The Extension of UCC's Article 2 To 'Hybrid' Software Transactions

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THE EXPONENTIAL growth of computer technology during the last two decades has made computers directly or indirectly a part of everyone's day-to-day life. Experts have predicted that by 1990 there will be 10 million small home computers in use and that everyone in the business world will have a computer on his or her desk by the end of the next decade. It is inevitable that this growing use of computers has raised many legal issues.

The use of trade-secret, patent and copyright law to protect software has engendered significant litigation, scholarly commentary and congressional action. n1 However, one important legal issue relating to software -- whether Article 2 of the Uniform Commercial Code applies to computer software transactions -- has received less attention. This issue is of great importance because failure to bring software into the domain of Article 2 leaves an enormous commercial industry subject to individual state statutes and state common law. n2

A major drawback of excluding software from Article 2 coverage is that it returns the software industry to pre-UCC days when legal formalities rather than business and commercial practices governed legal relationship. Also, reliance on state common law may result in a return to the lack of uniformity among different jurisdictions that existed before the enactment of the UCC. Various states already are beginning to pass specific legislation for the computer industry, and this ultimately will create a confusing body of law that will vary among jurisdictions. n3

The applicability of Article 2 to software depends on two determinations. First, software must be a "good" as defined by Article 2. Second, software must be either sold or supplied through a non-sale transaction that is determined to be within the domain of Article 2.

Is software a good? Although Article 2 broadly defines goods to be all "movable" things, much confusion and disagreement exists among commentators about the status of software. n4 One source of this confusion is inconsistent use of terminology such as the use of the term "software" to describe different things. Not only are different definitions of software advanced, but software generally refers to a computer program regardless of its stage of development or the medium used to contain the software.

Software expressed in source code or in object code is still called software whether embodied in a hard disk, a diskette or a deck of punched paper cards. The hiring of a programmer to create software to be used exclusively on the purchaser's computer also is referred to as purchasing software rather than as the rendering of services.

In contrast, music is described by different terms depending on the form it is in. Music sold as notes written on scales is called sheet music. Accompanying words to the music are called lyrics. If music is recorded on a phonograph record it is generally referred to as a record. Finally hiring a band to play music involves a service contract. The proper determination of whether software is a good, therefore, must focus on the stage of software development and the medium in which the software is embodied.

ANOTHER source of confusion arises from the failure to distinguish between tangible and intangible property aspects of software. Even though software in the form of a tangible medium such as a diskette is a movable thing within the Article 2 definition of a good, it simultaneously may incorporate intangible intellectual property that falls outside the scope of Article 2.

In Triangle Underwriters Inc. v. Honeywell Inc., n5 a sale of a computer system consisting of hardware, standard software and custom software resulted in breach-of-contract claims when the system failed to function properly because the software did not operate as promised. In determining that the system as a whole was within the Article 2 definition of goods, the court noted that the software consisted of both intangible intellectual property aspects, represented by ideas and concepts, and the resulting product of those intellectual-property aspects, which was software.

It has been asserted, however, that when purchasers or licensors of software contained in a medium such as a diskette pay for such software, they really are paying for the intangible ideas represented by the software and not the diskette, which has little value unless it is encoded with the software. Although this argument initially may seem logical, it breaks down when applied to some of the many things held to be goods.

For example, a book is a tangible object consisting of paper, ink and glue but it also embodies intangible intellectual property protected by copyright law. Books are goods, however, under Article 2, even though their value lies in the intangible information they contain and not in the paper, binding or ink. n6

It is difficult to discern any distinction between software embodied in a physical medium and an author's ideas or stories embodied in a physical medium. Both start out as intangible ideas that ultimately are refined and incorporated into a tangible form. Software can be contained on a diskette, while an author's ideas can be embodied in a printed book. In both cases, the initial idea existing in the author's or programmer's mind is an intangible, which is not a movable thing and therefore is not a good under Article 2. However, once this intangible idea is converted to a tangible object that embodies the idea, a movable thing exists that is a good under Article 2.

If the existence of underlying intangible ideas in a tangible product divested the tangible product of its status as a good, few products would be considered goods under Article 2. Many products routinely viewed as goods under Article 2 are really of value only because they encompass intangible property protected by patent, copyright, trade-secret or trademark law.

It is interesting to note that a careful analysis of the case law does not reveal great judicial uncertainty about whether to treat software as a good. The weight of authority, although limited, treats computer software as being within the Article 2 definition of a good, although these decision exhibit an absence of lengthy analysis or discussion of this issue. n7

Licensing of software. The determination that software is a good does not automatically make Article 2 applicable to software. Although it is generally agreed that the sale of goods is subject to Article 2, disagreement exists about whether transactions other than pure sales are within the scope of Article 2. This is significant with regard to software, as it is usually provided to users via license agreements that are non-sale transactions.

The extension of Article 2 to non-sale transactions is not without precedent. In Hertz Commercial Leasing Corp. v. Joseph n8 and Hertz Commercial Leasing Corp. v. Transportation Credit Clearinghouse n9 equipment leasing transactions were found to be within the domain of Article 2 despite the failure of Article 2 to apply to leases expressly.

In Transportation Credit Clearinghouse the court recognized that leasing of equipment is a recent device that is often equivalent to a sale but is used for tax purposes. The court realized that it would be anomalous if this expanding volume of commercial transactions structured as leases were subject to different rules than outright sales, when both transactions resulted in identical economic results.

Furthermore, establishing a separate body of law to cover each new type of non-sale transaction used in place of a sale would undermine the original impetus behind the UCC -- which was to unify and clarify commercial law.

Transportation Credit Clearinghouse and other cases that apply Article 2 to leases look beyond the name given to a transaction. These cases focus on the underlying reason for the transaction and whether the transaction is equivalent or analogous to a sale. The effect of software license transactions and the underlying rationales of such transactions must therefore be examined.

LEGAL AND practical limitations on the use of patent and trade-secret law to protect software has resulted in copyright becoming the major source of legal protection for software. Under the copyright law, the copyright owner has several exclusive rights, which include the right to control the marking of copies and the public distribution of copyrighted works. This means that copyrighted software cannot be reproduced or distributed without the permission of the copyright owner.

However, the so-called "first-sale doctrine" provides that the sale of a copy of the copyrighted work embodied in a tangible medium extinguishes the copyright owner's distribution right with regard to the particular copy sold. n10 As a result, once software embodied in a tangible medium such as a diskette is sold, the buyer is free to sell or otherwise dispose of that diskette without the permission of the copyright owner. However, if the software vendor retains ownership of all copies of the software by only selling users a license to use the software, the effect of the first-sale doctrine is avoided.

Software licenses also are used to attach additional conditions to the use of software. One typical condition is that the software user must protect the underlying algorithms and processes used in the software that are beyond the scope of copyright protection. Typically, this underlying information is alleged to be the software producer's trade secret, which the software user is required to maintain in confidence.

Although licensing of software is not an actual sale under Article 2 because the software producer retains title to the software, it has many of the incidents of a sale. Mass-marketed software obtained subject to a "shrinkwrap" license is most analogous to a sale. A typical license of this type would be classified as the perpetual paid-up license because the one-time license fee paid for the software is all that is required for a perpetual right to use the software. In this type of transaction, the software producer effectively has sold the software despite the retention of title, as the producer has no realistic expectation of ever getting the software back.

Individual licensing of special-purpose software on a limited and carefully controlled basis to preserve trade secrecy has fewer incidents of a sale. The software producer will have more control over how the software is used, periodic license fees may be required, and the software may be subject to return to the licensor once the license is terminated. The duration of such a license may be critical however.

In HMO Systems v. Choice Care Health Services, n11 software was provided by a non-expiring or perpetual license, and therefore the fact that the title was not transferred does not seem relevant because a permanent right to use the software existed.

Additionally, the exponential advancement of computer technology can render a limited-duration license equivalent to a sale.

In State v. Central Computer Services Inc., n12 a 99-year license was entered into to use software. The advancement of computer technology guarantees that this software will be obsolete before the end of the license term. Therefore, although the licensor has retained title to the software, the licensor has no expectations that the software will ever be returned by the licensee because it will be worthless long before the license term ends.

If the duration of the individually negotiated license is for a very limited time, then this type of transaction is less analogous to a sale. However, despite the fact that some license transactions may have fewer incidents of a sale than others, most of these transactions are, to a greater or lesser degree, closely analogous or equivalent to sales.

JUST AS THE court in Transportation Credit Clearinghouse recognized that leases analogous or equivalent to sales should be treated as being within the scope of Article 2 to avoid creation of a separate body of law for an increasingly common type of transaction, software licenses also should be covered by Article 2 for the same reasons. Software typically is licensed to protected certain rights provided by copyright and to protect underlying proprietary information used in creating the software. In all other respects, most software license transactions resemble sales and should therefore be treated as being within the scope of Article 2.

Software provided with services. Software often is provided in combination with various types of services or used in the performance of service contracts. Because of these service aspects, it has been argued that software is outside the domain of Article 2 because Article 2 does not apply to service contracts. Before determining the appropriate treatment of such software transactions, judicial treatment of hybrid sales-service transactions generally must be examined.

Although various judicial analyses have been applied to such hybrid transactions, the most frequently used analysis is the "predominant feature" analysis. Under this approach, the transaction is examined to determine if it predominantly involves the performance of services or the sale of goods and it is classified according to the predominant feature.

In RRX Industries Inc. v. Lab Con Inc., n13 the court was confronted with a software transaction that involved the sale of both software and the accompanying services. The seller contracted to install the software on the buyer's computer and to correct any errors in the software discovered after installation. The seller also agreed to train the buyer's employees in the operation of the software and to upgrade the software in the future. The system proved unreliable, however, because the seller was unable to correct defects in the software.

The buyer successfully brought suit for breach of contract and was awarded general and consequential damages. In affirming the award, the court of appeals noted that the district court's award of consequential damages under Article 2 could stand only if the software was a good and if the software transaction was a contract for the sale of goods rather than a contract to provide services. The court then found that the sale-of-goods aspect -- the sale of the software -- was the predominant feature of the contract with the services being only incidental.

Consequently, the court of appeals found -- under the predominant-feature test -- that in this case the sale of software with accompanying services was a contract for the sale of goods covered by Article 2.

In Data Processing Services v. L. H. Smith, n14 the court squarely addressed the issue of whether a contract to develop custom software designed to meet the specific needs of the user was a contract for the sale of goods or a contract to perform services. The trial court found Article 2 applicable and awarded damages for breach of contract based on a finding that the software failed to perform as promised.

ON APPEAL, the court affirmed the award of damages, but its decision was based on the common law because the appellate court determined that the contract to develop software was a contract to provide services. The court, however, distinguished the custom software involved in this case from the sale of "generally available standardized software," which other courts have held to be within Article 2.

In Liberty Financial Management v. Beneficial Data, n15 Beneficial Data entered a contract to provide on-line data-processing services to Liberty, a consumer loan company. Dissatisfaction with the services resulted in Liberty bringing a breach-of-contract action which yielded a jury award of more than $1 million.

On appeal, the trial court decision was reversed and the case was remanded in part because a clause in the contract limiting consequential damages for negligence was withdrawn from the consideration of the jury. In analyzing the validity of the clause limiting consequential damages, the appellate court found the clause valid, but rejected application of Sec. 2-719 of Article 2 because it concluded that the scope of Article 2 was limited to transactions in goods.

The court determined that the contract in this case was primarily for data-processing services (with reels of tape and other tangible items provided to Liberty being only incidental to the contract), and therefore the contract was not within the scope of Article 2.

In Computer Servicenter Inc. v. Beacon Manufacturing Co., n16 an oral contract was entered into that provided that Computer Servicenter would provide data-processing services to Beacon in the form of analysis, collection, storage and reporting of certain data supplied by Beacon. The services had been provided for three months when Beacon notified Computer Servicenter that these services were no longer needed.

Computer Servicenter brought an action for breach of contract but Beacon's motion for summary judgment was granted based on the oral contract being unenforceable under the statute of frauds. In reaching its decision, the court determined that the transaction was a contract to provide services, as opposed to a contract for the sale of goods, and therefore the common-law statute of frauds, rather than Sec. 2-201 of Article 2, applied.

The extension of Article 2 to hybrid software transactions that involve software, which is a good, and accompanying services must be examined in light of judicial treatment of hybrid transactions generally. The majority of courts classify a hybrid transaction as being within Article 2 or outside Article 2 depending on whether the sale-of-goods or service aspects of the transaction predominates. This approach leads to a case-by-case analysis with regard to whether Article 2 applies to a software transaction involving both software and accompanying services. Although this provides some lack of predictability, this approach has been followed consistently with regard to hybrid transactions and therefore there is no reason to believe it cannot be used for software transactions.

Footnotes

n1 See, e.g., Rodau, "Protecting Computer Software: After *Apple Computer Inc. v. Franklin Computer Corp., 714 F.2d 1240 (3d Cir. 1983),* Does Copyright Provide the Best Protection," *57 Temple L.Q. 527 (1984).*

n2 The total investment in software in the United States already exceeds $200 billion despite the fact that the computer industry is only in its infancy. Bender, "Software Protection: The 1985 Perspective," 7 W. New Eng. L. Rev. 405, 407 n. 3 (1985).

n3 See, e.g., Software License Enforcement Act, Ill. Rev. Stat. ch. 29, Secs. 801-08 (Supp. 1986) (statutorily establishes validity of shrink-wrap licenses).

n4 Compare Note, "The Warranty of Merchantability and Computer Software Contracts: A Square Peg Won't Fit in a Round Hole," *59 Wash. L. Rev. 511 (1984)* (software not within scope of Article 2) with Rodau, "Computer Software: Does Article 2 of the UCC Apply?" *35 Emory L. J. 853 (1986)* (Article 2 applies to software).

n5 *457 F. Supp. 765 (E.D.N.Y. 1978),* modified, *604 F.2d 737 (2d Cir. 1979)* (reversed in part because district court did not apply statute of limitations properly).

n6 *Cardozo v. True, 342 So. 2d 1053 (Fla. Dist. Ct. App. 1977).*

n7 See, e.g., *W.R. Weaver Co. v. Burroughs Corp., 580 S.W.2d 76 (Tex. Civ. App. 1979).*

n8 *641 S.W.2d 753 (Ky. Ct. App. 1982).*

n9 *289 N.Y.S.2d 392 (Civ. App. 1969),* rev'd on other grounds, *316 N.Y.S.2d 585 (App. Div. 1970).*

n10 See *17 U.S.C. 109*(a)(1982).

n11 665 p.2d 635 (Colo. Ct. App. 1983.)

n12 *349 So. 2d 1160 (Ala. 1977).*

n13 *772 F.2d 543 (9th Cir. 1985).*

n14 *492 N.E.2d 314 (Ind. Ct. App. 1986),* reh'g denied, *493 N.E.2d 1272 (1986).*

n15 *670 S.W.2d 40 (Mo. App. Ct. 1984).*

n16 *328 F. Supp. 653 (D.S.C. 1970),* aff'd, *443 F.2d 906 (4th Cir. 1971).*