Supp 1
WHAT LAW APPLIES WITHIN A STATE

In 1934, Llewellyn commented: "One system of precedent' we may have, but it works in forty different ways." Karl Llewellyn, "On Philosophy in American Law," 82 U. PA. L. REV. 205, 205 n. 178 (1934). That observation is even more accurate today. There are important questions of what contract law within a state or country applies to contracts. Is this a product of common law" For example, if you were debating/considering issues about a license of a copyright, what case law would you consult and how would that differ from the case law you would consult if your transaction involved a lease of real estate or and oil and gas lease?

The Limited View: In the U.S. some view contract law as essentially carved into two categories - Uniform Commercial Code (UCC) sales contracts and common law contracts as represented by the *Restatement (Second) of Contract*.

The real view: But there is greater diversity. The *Restatement* states only one group's view of what the common law should be, but does not purport to be nor is it followed in all states. Common law varies from state to state. Within states there are differences between the contract law applicable to various types of subject matter that have evolved through the process of common law decision-making which considers the context and prior cases dealing with similar contexts and through the enactment of statutes pertaining to particular subject matter, including the sale and leasing of goods.

How the question is framed:

That being said, if the question is framed initially as whether Article 2 applies, there are four issues discussed:

- Is the entire subject matter comprised of "goods" or "non-goods"? (*classification*)
- If a transaction involves "goods" *and* another subject matter, two approaches occur:
  - One asks if the "goods" or the "other" subject matter predominates. This test has primarily been applied with respect to the difference between "goods" and "services". If goods are the predominant purpose, Article 2 applies to the entire transaction. (*predominant purpose*)
  - The other asks what issue is being disputed and to what subject matter is it addressed, applying contract law applicable to that subject matter (e.g., intellectual property, information content, real estate) (*gravamen of the action*)
- If Article 2 does not directly apply, should Article 2 rules apply by analogy as part of common law. (*analogy*)
- If none of the above govern, common law applies. (*not goods*)

The issue often is not framed this way, however.

ZAPATHA V. DAIRY MART, INC.
381 Mass. 284, 408 N.E.2d 1370 (Mass. Supreme Ct. 1980)

WILKINS, Justice.

We are concerned here with the question whether Dairy Mart, Inc. (Dairy Mart), lawfully undertook to terminate a franchise agreement under which the Zapathas operated a Dairy Mart store on Wilbraham Road in Springfield. The Zapathas brought this action seeking to enjoin the termination of the agreement, alleging that the contract provision purporting to authorize the termination of the franchise agreement without cause was unconscionable and that Dairy Mart's conduct was an unfair and deceptive act or practice in violation of G.L. c. 93A. The judge ruled that Dairy Mart did not act in good faith, that the termination provision was unconscionable… We reverse. ……

We consider first the question whether the franchise agreement involves a "transaction in goods" within the meaning of those words in article two of the Uniform Commercial Code … and that consequently the provisions of the sales articles of the Uniform Commercial Code govern the relationship between the parties. The Zapathas point specifically to the authority of a court to refuse to enforce "any clause of the contract" that the court finds "to have been unconscionable at the time it was made." [UCC § 2-302]. They point additionally to the obligation of good faith in the performance and enforcement of a contract … and to the specialized definition of "good faith" in the sales article as meaning "in the case of a merchant . . . honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." [UCC § 2-103(1)(b)].

We need not pause long over the question whether the franchise agreement and the relationship of the parties involved a transaction in goods. Certainly, the agreement required the plaintiffs to purchase goods from Dairy Mart. "Goods" for the purpose of the sales article means generally "all things . . . which are movable." [UCC § 2-105(1)]. However, the franchise agreement dealt with many subjects unrelated to the sale of goods by Dairy Mart. About 70% of the goods the plaintiffs sold were not purchased from Dairy Mart. Dairy Mart's profit was intended to come from the franchise fee and not from the sale of items to its franchisees. Thus, the sale of goods by Dairy Mart to the Zapathas was, in a commercial sense, a minor aspect of the entire relationship.[1] We would be disinclined to import automatically all the provisions of the sales article into a relationship involving a variety of subjects other than the sale of goods, merely because the contract dealt in part with the sale of goods. Similarly, we would not be inclined to apply the sales article only to aspects of the agreement that concerned goods. Different principles of law might then govern separate portions of the same agreement with possibly inconsistent and unsatisfactory consequences.

[However, we] view the legislative statements of policy concerning good faith and unconscionability as fairly applicable to all aspects of the franchise agreement, not by subjecting the franchise relationship to the provisions of the sales article but rather by applying the stated principles by analogy. This basic common law approach, applied to

[1] FN9. The essential thrust of the transaction was an exchange of intangible rights, obligations and services. Viewed in a realistic economic light, the franchise agreement contemplated the licensing by Dairy Mart of an entire "business format," including a trademark, a system of doing business, and the right to occupy a fully equipped store, in return for which it was to receive a franchise fee and the expectation that the Zapathas' efforts, in keeping with their obligations under the agreement, would enhance the goodwill of the Dairy Mart franchise chain as a whole.

statutory statements of policy, permits a selective application of those principles expressed in a statute that reasonably should govern situations to which the statute does not apply explicitly.

> [We] consider first the plaintiffs' argument that the termination clause of the franchise agreement, authorizing Dairy Mart to terminate the agreement without cause, on ninety days' notice, was unconscionable by the standards expressed in [Article 2]. The same standards are set forth in Restatement (Second) of Contracts § 234. The issue is one of law for the court, and the test is to be made as of the time the contract was made. In measuring the unconscionability of the termination provision, the fact that the law imposes an obligation of good faith on Dairy Mart in its performance under the agreement should be weighed.
>
> [The] official comment to s 2-302 states that "(t)he basic test is whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract. . . . The principle is one of prevention of oppression and unfair surprise . . . and not of disturbance of allocation of risks because of superior bargaining power." Official Comment 1 to U.C.C. § 2-302. …
>
> We start with a recognition that the Uniform Commercial Code itself implies that a contract provision allowing termination without cause is not per se unconscionable…. We find no potential for unfair surprise to the Zapathas in the provision allowing termination without cause. We view the question of unfair surprise as focused on the circumstances under which the agreement was entered into. The termination provision was neither obscurely worded, nor buried in fine print in the contract. The provision was specifically pointed out to Mr. Zapatha before it was signed; Mr. Zapatha testified that he thought the provision was "straightforward," and he declined the opportunity to take the agreement to a lawyer for advice. The Zapathas had ample opportunity to consider the agreement before they signed it. … We conclude that a person of Mr. Zapatha's business experience and education should not have been surprised by the termination provision and, if in fact he was, there was no element of unfairness in the inclusion of that provision in the agreement.

We further conclude that there was no oppression in the inclusion of a termination clause in the franchise agreement. We view the question of oppression as directed to the substantive fairness to the parties of permitting the termination provisions to operate as written. The Zapathas took over a going business on premises provided by Dairy Mart, using equipment furnished by Dairy Mart. As an investment, the Zapathas had only to purchase the inventory of goods to be sold but, as Dairy Mart concedes, on termination by it without cause Dairy Mart was obliged to repurchase all the Zapathas' saleable merchandise inventory, including items not purchased from Dairy Mart, at 80% of its retail value. There was no potential for forfeiture or loss of investment…. To find the termination clause oppressive merely because it did not require cause for termination would be to establish an unwarranted barrier to the use of termination at will clauses in contracts in this Commonwealth, where each party received the anticipated and bargained for consideration during the full term of the agreement.
……. REVERSED

NOTES

Note 1: This court created a new common law rule for the state of Massachusetts. Notice the date of the decision. Now, all U.S. states recognize unconscionability as part of their common law of contracts. How would you describe the court's reasons for doing this?

If you were a lawyer putting together a franchise agreement after this case was decided, what law should apply to determine if the inventory purchased by Zapatha came with an implied warranty of merchantability found in Article 2, but not in common law?

After this case, does unconscionability doctrine apply to a services contract?

Applying a rule by analogy is an important feature of common law reasoning. When is it appropriate? When is it inappropriate?

Let's look at software contracts:

………

ADVENT SYSTEMS LTD v. UNISYS CORP.
925 F.2d 670 (3d Cir. 1991)

WEIS, Circuit Judge.

Plaintiff, Advent Systems Limited, is engaged primarily in the production of software for computers. As a result of its research and development efforts, by 1986 the company had developed an electronic document management system (EDMS), a process for transforming engineering drawings and similar documents into a computer data base.

Unisys Corporation manufactures a variety of computers. As a result of information gained by its wholly-owned United Kingdom subsidiary during 1986, Unisys decided to market the document management system in the United States. In June 1987 Advent and Unisys signed two documents, one labeled "Heads of Agreement" (in British parlance "an outline of agreement") and, the other "Distribution Agreement."

In these documents, Advent agreed to provide the software and hardware making up the document systems to be sold by Unisys in the United States. Advent was obligated to provide sales and marketing material and manpower as well as technical personnel to work with Unisys employees in building and installing the document systems. The agreement was to continue for two years, subject to automatic renewal or termination on notice.

During the summer of 1987, Unisys attempted to sell the document system to Arco, a large oil company, but was unsuccessful. Nevertheless, progress on the sales and training programs in the United States was satisfactory, and negotiations for a contract between Unisys (UK) and Advent were underway. The relationship, however, soon came to an end. Unisys, in the throes of restructuring, decided it would be better served by developing its own document system and in December 1987 told Advent their arrangement had ended. Unisys also advised its UK subsidiary of those developments and, as a result, negotiations there were terminated.

Advent filed a complaint in the district court alleging, inter alia, breach of contract, fraud, and tortious interference with contractual relations. The district court ruled at pretrial that the Uniform Commercial Code did not apply because although goods were to be sold, the services aspect of the contract predominated. …..

II.
SOFTWARE AND THE UNIFORM COMMERCIAL CODE

The district court ruled that as a matter of law the arrangement between the two parties was not within the Uniform Commercial Code and, consequently, the statute of frauds was not applicable. As the district court appraised the transaction, provisions for services outweighed those for products and, consequently, the arrangement was not predominantly one for the sale of goods.

In the "Heads of Agreement" Advent and Unisys purported to enter into a "joint business collaboration." Advent was to modify its software and hardware interfaces to run initially on equipment not manufactured by Unisys but eventually on Unisys hardware. It was Advent's responsibility to purchase the necessary hardware. "[I]n so far as Advent has successfully completed [some of the processing] of software and hardware interfaces," Unisys promised to reimburse Advent to the extent of $150,000 derived from a "surcharge" on products purchased. Advent agreed to provide twelve man-weeks of marketing manpower, but with Unisys bearing certain expenses. Advent also undertook to furnish an experienced systems builder to work with Unisys personnel at Advent's prevailing rates, and to provide sales and support training for Unisys staff as well as its customers.

The Distribution Agreement begins with the statement, "Unisys desires to purchase, and Advent desires to sell, on a non-exclusive basis, certain of Advent hardware products and software licenses for resale worldwide." Following a heading "Subject Matter of Sales," appears this sentence, "(a) Advent agrees to sell hardware and license software to Unisys, and Unisys agrees to buy from Advent the products listed in Schedule A." Schedule A lists twenty products, such as computer cards, plotters, imagers, scanners and designer systems.

Advent was to invoice Unisys for each product purchased upon shipment, but to issue separate invoices for maintenance fees. The cost of the "support services" was set at 3% "per annum of the prevailing Advent user list price of each software module for which Unisys is receiving revenue from a customer." Services included field technical bulletins, enhancement and maintenance releases, telephone consultation, and software patches, among others. At no charge to Unisys, Advent was to provide publications such as installation manuals, servicing and adjustment manuals, diagnostic operation and test procedures, sales materials, product brochures and similar items. In turn, Unisys was to "employ resources in performing marketing efforts" and develop "the technical ability to be thoroughly familiar" with the products.

In support of the district court's ruling that the U.C.C. did not apply, Advent contends that the agreement's requirement of furnishing services did not come within the Code. Moreover, the argument continues, the "software" referred to in the agreement as a "product" was not a "good" but intellectual property outside the ambit of the Uniform Commercial Code.

Because software was a major portion of the "products" described in the agreement, this matter requires some discussion. Computer systems consist of "hardware" and "software." Hardware is the computer machinery, its electronic circuitry and peripheral items such as keyboards, readers, scanners and printers. Software is a more elusive concept. Generally speaking, "software" refers to the medium that stores input and output data as well as computer programs. The medium includes hard disks, floppy disks, and magnetic tapes.

In simplistic terms, programs are codes prepared by a programmer that instruct the computer to perform certain functions. When the program is transposed onto a medium compatible with the computer's needs, it becomes software. …. The increasing frequency of computer products as subjects of commercial litigation has led to controversy over whether software is a "good" or intellectual property. The Code does not specifically mention software.

In the absence of express legislative guidance, courts interpret the Code in light of commercial and technological developments. The Code is designed "[t]o simplify, clarify and modernize the law governing commercial transactions" and "[t]o permit the continued expansion of commercial practices." As the Official Commentary makes clear:

> This Act is drawn to provide flexibility so that, since it is intended to be a semi-permanent piece of legislation, it will provide its own machinery for expansion of commercial practices. It is intended to make it possible for the law embodied in this Act to be developed by the courts in the light of unforeseen and new circumstances and practices.

The Code "applies to transactions in goods." Goods are defined as "all things (including specially manufactured goods) which are moveable at the time of the identification for sale." The Pennsylvania courts have recognized that " 'goods' has a very extensive meaning" under the U.C.C. Our Court has addressed computer package sales in other cases, but has not been required to consider whether the U.C.C. applied to software per se. Other Courts of Appeals have also discussed transactions of this nature. RRX Industries, Inc. v. Lab-Con, Inc., 772 F.2d 543 (9th Cir.1985) (goods aspects of transaction predominated in a sale of a software system); Triangle Underwriters, Inc. v. Honeywell, Inc., 604 F.2d 737, 742- 43 (2d Cir.1979) (in sale of computer hardware, software, and customized software goods aspects predominated; services were incidental).

Computer programs are the product of an intellectual process, but once implanted in a medium are widely distributed to computer owners. An analogy can be drawn to a compact disc recording of an orchestral rendition. The music is produced by the artistry of musicians and in itself is not a "good," but when transferred to a laser-readable disc becomes a readily merchantable commodity. Similarly, when a professor delivers a lecture, it is not a good, but, when transcribed as a book, it becomes a good.

That a computer program may be copyrightable as intellectual property does not alter the fact that once in the form of a floppy disc or other medium, the program is tangible, moveable and available in the marketplace. The fact that some programs may be tailored for specific purposes need not alter their status as "goods" because the Code definition includes "specially manufactured goods."

The topic has stimulated academic commentary with the majority espousing the view that software fits within the definition of a "good" in the U.C.C. Applying the U.C.C. to computer software transactions offers substantial benefits to litigants and the courts. The Code offers a uniform body of law on a wide range of questions likely to arise in computer software disputes: implied warranties, consequential damages, disclaimers of liability, the statute of limitations, to name a few.

The importance of software to the commercial world and the advantages to be gained by the uniformity inherent in the U.C.C. are strong policy arguments favoring inclusion. The contrary arguments are not persuasive, and we hold that software is a "good" within the definition in the Code.

The relationship at issue here is a typical mixed goods and services arrangement. The services are not substantially different from those generally accompanying package sales of computer systems consisting of hardware and software. Although determining the applicability of the U.C.C. to a contract by examining the predominance of goods or services has been criticized, we see no reason to depart from that practice here. As we pointed out in De Filippo v. Ford Motor Co., 516 F.2d 1313, 1323 (3d Cir.), cert. denied, 423 U.S. 912, 96 S.Ct. 216, 46 L.Ed.2d 141 (1975), segregating goods from non-goods and insisting "that the Statute of Frauds apply only to a portion of the contract, would be to make the contract divisible and impossible of performance within the intention of the parties."

We consider the purpose or essence of the contract. Comparing the relative costs of the materials supplied with the costs of the labor may be helpful in this analysis, but not dispositive. In this case the contract's main objective was to transfer "products." The specific provisions for training of Unisys personnel by Advent were but a small part of the parties' contemplated relationship.

The compensation structure of the agreement also focuses on "goods." The projected sales figures introduced during the trial demonstrate that in the contemplation of the parties the sale of goods clearly predominated. The payment provision of $150,000 for developmental work which Advent had previously completed, was to be made through individual purchases of software and hardware rather than through the fees for services and is further evidence that the intellectual work was to be subsumed into tangible items for sale.

We are persuaded that the transaction at issue here was within the scope of the Uniform Commercial Code and, therefore, the judgment in favor of the plaintiff must be reversed. …..

[The court further held that, under Article 2, the statute of frauds did not preclude enforcement of this contract, despite the absence of an express quantity term in the agreement, in part because Section 2-306 recognizes exclusive dealing agreements and imposes a dutiy of good faith that satisfies the requirement of a stated quantity.]

NOTES

1. As the court notes, many reported cases hold that transactions in computer software are within the scope of Article 2. But not all courts discussing contracts for software apply Article 2. Consider *Architectronics, Inc. v. Control Sys., Inc.*, 935 F. Supp. 425 (S.D.N.Y. 1996):

> "The [agreement] provided for two licenses. Under the first license, Architectronics granted CSI the right to use its DynaMenu software prototypes for joint venture-related purposes only. That license gave CSI a tool necessary for the development of the "Derivative Work," a new display driver. Under the second license, CSI granted Architectronics and CADSource the right to use, copy, and distribute the "Derivative Work." That license was the centerpiece of the transaction, because it provided Architectronics and CADSource with the valuable right to manufacture the new display driver and sell it to the public. Architectronics and CADSource bargained primarily for the right to mass market the product, not for the right to install single copies of the display driver onto their own PCs. CSI's upside in the deal also was linked to the rights to reproduce and distribute: the parties anticipated thousands of sales of the new product, and Architectronics and CADSource promised to pay CSI a $20-per-copy royalty on those sales. CSI stood to gain in royalties a sum that would dwarf the $2,000

> development fee. Because the predominant feature of the SDLA was a transfer of intellectual property rights, the agreement is not subject to Article Two of the UCC."

2. The appropriate treatment of software has been controversial and has lead to uniform legislation addressing the question. In 1999, the National conference of Commissions on Uniform State Law (NCCUSL) promulgated UCITA, which treats software (and other computer information transactions) under a uniform law separate from Article 2. UCITA has been adopted in two states. Around the same time, revised Article 9 was promulgated and later adopted in all fifty states. Article 9, which deals with secured financing, excludes most software from the definition of "goods." It states: "Goods" means all things that are movable when a security interest attaches. The term includes …. a computer program embedded in goods and any supporting information provided in connection with a transaction relating to the program if (i) the program is associated with the goods in such a manner that it customarily is considered part of the goods … The term does not include a computer program embedded in goods that consist solely of the medium in which the program is embedded. The term also does not include accounts, chattel paper, commercial tort claims, deposit accounts, documents, general intangibles … " UCC § 9-102(a)(44). The term "general intangibles" includes "software."

After over 12 years of debate, controversial amendments to Article 2 were promulgated in 2003. They were subsequently withdrawn when no state adopted them. Among many other provisions, the amendments stated: "goods" means "all things that are movable at the time of identification to a contract for sale. The term does not include information …." The comments to this section stated:

> "The definition of "goods" in this article has been amended to exclude information not associated with goods. Thus, this article does not directly apply to an electronic transfer of information … However, transactions often include both goods and information: some are transactions in goods as that term is used in Section 2-102, and some are not. For example, the sale of "smart goods" such as an automobile is a transaction in goods fully within this article even though the automobile contains many computer programs. On the other hand, an architect's provision of architectural plans on a computer disk would not be a transaction in goods. When a transaction includes both the sale of goods and the transfer of rights in information, it is up to the courts to determine whether the transaction is entirely within or outside of this article, or whether or to what extent this article should be applied to a portion of the transaction.

UCC § 2-103, *Comment* 7 (2003 Official Text). While the amendments did not define "information", other NCCUSL Uniform Laws promulgated during the late 1990's do. The Uniform Electronic Transactions Act (UETA) states: ""Information" means data, text, images, sounds, codes, computer programs, software, databases, or the like." UETA § 2(10).

3. Independent of this dispute, reported cases split on whether Article 2 applies to software or other development contracts. The issue is often described as requiring a determination of whether the contract predominantly involves the development services, or whether it is a contract for goods (e.g., the end product delivered). The answer may turn on contractual issues such as how is the developer paid, what is defined as successful completion of the contract, and what language the agreement uses. See Micro-Managers, Inc. v. Gregory, 434 N.W.2d 97 (Wisc. App 1988). *See also* Data Processing v. L. H. Smith Oil Corp., 493 N.E.2d 1272 (Ind. App. 1986) ("DPS was to act with specific regard to Smith's need. Smith bargained for DPS's skill in developing a system to meet its specific needs.").

4. Internationally, some cases are handled under the **Convention on the Sale of Goods (CISG).** This Convention applies to contracts of sale of goods between parties whose places of business are in different States: (a) when the States are Contracting States; or (b) when the rules of private international law lead to the application of the law of a Contracting State. "This Convention does not apply to sales: (a) of goods bought for personal, family or household use, unless the seller, at any time before or at the conclusion of the contract, neither knew nor ought to have known that the goods were bought for any such use; …… [or] to contracts in which the preponderant part of the obligations of the seller consists in the supply of labor or other services." The parties may exclude the application of this Convention.

5. **Consider the following**: You have been hired to advise and draft a contract for Karl Co, a company that will distribute an app to be downloaded onto smart phones that enable the user to contact the "Uber" car service, arrange for a car, give the location for pick-up, and pay the driver plus tip. The issue is what law governs the contract for this app – Article 2, which implies warranties of merchantability and fitness for the purpose, but gives specific ways to eliminate those warranties, or common law, which merely assumes that the provider exercised reasonable care and workmanlike conduct in its contract. Which law applies and does it matter?

6. **Principles.** While it is clear to virtually all observers that digital information transactions entail considerations different from those involving the sale of goods, there are some who believe that the differences require greater regulation and substantive limitation than do other types of modern commercial transactions and that transactional approaches that have become common in current commerce and are routinely used for the goods, computer information and other industries should be restricted (or banned) in reference only to software and related transactions. Aspects of this view came to dominate a project of the American Law Institute (ALI) that, in 2009, resulted in the promulgation by ALI of the <u>Principles of the Law of Software Contracts</u>. The reporters for the Principles were two well respected and knowledgeable academics, but many aspects of the product itself reflect the influence of interest groups whose views were rejected in debates regarding UCITA, proposed revisions for U.C.C. Article 2 or in legislative forums, and have not been adopted by courts.

The Principles were developed without substantial participation by software providers whose practices would be most directly affected if the Principles were ever to be followed in court. As underscored by the Reporters' Notes, an ALI Principles project does not restate existing law, but suggests what the drafters regard as "best practices" for the particular area of law. In effect, then, the publication is in the nature of an article or treatise expressing the viewpoint of the drafters and those that dominated the drafting process without input from the affected industry. Despite this, most of the "principles" are stated in a form that reads like a proposed statute. The Principles contain an odd mixture of approaches. Some are drawn from UCITA or from Article 2. But the majority do not directly reflect either source. Indeed, but often reject or purport to alter those laws or statutory provisions. How can a "best practice" reject mandatory statutory law?