranty of merchantability, and violation of the Texas Deceptive Trade Practices Act. The seller's defense was a disclaimer and limitation of remedy contained in the contract. The court first found the disclaimer and limitation were effective under the Texas Uniform Commercial Code. Then, in dismissing the buyer's challenge that the contract provisions were unenforceable under the Texas Deceptive Trade Practices Act, the court interpreted the plaintiff's claims as simple claims for breaches of the warranties that the seller had disclaimed in the contract.

The buyer's claims were far stronger and the seller didn't fare as well in Hycel, Inc. v. Wittstruck.113 That case didn't involve computers at all but, rather, a high-tech automated blood chemistry analyzer sold to a pathology laboratory. The action was brought under the Texas Deceptive Trade Practices Act alleging misrepresentation. The court found that there were indeed misrepresentations as to the machine's abilities, benefits, and characteristics and that damages could be awarded under the Act. The court found that the disclaimer of warranties and limitation of remedies that would have been effective under the U.C.C. were unenforceable under the Act, and it ordered treble damages as permitted under the Texas legislation.

Claims of misrepresentation produced additional, noncompensatory damages in Computer Systems Engineering v. Qantel Corp.114 The opinion by Judge

110. 612 F. Supp. at 454.
111. Id. at 452.
114. 740 F.2d 59 (1st Cir. 1984).
Keeton discusses many matters of procedure and damages such as the parol evidence rule, sufficiency of evidence for computing lost profit damages, the awarding of double damages for misrepresentation made with reckless disregard as to its truth or falsity, and the prejudicial effect of erroneously submitting an issue of punitive damages to the jury. The appellate court upheld the trial court against the seller on all issues save punitive damages. On that issue, it found that Massachusetts law, not California law, applied, which permitted only double or treble damages, not punitive damages.

**Disclaimers**

Disclaimers are generally effective and courts interpret them in the same way as in other contracts. A straightforward case involving interpretation of a disclaimer is *Prime Time Television v. Coastal Computer Systems.* The lessee tried to avoid its obligations under a lease by arguing that the vendor did not provide the software it was to deliver with the computer equipment. However, the lease covered only the computer equipment and not the software, and as in most financing lease transactions, the lessor disclaimed all warranties but assigned to the lessee the warranties given the lessor by the vendor. The court upheld the disclaimer of warranties in the lease agreement and held that the lessee's remedy was against the vendor pursuant to the assignment.

When fraud claims surface, the issue is whether the disclaimer bars the fraud claims. Thus in *Rio Grande Jewelers Supply v. Data General Corp.*, the dissatisfied buyer of computer equipment sued the seller, alleging negligent misrepresentation, fraud, negligence, breach of express and implied warranties, and strict liability. The court interpreted the disclaimer to bar the tort causes of action under U.C.C. section 2-316 and rejected the buyer's attempt to introduce evidence of misrepresentations made before the contract under the article 2 parol evidence rule.

**REMEDIES ISSUES**

The common law shows its ability to move with a rapidly changing society when it sorts out remedies for a broken contract involving the computer industry. While there are really breathtaking developments in this series of cases, courts and advocates remain facile and reasonably comfortable with traditional contract tools.

116. This decision also comports with the result under the new article 2A, which provides in § 2A-209 that the lessee under a finance lease is the beneficiary of the supply contract, and in §§ 2A-212 and 2A-312 that lessor warranties are not implied in a finance lease. Note that if article 2A had applied in *Prime Time*, the disclaimer and assignment of warranties in the lease agreement might not have been necessary.
117. 689 P.2d 1269 (N.M. 1984).
**Vendor Remedies—Damages**

When a seller seeks damages for breach of contract, the loss on the bargain is usually the money the buyer did not pay less expenses saved because the buyer breached.\(^{119}\) Where goods are involved, the U.C.C. deducts from the seller's loss either the amount the seller gets by reselling the goods\(^ {120}\) or the market price of the goods in most cases.\(^ {121}\) Where the seller cannot resell the goods or where the buyer will not or cannot return them, the seller may recover the price of the goods.\(^ {122}\)

In the computer industry, the "product" may be hardware, which depreciates nearly as quickly as vegetables, or software, which, once produced, is of little value to the vendor. Or it could be data processing services purchased for a term. On the hardware side, one expects a resale price that is considerably less than the selling price. One would expect very little "loss avoided" in a broken software or data processing service contract.

Recent cases bear this out. In *ADP-Financial Computer Services v. First National Bank*,\(^ {123}\) ADP sued the bank when it stopped paying minimum monthly service fees for ADP's computer services. Damages were set at the monthly minimum service charges for the remainder of the contract term. Reasoning that there had been "no repudiation," the court held that ADP had no duty to mitigate its losses and, by implication, that there was no deduction for costs saved on account of the breach.

Even if the court did not embrace the "no repudiation" rationale for concluding that no costs were (or should have been) saved an account of the breach, it probably would have reached the same conclusion that the measure of damages was the minimum monthly fees with no deduction. One senses that ADP could not have saved money even if notified in unmistakable terms that the bank did not want its services.

*Kearsarge Computer v. Acme Staple Co.*\(^ {124}\) demonstrates the improbability that a court will hold that a data processing company saved money as a result of one of its customers' breaches. The pattern there was similar to *ADP*: Kearsarge, a three-employee business, supplied data processing services under a term contract and the customer stopped paying before the contract was over.\(^ {125}\) The defendant claimed that the data processor could have—and in fact did—save and make money when defendant breached and that this money should be deducted from Kearsarge's damages. The court disagreed. Analogizing the data processing contract to a construction contract, the court maintained that "the

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119. See Restatement (Second) of Contracts § 347; 5 A. Corbin, Contracts § 1038 (1964); E. Farnsworth, Contracts § 12.10, at 848 (1982).
120. U.C.C. § 2-706.
121. U.C.C. § 2-708.
122. U.C.C. § 2-709.
123. 703 F.2d 1261 (11th Cir. 1983).
125. As is typical in contracts cases, the customer stopped paying because it claimed the services were unsatisfactory.
law presumes that [contractors] can accept a virtually unlimited amount of business so that income generated from accounts acquired after the breach does not mitigate the plaintiff’s damages.  

This is a sound decision and is apparently the first to extend the rule that has long been in place for contractors to the supplier of data processing services.  

A court sensibly decided another damage question in *NTA National, Inc. v. DNC Services Corp.* The data processor, NTA, agreed to supply the Democratic National Committee ("DNC") with data processing services in connection with the DNC Data Bank, a program designed to facilitate direct voter contact. As initially negotiated, the monthly payment schedule began at $6,250 in September 1977 and went up to $30,500 per month by December 1980, the end of the contract. Taking advantage of the back-loaded payment schedule, the DNC argued that damages were limited to the $65,000 it failed to pay pursuant to the payment schedule up to the time of the repudiation. The court concluded that the payment schedule had nothing to do with the parties’ judgment about the value of NTA’s services over the term of the contract. Rather, it reflected their judgment about the DNC’s increasing cash flow and ability to pay as the election drew near. So instead of following the parties’ payment schedule, the court apportioned the total compensation evenly over the entire contract and calculated much higher damages accordingly.  

**Vendee Remedies—The Mitigation Requirement**  

When a buyer is the injured party in a contract, its loss is that which was not delivered or supplied under the contract. One calculates damages by putting a value on that loss and subtracting from it those payments the buyer didn’t make as a result of the breach. The buyer is required to mitigate its damages. The mitigation requirement emerges in *Accusystems v. Honeywell.* The buyer alleged fraud, negligence, and breach of contract in connection with its purchase of computer hardware and software. The court found that the defen-
dant’s salesperson intentionally misrepresented the capabilities of the computer system to induce the plaintiff to make its purchase. Damages were permitted up to the time the plaintiff realized that the system would not work properly; after that, it was obligated to mitigate its damages rather than experiment further with the system. The court also held that plaintiff had no right to lost-profits damages for its fraud claim, nor was it entitled to punitive damages because the necessary “moral culpability” was lacking.

**Rejection, Revocation, Rescission**

One difficulty in vendor breach cases is placing a value on the product that was not supplied or on the defect in the product that was supplied.

In the computer industry, if the contract involves a sale of hardware, one may calculate damages under the U.C.C. either by the vendee’s cost to purchase elsewhere or “cover,”\(^{134}\) or by the market value of the hardware not delivered.\(^ {135}\) However, if the vendor is to supply computing, software development, or data processing services, it may become difficult to value the loss through relatively objective criteria such as a repurchase or a market. A buyer’s options where damages become impossible to prove are the remedies of rescission or specific performance. Owing to the nature of some of the “products” within the computer industry, one expects more cases involving these remedies than in other industries.

In addition, this is an industry where prices are volatile and the value of given hardware or software can plummet with a technological advance. Consequently, parties to disputes will inevitably argue about who “owns” the product and who bears the market loss pending resolution of their differences. Article 2 of the U.C.C. addresses this issue through its concepts of “rejection”\(^ {136}\) and “revocation of acceptance.”\(^ {137}\) If the buyer makes an effective rejection or revocation of acceptance, the goods remain the seller’s and the seller thereby bears the market risk while the parties fight about their rights. Outside of article 2, the law has approached the problem through the remedy of rescission. Successful rescission of a contract means that the vendor “owns” the exchanged property and bears the market risk which accompanies that ownership.

Courts have used both the U.C.C. sales concepts and the older rescission analysis in these cases. While market peculiarities in the computer field may motivate buyers to argue rejection, revocation of acceptance, or rescission, courts seem to have broken no new ground when addressing these issues in computer-related contracts. It is important to note that those courts that employ an article 2 analysis do so whether they involve hardware or software contracts.

134. U.C.C. § 2-712.
135. U.C.C. § 2-713.
136. Provisions that address rejection include U.C.C. §§ 2-602, 2-603, 2-604.
137. U.C.C. § 2-608 is the principal provision dealing with revocation of acceptance. It provides that “[a] buyer who so revokes has the same rights and duties with regard to the goods involved as if he had rejected them.” U.C.C. § 2-608(3).
Management Systems Associates v. McDonnell Douglas Corp.\textsuperscript{138} raised a notice question in the vendor-breach context. The buyer, known as McAuto, contracted to purchase software from Management Systems Associates ("MSA") under a licensing purchase agreement. When the software arrived, the buyer decided it did not conform to the contract and sought to reject the delivery. The question was whether the buyer had given adequate notice.

The Fourth Circuit relied on the Maybank\textsuperscript{139} rule, which provides that if the buyer-plaintiff's "evidence shows that the policies behind the requirement [of notice under U.C.C. 2-607(3)] have not been frustrated and, instead, have been fulfilled, the evidence is sufficient to withstand a directed verdict motion."\textsuperscript{140} The court found that the record showed that McAuto had repeatedly brought the alleged shortcoming of the software to MSA's attention. This evidence was sufficient to make adequacy of the notice a jury question immune from a directed verdict.

To revoke acceptance under article 2, the nonconformity must "substantially impair" the unit's commercial value to the buyer. The court employed that analysis in Winterbotham v. Computer Corps.\textsuperscript{141} Owners of a horse breeding farm purchased equipment to computerize their recordkeeping. The software was defective, but the hardware conformed to the contract. The parties asked the court to decide whether the buyers were limited to revoking acceptance of the software or whether they could revoke acceptance of the whole package, including the hardware. The court held that without the software the value of the package was substantially impaired. Accordingly, the buyers could "re-scind" (read "revoke acceptance") of both hardware and software.

Revocation of acceptance comes later than rejection, after the vendee has used the product for some period of time. The U.C.C. requires that the buyer revoke acceptance within a reasonable time after discovery of the defect and "before any substantial change in condition of the goods which is not caused by their own defects."\textsuperscript{142} In Redmac, Inc. v. Computerland of Peoria,\textsuperscript{143} the plaintiff sued Computerland for the purchase price of a computer and auxiliary equipment and software, as well as consequential damages. Computerland's salesman had told Redmac's Richard Taylor "that the equipment would be free from defects at the time it was delivered; that if defects were found during the ninety-day warranty period Computerland would repair the equipment; and that the Dynabite hardware and operating system would work for a reasonable period of time."\textsuperscript{144} Redmac experienced difficulties with the equipment as soon as Computerland installed it. Computerland made seven service trips during the war-

\textsuperscript{138} 762 F.2d 1161 (4th Cir. 1985).
\textsuperscript{140} 762 F.2d at 1180 (quoting Maybank, 302 N.C. at 134, 273 S.E.2d at 684, 30 U.C.C. Rep. Serv. (Callaghan) at 989).
\textsuperscript{141} 490 So. 2d 1282 (Fla. Dist. Ct. App. 1986).
\textsuperscript{142} U.C.C. § 2-608(2).
\textsuperscript{144} Id. at 743, 489 N.E.2d at 382, 42 U.C.C. Rep. Serv. (Callaghan) at 1243.
The warranty period and shortly thereafter, but the system continued to malfunction. Taylor attempted to rescind the purchase agreement, and finally, six months after installation, Taylor loaded the system into his pickup truck, hauled it back to Computerland, and dropped it off on the premises.

The court found that the salesman’s statements were express warranties—not “puffing”—and were clearly part of the basis of the bargain of the parties. It further found no evidence that the plaintiff had mishandled or misused the system, caused the defect, and thereby lost the remedy of revocation of acceptance. In addition, the court found no evidence that the plaintiff had mishandled the equipment when returning it, and accordingly it rejected the defense that plaintiff had returned the equipment in a commercially unreasonable manner.

By contrast, in Eaton Corp. v. Magnavox Co., the facts foreclosed revocation of acceptance. The contract involved Magnavox’s sale of a minicomputer controller for installation into truck antilock brake systems manufactured by Eaton. In July 1977, Eaton discovered that Magnavox was using a component part not approved by Eaton as required by the 1974 contract. The component did not provide for reliable operation of the safety device. This led to a recall and Eaton sought damages for the cost of the recall.

The breach of contract claim required Eaton to show revocation of its acceptance. The court ruled that under the U.C.C., revocation following acceptance requires that there be no substantial change in the condition of the goods not caused by their own defects. In this instance, Eaton installed the controllers in the antilock device; these devices were then installed in trucks that were used for extended periods of time. The court found that this constituted such a substantial change that Eaton had not proved this element essential for revocation of acceptance.

In addition, the court said Eaton did not do what was required: to take physical possession of the goods and provide an opportunity for the seller to remove them. Eaton simply put those few controllers that were returned to it into a warehouse and did not tender them back to Magnavox. The vast majority of the controllers remained in the field, and since Eaton did not have possession or control of them, it could not return them. The court appeared uncomfortable about this ground for its decision. U.C.C. section 2-602(2)(b) provides that if the buyer has taken physical possession of the goods, they must be kept for the seller, and 2-602(2)(c) provides that “the buyer has no further obligations with regard to goods rightfully rejected.” The facts in Eaton may not have triggered the duties on which the court relied.

Computerized Radiological Systems v. Syntex Corp. illustrates the problems confronting a buyer who attempts to revoke acceptance but would be substantially burdened by surrendering the product without a replacement. The

146. Id. at 1530 n.40.
147. U.C.C. § 2-608(3) gives the buyer who revokes acceptance the same rights and responsibilities as a buyer who rejects.
148. 786 F.2d 72 (2d Cir. 1986).
seller of a CAT scanner, equipped only for head scans, promised that the scanner could be upgraded to do full body scans. Unfortunately, the seller, Syntex, lost the technology race to competitors and abandoned its attempts to upgrade. It offered the buyer, CRS, a substitute which CRS described as worthless and refused to take. CRS sent Syntex a letter revoking acceptance yet continued to use the head scanner for twenty-two months and filed suit.

The court held that CRS's continued use of the head scanner invalidated the revocation of acceptance because the continued use was inconsistent with the seller's ownership and resulted in acceptance. The court cited a motor vehicle case to the effect that a buyer cannot use a vehicle after revocation except to avoid undue hardship and specified as an example of hardship the abandonment of a mobile home used as a residence. Under the facts, the appellate court concluded that CRS had waited too long to return the scanner:

Under the U.C.C., a buyer who revokes acceptance rather than relying solely upon an action for breach of warranty must begin the search for replacement goods with reasonable dispatch and may not put off purchase until a seller offers ideal financial terms. CRS' desultory search for another scanner simply belies its revocation claim, much as the long delay in the hope of avoiding personal liability implies that CRS continued to use the Syntex scanner because continued use was more advantageous than the existing alternatives. CRS' extended use of the defendant's scanner thus invalidates the purported revocation of acceptance.

Atkinson v. Total Computer Systems involved plaintiff's contract to purchase a computer, printer, and software as a package. The vendor did not supply the software ordered, and the court found that the software it substituted was defective, as was the printer. Because the defective components produced a defective "system," the appellate court reversed the trial court, found the contract rescinded, and decreed that the plaintiff was entitled to return of his purchase price. In addition, because "the benefits of the use of the system were outweighed by the inconvenience of its redhibitory vices," the court deducted nothing from the purchase price for its use. The case fits comfortably into existing contract law and reasonably relates the buyer's remedy to the sales pitch that causes one to expect a working "system," not a set of components unable to function as promised.

149. U.C.C. § 2-606(1)(c).
151. 786 F.2d at 75.
153. Id. at 123.
154. In all cases in this section, the issue was the ability of the vendee to reject, revoke acceptance, or rescind the contract. Even if these remedies are unavailable, the vendee may still have an action for damages.
Specific Performance

Databases and data processing services have become commonplace and many people—including lawyers—have come to rely on them. When a buyer purchases and begins to rely on services supplied by data processors or owners of databases, calculating the loss when the vendor terminates can border on the impossible. If substitute services are available, they could form a basis for making a calculation; however, if one cannot get a reasonable substitute, one might obtain a decree of specific performance.

Trans Union Credit Information Co. v. Associated Credit Services was such a case. The defendant Credit Bureau of Cincinnati ("CBC") was the dominant credit bureau in the Cincinnati area, controlling nearly ninety-five percent of the market share. It reached an agreement with plaintiff ("TUC"), a national supplier of data processing services and credit reporting, providing that each would permit the other unrestricted access to credit information within their files. After the relations soured, TUC sued for breach and claimed a right to specific performance of the agreement. In affirming the lower court's specific performance decree, the Sixth Circuit emphasized TUC's inability to get comparable information elsewhere. As to the difficulty of calculating damages, the court said:

[T]he synergistic loss, namely the loss of goodwill and exposure that TUC would have otherwise enjoyed as a result of the undeterminable increase of business with credit grantors and other credit bureaus across the nation during the term of the service agreement as well as the consequent increased recognition and business for TUC after the contract's term expires, certainly does not easily lend itself to a damages calculation.

Many commentators have advocated the greater use of specific performance in contract cases, and beginning with school desegregation cases in the 1950s, courts have lost some of their fear of the continued involvement and supervision that comes with equitable decrees. Because many in the industry supply services that a court could conclude are "unique," there is likely to be greater use of equitable remedies in computer-related contracts cases.

155. 805 F.2d 188 (6th Cir. 1986).
156. While the court affirmed the grant of specific performance, it remanded the case to the lower court for a more specific decree. Id. at 192–93.
157. Id. at 192. Had damages on the bargain been ascertainable, it seems likely that a court would have deemed loss of goodwill and increased future business as "speculative" or "uncertain" and thereby denied recovery of those items of consequential damages. On "uncertainty" as a limitation on damages, see 5 A. Corbin, Contracts § 1020, at 124; E. Farnsworth, Contracts § 12.15, at 881 (1982); Restatement (Second) of Contracts § 352. The unavailability of these damages here (when they are usually unrecoverable anyway) thus serves as somewhat thin justification for the court's specific performance ruling.
CREDITORS' RIGHTS AND BANKRUPTCY

Provisional Remedies

It is a fact of life in our system of litigation that a defendant may not have enough money to pay a judgment that a plaintiff ultimately wins. The defendant may simply not have any money. Or the defendant may decide to pay, or allow collection of, others' legitimate claims leaving nothing for the plaintiff at the end of the litigation. Creditors' rights courses routinely address this harsh reality of collecting money and examine ways in which those embarking on litigation might better the odds that they will get paid when it is all over.

The field has certain basic propositions. The law has long held that outside of bankruptcy a debtor may choose to pay one creditor before the next. When one is merely a claimant, this danger is acute because one ordinarily has to reduce one's claim to judgment and either record it or execute on it before one can gain access to the debtor's assets. While one is litigating, the debtor may choose to pay what it regards as legitimate claims with impunity, or (subject to constraints of fraudulent conveyance law) may otherwise dissipate assets or go out of business. A claimant without a judgment has two primary defenses against being left out: (i) to acquire a priority position through a consensual security interest or (ii) obtain a nonconsensual lien or its equivalent through some procedure provided by law. Prejudgment attachment or garnishment procedures can supply a lien in narrow, well-defined circumstances; if one can qualify as a "reclaiming seller," one might oust others from a priority position in debtor-owned personality; the law of restitution, by declaring a constructive trust, can effectively confer priority.

In Teradyne, Inc. v. Mostek Corp., the First Circuit Court of Appeals may have added to the stockpile of weapons that a person with a disputed claim can use to wrest a priority position in finite assets. Teradyne claimed some $3.5 million in damages for "cancellation charges, alleged failure to pay unearned price discounts on goods delivered, for goods and services invoiced, and for incidental and consequential damages" and had sought arbitration under a clause in the contract. While the demand for arbitration was pending, Teradyne was notified that Thompson Semiconductors would buy all of Mostek's assets for $71 million cash and that the proceeds would be put into a bank account in Mostek's name and dedicated to the payment of claims of Mostek's creditors. Following that notice, Teradyne sought an injunction in the district court requiring Mostek to set aside sufficient funds to satisfy a Teradyne judgment pending the outcome of the arbitration. The district court granted the injunction. The district court's authority to grant such an injunction in an arbitrable dispute and the propriety of its grant of relief was appealed.

159. 797 F.2d 43 (1st Cir. 1986).
160. Id. at 45.
161. The appealability of the district court's injunction prior to final disposition of the case was also before the court. The problem was that analogous prejudgment attachment orders were not immediately appealable whereas grants of injunctive relief were. The court decided it could hear the appeal and went on to address the merits.
Addressing the arbitration question, the court acknowledged a split in the circuits. One group of courts had held that the Federal Arbitration Act did not strip a district court of its obligation to consider the merits of a requested preliminary injunction. The Eighth Circuit took another position: that Congress intended the Arbitration Act to facilitate a quick, expeditious recovery, and entertaining requests for preliminary injunctions in arbitrable disputes would undermine that intent. By disagreeing with the Eighth Circuit's interpretation of the cases on which it relied, the Teradyne court sided with the other view and considered the merits of the relief granted below.

The court proceeded with an orthodox review of a preliminary injunction. It considered whether there was probable irreparable harm and inadequate legal remedies, looked at the balance of hardships, and considered the likelihood of Teradyne's success on the merits. The first aspect of the court's analysis is the most interesting. The district court had held that Mostek's freedom to dispose of its assets created a substantial risk of irreparable harm to Teradyne, given that Mostek was in the process of winding down after selling the bulk of its assets, that it had failed to provide adequate assurances to alleviate Teradyne's concerns, and that it could at any time make itself judgment proof.

The trial court had rejected the claim that other creditors would rush to court for the same relief, that the injunction "would have no precedential effect on other disputed claims, and that Mostek could pay undisputed claims and thereby avoid any possible ripple effect on them." Taking these facts, the First Circuit cited one Supreme Court and several circuit court opinions to support its holding that equitable relief was permissible in these circumstances.

If the case warrants criticism, it is in the court's inattention to the creditors' rights ramifications of its decision. An implication of the injunction, presumably, was that the $4 million set aside would pay Teradyne's judgment before it would pay others' claims against Mostek. But there was nothing particularly compelling about Teradyne's claim to justify a special priority in particular assets in advance of judgment and execution.

The main case the court cites to support its conclusion, the Supreme Court's decision in Deckert v. Independence Shares Corp., involved claims for rescis-
sion of a fraudulent sale and restitution of the consideration paid. Historically, such a claim can effect preferred status for the claimant through the constructive trust device.\(^1\) The other supporting cases either involved similar historically preferred claims\(^2\) or did not actually permit the relief sustained in *Teradyne*.\(^3\)

Prejudgment attachment has long been the remedy designed to protect the judgment creditor from a defendant about to leave town with all the assets. Constitutional decisions have much narrowed the remedy in recent years and plaintiffs have difficulty obtaining it. It operates—like the execution system itself—without necessary direct judicial involvement. It is unclear from the *Teradyne* opinion why such a remedy was not pursued there.\(^4\)

More to the point, it appears that *Teradyne* has authorized a loose version of prejudgment attachment that directly involves the trial and appellate court in every case. If it has, it is questionable whether our legal system now has the resources to change from a largely automated prejudgment attachment remedy to an injunction remedy requiring case by case scrutiny by lower and appellate courts.

The computer industry is volatile. Companies go into and out of business every day. Many claimants, particularly in this industry, think defendants will not have enough money to satisfy a judgment or will pay others while litigation is grinding to an end. *Teradyne* may give claimants a new weapon to battle this fact of life of creditors’ rights law. How many will rush into court seeking a preliminary injunction to freeze assets in advance of judgment? Will the defendants then be permitted to appeal as they were in *Teradyne*? Will the litigants do all this in the midst of an arbitrable dispute as the *Teradyne* court allowed? And how will these rights affect desirable speed in arbitrating commercial disputes and in adjudicating the myriad other matters before our courts? *Teradyne* has provoked these questions; they remain to be answered.\(^5\)

There will likely be more cases like *Teradyne* in the near future.

**Bankruptcy Cases**

The bankruptcy field has had more than its share of cases involving the computer industry. Three are of particular interest.


172. *Productos Carnic* involved a dispute over ownership of a load of frozen beef. The court ordered the sale of the beef and deposit of the proceeds in an interest bearing account pending the outcome of the suit. *Foltz v. U.S. News & World Report* involved claims of defendants’ breach of fiduciary duty in connection with funds in an employee profit sharing plan.

173. Roland Machinery Co. v. Dresser Indus., 749 F.2d 380 (7th Cir. 1984).

174. Fed. R. Civ. P. 64 incorporates into federal court actions the prejudgment remedies “provided by the law of the state in which the district court is held, existing at the time the remedy is sought . . . .”

175. The appellate court implicitly questioned the continuing viability of Rotolith, Ltd. v. F.P. Bartlett & Co., 297 F.2d 497 (1st Cir. 1962), probably one of the most maligned decisions in the history of the Uniform Commercial Code. The court rejected Mostek’s claim that their “battle of the forms” created no contract under U.C.C. § 2-207 and thereby buttressed its conclusion that *Teradyne* would likely succeed on the merits.
Lubrizol Enterprises v. Richmond Metal Finishers\textsuperscript{176} addresses the status of a technology license or software. Lubrizol was a licensee of proprietary technology whose licensor filed a chapter 11 petition and sought to reject the license agreement as an executory contract. The court noted the continuing obligations of both licensor and licensee under the agreement and ruled that the debtor/licensor could reject it. The court also held specifically that only the debtor’s business judgment would be considered in ruling on the rejection—thus ignoring the impact on the licensee—and that the licensee would be barred from using the technology.

In re Logical Software\textsuperscript{177} also underscores the fragility of ongoing contractual relations when the contracting partner is a software house in chapter 11 bankruptcy. The debtor in bankruptcy had licensed to the petitioner (Infosystems Technology) exclusive distribution rights to its LOGIX source code in exchange for prepaid license fees and a percentage of the petitioner’s revenues derived from use of the technology. The petitioner developed software based on the LOGIX technology and derived all its earnings from the resulting program. Once in bankruptcy, the debtor moved to reject the license agreement as an executory contract under section 365 of the Bankruptcy Code. In approving the debtor’s rejection of the contract, the court relied, in part, on Congress’s failure to grant special treatment to technology licensees.

On the licensee’s appeal, the district court reversed the bankruptcy court.\textsuperscript{178} While both courts agreed that the debtor would have the right to reject the license agreement, they differed on the standard to be applied under section 365 of the Bankruptcy Code. The district court ruled that the business judgment test was applicable and that the bankruptcy court’s consideration of the effect of rejection on the nondebtor licensee was irrelevant and could not be a factor in the determination.

While not a particularly remarkable result under the bankruptcy statute, the decision is an important reminder that continuing contractual relationships inevitably carry the risk that the other side will disappear, go out of business, or wind up in bankruptcy. The volatility of the computer industry may make such risks higher than they are in other industries. A company that would build a substantial business on licensed technology needs to be most careful about assessing such risks at the outset.

Partially as a result of the Lubrizol and Logical Software cases, licensees have sought remedial legislation from Congress. A bill pending in the Senate\textsuperscript{179} at this writing would overrule the results in Lubrizol by permitting the licensee of a

\textsuperscript{176} 756 F.2d 1043 (4th Cir. 1985).
\textsuperscript{179} S. 1626, 100th Cong., 1st Sess. (1987) (introduced Aug. 5, 1987, by Senators DeConcini and Heflin). The bill would also protect the confidentiality of intellectual property and may validate source code escrows.
rejected license agreement to continue using the intellectual property after rejection.

The licensor could be seen as a victim of the bankruptcy process in In re Wheeling-Pittsburgh Steel Corp.180 Phoenix Leasing was the lessor of computer equipment to the debtor, which was three months behind in payments before filing its bankruptcy petition. Wheeling-Pittsburgh had remained current after its bankruptcy filing, and Phoenix was before the court to force the debtor to end the contract by rejecting it or to continue the lease contract by assuming it.

Usually181 the Bankruptcy Code allows the debtor in bankruptcy to assume or reject an executory contract "at any time before the confirmation of a plan . . ."182 Phoenix argued that if the debtor decided to reject the lease after technological advances had occurred, lessor's ability to re-lease the equipment and recoup its investment might be effectively destroyed. Given the debtor's continuing payments under the contract, the court could see no prejudice to Phoenix sufficient to require an earlier election by the debtor.

Phoenix was equally unsuccessful in its attempt to get compensation for the depreciation of its equipment in the form of "adequate protection" while the debtor made up its mind. Acknowledging split authority on the question, the court concluded that such protection was available only to secured creditors and was not applicable to lessors.183 In addition, because "Phoenix [was] receiving precisely what it bargained for since the Debtor [was] fulfilling its post-petition obligations under the Lease Agreement,"184 Phoenix was already getting all it deserved.

The court's decision on the adequate protection question probably takes the correct view of the structure of the statute and is sound given the debtor's post-petition payment history. On the other hand, the Bankruptcy Code was drafted before the substantial recent growth of personal property leasing and the codification of the field in newly-promulgated U.C.C. article 2A. Those latter developments might prompt another look at the protection the personal property lessor ought to receive in the bankruptcy setting.

In re Bedford Computer Corp.185 is a classic example of a financing buyer making claims to priority treatment in bankruptcy. The debtor's business was development, manufacturing, and marketing of "real time" computer text and graphic composition systems. BEHR Venture Products ("Partnership") contracted with the debtor for debtor's development of four new products. The contract granted BEHR security interests in the new technology and provided that all the work in progress "shall be property of the Partnership and shall be

181. If the contract is an unexpired lease of nonresidential real property in which the debtor is lessee, the trustee must assume or reject within 60 days. 11 U.S.C. § 365(d)(4) (Supp. IV 1986).
184. Id. at 391.
delivered to it upon its written request to the Contractor.\textsuperscript{186} Significantly, the buyer decided not to file financing statements to protect its security interests "for fear that such notice filing would 'inhibit' borrowing by Bedford."\textsuperscript{187}

The buyer claimed it had rights as "owner ab initio" in Bedford's work product as the contract progressed. Rejecting the contract language itself as controlling,\textsuperscript{188} the court proceeded to a functional analysis of the entire transaction. As the court saw it, the claim depended in part on whether the buyer acquired rights under U.C.C. section 2-402(1) or common law superior to those of unsecured creditors,\textsuperscript{189} and in either case, the buyer's claim rested on the buyer's ability to identify and segregate its claimed property from that of other creditors. In \textit{Bedford}, the buyer's inability to do so was fatal to its claim.\textsuperscript{190}

In passing, the court had advice for the financing buyer of computer technology:

[I]t would behoove any financing party, whether a developmental buyer or a secured lender, to take easily available steps to identify and segregate the relevant source code embodiment of this new and elusive type of property interest, i.e., the "software" and "technology" of a company involved in the computer industry. Such identification and segregation, with appropriate warning to the world of the third-party's interest in such slippery and changeable property, should suffice to protect the third-party from assertion of creditors' rights in any subsequent bankruptcy proceeding.\textsuperscript{191}

\textsuperscript{186} \textit{Id.} at 560.
\textsuperscript{187} \textit{Id.} at 562.
\textsuperscript{188} \textit{Id.} at 566.
\textsuperscript{189} U.C.C. § 2-402(1) provides:

Except as provided in subsections (2) and (3), rights of unsecured creditors of the seller with respect to goods which have been identified to a contract for sale are subject to the buyer's rights to recover the goods under this Article (Sections 2-502 and 2-716).

\textsuperscript{190} The court added some important dicta on the question whether software is "goods" for purposes of U.C.C. article 2:

If the court in the present case were compelled to make a definitive characterization, I believe I would conclude that the software here involved should be characterized as tangible rather than intangible property. The evidence establishes in excruciating detail that the source code and object code embodiment of that "technology" cannot exist independent from the actual hardware components to which it gives operational life. The source code does not demonstrate some broad generalized technology of technical principles and ideas, existing apart from a particular tangible machine already in existence, but instead presupposes the prior existence of particular hardware to give the source code itself any meaning. Moreover, the source code is embodied in tangible magnetic media of various types, and when translated into equally-tangible object code media, becomes just as much a part of the "computer machine" being developed as any of its other tangible facets.

\textit{Id.} at 567 (footnote omitted).

\textsuperscript{191} \textit{Id.} at 570 (footnote omitted).
The seeds of future litigation—and statutory reform—are in these words, reminiscent of earlier eras of uncertainty about financing new commercial products.