

News from our Technology Transactions Group

## New ALI Software Principles Will Require Companies to Update Their Form Agreements

### Introduction

On May 19, 2009, the American Law Institute (ALI)<sup>1</sup> is expected to approve the Principles of the Law of Software Contracts (the “Software Principles”), which will create new rules and set new standards for software contracts in a number of areas.<sup>2</sup> Although ALI Restatements and Principles are not binding law, they are highly persuasive because they are developed over several years with extensive input from law school professors, judges, and practitioners.<sup>3</sup> As a result, it is likely that future courts will rely on the Software Principles as setting the bar for best practices for software licensing transactions. This will present challenges for software companies who must continue to comply with existing law, but may also want to conform their contracts to the Software Principles.

### Recommendations

If your company licenses software, you should review your form software agreements for compliance with the Software Principles. In particular, you should consider taking the following steps:

1. Review your advertisements and other literature to eliminate any unintended express warranties that may be included in them.
2. Make sure that the disclaimers of both the implied warranties of merchantability and fitness for a particular purpose are conspicuous.
3. Review and update your warranties and warranty disclaimers to make sure that

appropriate limitations on liability to third-party beneficiaries are included.

4. In light of the new, non-waivable implied warranty of no material hidden defects, consider whether, and how, to disclose material bugs in your software to customers before the point of sale.
5. If you do not intend to indemnify your customers for infringement of intellectual property or like rights that exist at the time of transfer and are based on the laws of the United States or any state thereof, make sure that any exclusion or modification of this new implied indemnification obligation is (a) in a record, (b) conspicuous, and (c) uses language that gives the transferee reasonable notice of the exclusion or modification.
6. Remove any provision that allows for cancellation of an agreement for breach without reasonable notice of cancellation to the party in breach.
7. Ensure that automated disablement is not included in a standard-form agreement as a remedy for breach and that any automated disablement provision in other agreements complies with the provisions of Section 4.03 of the Software Principles.
8. Review your agreements to determine if there are any provisions that might conflict with federal intellectual property laws, and if so, consider removing such provisions or modifying them so that they are more likely to be upheld.

In addition, you should also consider taking the following steps to maximize the enforceability of your standard-form agreements for the transfer of generally available software<sup>4</sup>:

1. Review the standard-form contracts to ensure that the terms can be understood by a person of average intelligence and education.
2. Post standard-form agreements on the home page of the vendor’s website, or at most a few clicks away from the home page and make sure that they can be printed in hard copy.
3. In the case of electronic forms, ensure that customers receive conspicuous notice of, and access to, the standard-form agreement prior to payment or completion of the transaction. The notice should include a hyperlink that leads within several clicks to the standard-form agreement. Customers should be

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required to signify agreement by clicking an “I agree” icon that is positioned adjacent to a scroll-down window that contains the standard-form agreement.

4. In the case of electronic forms, modify any provisions that require transferees to agree in advance to future modifications of the agreement. When making modifications to an electronic form, provide reasonable electronic notice of the modification and require your customers to signify agreement to the modification electronically, either at the end of or adjacent to the electronic notice.
5. Remove any provisions that provide for automated disablement as a remedy for breach of a standard-form agreement.
6. Maintain archival records of your website content, including when you posted your standard-form agreements on the website, as well as any modifications to the standard-form agreements.
7. If you are taking orders for software by telephone, make sure that your telephone sales personnel advise all customers of the availability of the standard-form agreement on the Internet, including specific instructions regarding how to access the agreement.
8. If you are selling software in brick and mortar stores, make sure that the stores post or distribute the standard-form agreement, or make a computer available so that customers can review the agreement online, before purchasing the software.

## Background

The Uniform Commercial Code is a joint initiative of the ALI and the National Conference of Commissioners on Uniform State Law (“NCCUSL”),<sup>5</sup> which aims to harmonize the law regarding commercial transactions among the fifty states. All UCC articles, and any amendments to the Articles, must be approved by both the ALI and NCCUSL. UCC Article 2 on the sale of

goods was drafted in the 1940s and has been adopted in some form in every state except Louisiana. Although Article 2 was drafted before the development of commercial computer software, most cases that have addressed the subject have held, either directly or by analogy, that Article 2 applies to software licenses.

During the 1990s, there was an attempt to add a separate article (Article 2B) to the UCC to deal specifically with software licenses. The early drafts of Article 2B were limited to computer software, but later drafts expanded the scope to cover all types of “information” transactions. Many businesses affected by the expanded scope, including the entertainment industry, objected to being covered by Article 2B. In addition, consumer groups criticized Article 2B as being too business-friendly. In 1999, the ALI rejected the final version of Article 2B, ending its chances to become a part of the UCC, but NCCUSL renamed it the Uniform Computer Information Transactions Act (“UCITA”) and approved it as a model state law. UCITA was quickly enacted into law by Virginia and Maryland, but it has not been enacted into law by any other state. In 2003, NCCUSL attempted to jumpstart the adoption of UCITA by persuading the American Bar Association to approve UCITA, but NCCUSL subsequently withdrew its request in the face of opposition by several ABA sections. As a result, NCCUSL decided to forgo, at least for the time being, further efforts to convince states to enact UCITA.

In 2005, the ALI decided to generate a set of Software Principles because it appeared that the statutory path to regulation of software licenses was not promising. The ALI selected Robert Hillman, an expert on contract law, to serve as Reporter for the project and Maureen O’Rourke, an expert on commercial law, to serve as Associate Reporter. In addition, the ALI selected a group of advisors who included academics, jurists, inhouse lawyers, and attorneys

from law firms and nonprofit associations, as well as a Members Consultative Group. The reporters met with the advisors four times, and held a number of open meetings, before the final draft was created in March 2009.

The Software Principles address three general areas: (1) scope and classification, (2) contract formation, and (3) content of terms.

## Scope and classification

### Enforcement of terms under federal intellectual property laws

Although the reporters note that a model set of principles addressing transactions that are contractual in nature would not typically address its relationship to federal law, the reporters note that the Software Principles address federal law because software licensing intersects with federal copyright and patent law, which places some express limits on enforceable contract terms, especially when state contract law enforces standard-form agreements. Section 1.09(a) of the Software Principles provides that parties cannot contract around mandatory rules of the intellectual property laws. By way of example, the Comments to Section 1.09 note that because rules requiring a record for transfer of copyright ownership and assignment of patents and copyrights are mandatory, an agreement to orally transfer ownership of the copyright in software to another would be unenforceable. Section 1.09(b) states that a term of an agreement that impermissibly conflicts with federal intellectual property law is also unenforceable. Although the Software Principles do not identify particular suspect terms in the “black letter” portion of Section 1.09, the Comments provide that provisions that purport to do any of the following could be problematic: (1) preclude the transferee generally from making fair uses of the work, (2) ban or limit reverse engineering, (3) restrict copying or dissemination of factual information, (4) forbid transfer of the software, (5) require grant

back rights to the transferor in the transferee's independently created innovations, or (6) prohibit a transferee from seeking federal intellectual property rights on its own independently created innovations. Finally, Section 1.09(c) provides that terms that would constitute federal intellectual property misuse in an infringement proceeding are also unenforceable. Examples of terms that may constitute misuse include a term that prohibits a transferee in perpetuity from marketing games that work on the transferor's game console for use on any other company's game console, a term where a software provider attempts to use its copyright in a software program to control a transferee's use of uncopyrighted data, and a provision in a software license agreement that attempts to restrict the licensee's use of ideas contained in the software or its development of a competing program.

### Coverage limited to software

In contrast to the broad scope of UCITA, the Software Principles cover only software,<sup>6</sup> and expressly provide that software does not include digital content, which consists of digital art (literary and artistic information stored electronically, e.g., music, photos, movies, books, newspapers) and digital databases (compilations of facts stored electronically).<sup>7</sup> On the other hand, the software that renders digital content visible, audible, or otherwise perceivable is defined in the Software Principles as a "digital content player" and is included within the definition of software.<sup>8</sup>

The Software Principles apply to agreements to sell, lease, license, access, or otherwise transfer or share software for a consideration, including most open source license agreements.<sup>9</sup> The Software Principles apply to all agreements, but include some rules that apply only to standard-form transfers of generally available software. A "standard form" is defined as a record regularly used to embody terms of agreements

of the same type, and a "standard-form transfer of generally available software" is defined as a transfer, using a standard form, of (1) a small number of copies of software to an end user, or the right to access software to a small number of end users, if (2) the software is generally available to the public under substantially the same standard terms. Standard-form transfers of generally available software are not limited to consumer software or to consumer transactions,<sup>10</sup> but they do not include standard-form agreements for the transfer of, or access to, software to a large number of end users, or to custom software agreements.

### Embedded software and mixed transactions

The Software Principles use a test based on the predominant purpose of the transferee to determine whether they should be applied to agreements for the transfer of embedded software or of non-embedded software in a mixed transfer of non-embedded software and goods. Section 1.07(a) states that the Software Principles will apply to agreements for the transfer of embedded software if a reasonable transferor would believe the transferee's predominant purpose for engaging in the transfer is to obtain the software. Section 1.08(b) provides that the Software Principles will apply to a mixed transfer of non-embedded software and goods unless the transfer also includes digital content or services and a reasonable transferor would believe the transferee's predominant purpose is to obtain the digital content or services.

The test defines the predominant purpose as the most important purpose, not just a material purpose. Factors to be considered in determining the predominant purpose include (1) the language of the agreement, (2) the nature of the goods and the software, (3) the price of the goods and the software, (4) the nature of the parties' bargaining over the goods and software, (5) whether the software is generally available,

(6) whether there is a separate price for the software, and (6) whether the transferor developed the software for the particular transferee or the particular product.

The Comments to Sections 1.07 and 1.08 provide that these predominant purpose tests should be used to determine whether software in multimedia products, such as interactive games, is governed by the Software Principles. Although the reporters acknowledge that this creates "a line-drawing challenge," they also note that courts are free to apply the Software Principles by analogy to the transfer of software in multimedia products "when the reasoning behind these Principles applies persuasively to such transfers."

## Contract formation

### General approach to contract formation

Section 2.01 of the Software Principles sets forth the general approach to contract formation, based on UCC Article 2 and the Restatement Second of Contracts. Section 2.01 provides that a contract may be formed in any manner sufficient to show agreement, including by offer and acceptance and by conduct. In addition, a contract may be formed even though one or more terms are left open, if "there is a reasonably certain basis for granting an appropriate remedy in the event of breach,"<sup>11</sup> or if the parties' records are different.<sup>12</sup> Section 2.01 applies to both negotiated and standard-form contracts, but standard-form contracts are also subject to Section 2.02. As noted previously, standard-form transfers of generally available software do not include transfers of large quantities of software or custom software even when a standard-form agreement may be used. The Comments to Section 2.01 explain that, "Even if a transferee business is small and less sophisticated, large-quantity or custom-software transactions should constitute a red flag that the standard form is important and should be read. The Principles

therefore take the position that such transferees do not need the special safeguards of § 2.02.” On the other hand, the reporters warn that:

[C]ourts applying § 2.01 to any standard-form transaction should be especially vigilant about the formation process on the theory that even in large-quantity, standard-form transactions or custom-software transactions transferees may have little or no bargaining power or choice.... [As a result,] courts should not exempt [standard forms] from scrutiny simply because the transfer is large or of custom software.... In applying the objective test of assent [pursuant to § 2.01(a)], courts should ... consider factors not unlike those set forth in § 2.02(c) ... including whether the transferee received adequate notice of and access to the standard form before and at the time of the transfer, the likelihood that the transferee will read the standard form, and its comprehensibility.

### **Standard-term transfers of generally available software**

Section 2.02, which deals with the enforcement of standard-form transfers of generally available software represents a change to existing law. In the Summary Overview of Section 2.02, the reporters note that current contract law, as applied to both paper and e-worlds, generally recognizes the enforceability of shrinkwrap (where software is returnable) and clickwrap contracts, but strikes terms that are unreasonable, either in presentation or in content. Section 2.02(b) adopts the general contract law objective test of contract formation for standard-form transfers of generally available software only “when a reasonable transferor would believe the transferee intends to be bound to the form.” However, Section 2.02(c) then sets forth best practices for software transferors and provides a safe harbor that ensures enforcement of

a standard form under the objective test of formation provided that the contract terms are “reasonably comprehensible” and subject to Section 1.10 on public policy, Section 1.11 on unconscionability and other invalidating defenses available under the Software Principles or outside law. These safe harbor requirements are:

1. The standard form is reasonably accessible electronically prior to the transaction (regardless of whether the standard form is electronic or printed). The Comments to Section 2.02 provide that a transferor can meet this requirement by maintaining an Internet presence and by posting its license terms on the website. “Reasonable accessibility” means that the standard form should not disappear after appearing on a computer screen and should be conspicuously displayed and the terms should either be on the homepage or a few clicks away. The reporters believe that pre-sale availability of software terms will motivate transferors to write reasonable standard terms by allowing transferees and watchdog groups the opportunity to read and compare terms prior to a transaction.
2. Upon initiation of a transaction, the transferee must receive reasonable notice of and access to the standard form prior to payment or completion of the transaction. The Comments provide that “reasonable notice of and access to” the standard form requires that (a) the notice is conspicuous both in terms of placement and size so that the transferee cannot help but notice it, and (b) the notice should include a hyperlink that leads within several clicks to the standard form, which must also be conspicuously displayed. In the case of packaged software ordered by telephone, this requirement can be satisfied by an announcement of the form’s availability on the Internet, and if the transfer occurs in a store, the store must post or distribute the standard form or make a computer available so that customers can view the terms online.
3. The transferee must signify agreement at the end of or adjacent to the electronic form, or in the case of a standard form printed on or attached to a package, or separately wrapped from the software, the transferee must fail to return the unopened packaged software for a full refund within a reasonable period of time. The Comments note that this requirement is satisfied where an “I agree” icon is adjacent to a scroll-down window that contains the standard form, but that a “mere screen reference to terms that can be found somewhere else on the site,” or a scroll-down window containing the standard form without an “I agree” icon at the end of or adjacent to the form, would not satisfy this requirement. Where a physical copy of the software is transferred, the Software Principles require that the transferee return the unopened software package. The Comments explain that this requirement eliminates the transferor concern that the customer may have copied the software before returning it, but is fair to the customer as well because the standard form must be made accessible to the customer without opening the software package.
4. The terms must be reasonably comprehensible. The Comments to Section 2.02(d) state that this requirement follows general contract law, which asks whether “a person of average intelligence and education can understand the language with ordinary effort.” Unfortunately, the Comments provide only the following illustration of a term that would not meet this requirement, and therefore leave it to case law to determine how to apply this requirement.<sup>13</sup> B, a merchant with three employees, downloads a single copy of word-processing software from A. The standard form is reasonably accessible on A’s

homepage prior to the transaction and B clicks “I agree” at the bottom of a standard form on the computer screen before the software is downloaded. However, “the standard form, in garbled language, fails to clarify that A has conditioned B’s access to the word-processing software on B accepting another program consisting of spyware that will monitor B’s Internet activity and supply information to a third party.” The spyware terms are not “reasonably comprehensible” and are therefore unenforceable.

5. In the case of electronic terms, they are capable of storage and reproduction, such as by printing a hard copy.

Section 2.02(e) allocates the burden of production and persuasion to the transferor. The Comments explain that the transferor is in the best position to maintain records to prove that it displayed its standard form on the website for a reasonable period of time prior to the transfer, noting that many transferors already maintain archival records of website content, including when material was introduced, modified, and removed. Server logs can also demonstrate when and how a web page has been modified. The Comments also note, however, that transferors may be able to fraudulently modify their digital records and conclude that the trier of fact must determine the validity of proof just as a jury would determine whether paper records are fraudulent.

### Contract modifications

Section 2.03 follows the UCC and eliminates any requirement for consideration for contract modifications in lieu of an objective test focused on whether a party received adequate notice of and access to the modification, the clarity of the modification, and whether a reasonable person would believe that the party intended to agree to the modification.<sup>14</sup> Section 2.03(b) includes a safe harbor for transferors in electronic transfers, which states that a

transferee will be deemed to have agreed to a modification if the transferee (1) receives reasonable electronic notice of the modification, and (2) signifies agreement to the modification electronically at the end of or adjacent to the electronic notice. Parties are generally free to agree to procedures for modifying a contract. However, Section 2.03(d) rejects the ability of transferors to require transferees to agree in advance to future modifications of standard-form transfers of generally available software, stating that “mere notice of a material modification sent by one party is insufficient to prove agreement by the other party, even if the original contract authorizes this manner of modifying the contract.”

## Content of terms

### Indemnification for infringement

Noting that the widespread disclaimer of the UCC warranty of noninfringement suggests that another approach may be preferable, Section 3.01 of the Software Principles creates an obligation for the transferor to indemnify the transferee against any claim of a third party based on infringement of an intellectual property “or like right”<sup>15</sup> which exists at the time of transfer and is based on the laws of the United States or a state thereof, under certain specified conditions. The indemnity arises only if the transferor (1) deals in software of the kind transferred or holds itself out as having knowledge or skill peculiar to the software,<sup>16</sup> and (2) the indemnification is not disclaimed. The transferor may exclude or modify the infringement indemnification: (1) if the exclusion or modification (a) is in a record, (b) is conspicuous, and (c) uses language that gives the transferee reasonable notice of the exclusion or modification; or (2) by course of performance, course of dealing, or usage of trade. The Comments note that the requirement that the disclaimer be conspicuous is new, and the Comments to Section 3.01 make it clear that language that is currently used by vendors to disclaim the implied warranty of

noninfringement should not be found to waive this new indemnification obligation. Illustration 8 of the Comments provides the following example: A transfers software to B under an agreement that states, “There are no warranties, express or implied, written or oral, including but not limited to any implied warranty of fitness for use or for a particular purpose, with respect to any software provided hereunder.” This disclaimer, even if conspicuous, does *not* give the transferee reasonable notice of the transferor’s intent to disclaim the indemnification obligation, and it is not clear that the addition of an express reference to the implied warranty of noninfringement would change this result. Illustration 9 makes it clear that a standard disclaimer of indemnification will also not be sufficient unless it is conspicuous.

Although Section 3.01 permits the transferor to disclaim the indemnification, the Comments state that:

The hope is that by changing the applicable default rule from an implied warranty to the narrower obligation of implied indemnification, more vendors will be willing to offer a tailored indemnity than disclaiming liability altogether.

The reporters conclude by warning:

To the extent that vendors routinely disclaim indemnity, courts should be particularly concerned if infringement suits against consumers based on their exercising rights under the agreement were to become widespread. In such cases, courts might opt to use public policy or unconscionability to analyze whether a disclaimer should be enforced.<sup>17</sup>

### Express warranties

Section 3.02 also changes existing case law by providing that a vendor is potentially liable for express warranties to any transferee in the chain of distribution, including

intermediaries as well as the end user in the chain, and transferees who download or obtain access to the software directly from the vendor over the Internet. In addition, a distributor or dealer will also be liable for breach of warranty if it makes its own express warranty or if it adopts the vendor's warranty. The Comments provide that, "A party adopts a warranty when a reasonable transferee would believe the party intends to stand behind or appropriate as its own the warranty made by another party." By way of example, the Comments state that if software is displayed for sale as a particular kind of software, the dealer has adopted the maker's express warranty by description that the software is the particular kind of software with its average qualities.

Before a warranty arises, however, the vendor must make a warranty to the transferee, such as by making a promise directly by including a warranty in a record packaged with or accompanying the software offered to the end user. Section 3.02(b) provides that a warranty can also arise from advertising to the public. As an example, Illustration 3 to the Comments provides that where B sees an advertisement in a newspaper for A's KT-780 computer system, which includes software "compatible" with the hardware and B purchases a KT-780 system, but some of the software is not compatible with the system, A has breached an express warranty that the software would be compatible.

The Software Principles do not use the "benefit of the bargain" test which requires that the transferee has relied on the warranty. Instead, Section 3.02(b) provides that an affirmation of fact or promise constitutes an express warranty if a reasonable transferee *could* rely on it. As in the UCC, the transferee is not required to prove actual reliance. The reporters explain:

As such, affirmations of fact about the software, descriptions of the software, and other language or conduct indicating commitment and not puffing

ordinarily will constitute express warranties even if a transferee could not see the warranty until after paying for the software because, for example, the warranty is in the software package.... '[R]easonableness' is an objective test, but it should take into account the relative sophistication of the transferee.

Factors helpful in determining what a reasonable transferee would believe include (1) whether the transferor uses language of commitment, (2) the degree of specificity of the communication, (3) whether the statement can be verified, (4) the circumstances in which the transferor makes the statement, and (5) whether the statements are written or oral. As an example, the Comments state that a statement that software "will work wonders" would not be something a reasonable transferee would believe, but a statement that the software used for sorting data "will cut the time for sorting the data in half" may constitute an express warranty.

#### **Implied warranties of merchantability and fitness**

As is the case for goods sold under UCC Article 2, the Software Principles provide that a transferor that deals in software of the kind transferred or holds itself out by occupation as having knowledge or skill peculiar to the software warrants to the transferee that the software is merchantable. However, unlike the UCC, Section 3.03 includes a definition of merchantability that is tailored for software. The Software Principles also provide that a transferor makes an implied warranty of fitness for a particular purpose if the transferor at the time of contracting has reason to know any particular purpose for which the transferee requires the software and the transferee relies on the transferor's skill or judgment to select, develop, or furnish the software.<sup>18</sup>

Section 3.04(b) includes a warranty similar to UCITA Section 405(c), which provides

that a transferor makes an implied warranty that the software provided or selected will function together with hardware as a system, if an agreement requires the transferor to provide or select a system of hardware and software, and the transferor at the time of contracting has reason to know that the transferee is relying on the skill or judgment of the transferor to select the components of the system.

As is the case under the UCC and UCITA, the Software Principles provide that the implied warranties of merchantability and fitness can be excluded if the exclusion is in a record, communicated to the transferee, and mentions "merchantability" and "fitness for a particular purpose."<sup>19</sup> Unlike the UCC, which only requires that the disclaimer of merchantability be conspicuous, the Software Principles also require the disclaimer of fitness for a particular purpose be conspicuous. In addition, Section 3.06(a) of the Software Principles contains the following limitation on such exclusions, which are routinely made by vendors today and which could prove problematic in the future: "A statement intending to exclude or modify an express quality warranty is unenforceable if a reasonable transferee would not expect the exclusion or modification."

The Comments explain that Section 3.06(a) is intended to address an ambiguity in Article 2, which directs courts to attempt to construe language creating and nullifying express warranties consistently. The reporters assert that the UCC approach causes confusion because it is not clear how language of warranty can ever be "consistent" with language of disclaimer. The Comments provide that the relative clarity, distinctiveness, and conspicuousness of language or acts of warranty and disclaimer may help determine whether a disclaimer is unexpected for purposes of Section 3.06(a). Additional factors include whether the transferee drafted or helped draft the contract, and whether the transferee had

actual knowledge of the disclaimer. By way of example, the reporters state that if a contract states that software is “compatible with Windows Vista,” but also disclaims all express and implied warranties, a reasonable transferee would not expect the disclaimer to apply to the compatibility statement and the disclaimer would therefore fall out of the contract.

Although the Software Principles do not completely drop the requirement of privity of contract, Section 3.07 expands the parties who can sue for breach of warranty to include “any person for whose benefit the transferor intends to supply the software.” The transferor’s warranty to a consumer extends not only to the consumer and his or her immediate family and household members, but also to guests of the family or household if the transferor should reasonably expect use of the software by such guests. Case law involving sales of goods have not settled whether plaintiffs can sue as third-party beneficiaries if they claim only economic loss, but Section 3.07 of the Software Principles applies to both economic and personal injuries suffered by a third party. Under Sections 3.07(c) and (d), transferors can limit their exposure to third parties by expressly delineating for whom the transferor intends to supply the software and for whom it does not and by making clear that effective warranty disclaimers apply to third parties.

### **Implied warranty of no material hidden defect**

Section 3.05(b) of the Software Principles creates a new, nonwaivable, implied warranty of no material defects, which may prove to be the most problematic change presented by the Software Principles. The black letter law of this new implied warranty is short:

A transferor that receives money or a right to payment of a monetary obligation in exchange for the software warrants to any party in the normal chain of distribution

that the software contains no material hidden defects of which the transferor was aware at the time of the transfer. This warranty may not be excluded. In addition, this warranty does not displace an action for misrepresentation or its remedies.

In their Comments, the reporters state that a defect exists “if the software is not fit for its ordinary purpose,” and a “hidden defect” means that, “the defect would not surface upon any testing that was or should have been performed by the transferee.” Although the warranty arises only if the transferor was aware of the defect at the time of transfer,<sup>20</sup> it may be difficult for the transferor to prove that it was not aware of the defect.

In addition, the new implied warranty raises an issue regarding what steps a transferor must take to disclose a hidden defect. The Comments provide that, “a transferor cannot disclaim liability for such a defect, but the transferor can disclose the defect to insulate itself from liability.” A typical software product will contain hundreds of defects, or bugs, as indicated by the lengthy bug reports that vendors maintain. The Comments state that the warranty only applies to material defects, but what constitutes a material defect? The Comments do not answer this question, providing only that “[s]oftware that requires major workarounds to achieve contract-promised functionality and causes long periods of downtime or never achieves promised functionality ordinarily would constitute a material defect.”

In contrast to other implied warranties, the warranty of no hidden material defects cannot be disclaimed, but disclosure of the material will protect the vendor from liability. In the past, bug reports have typically been maintained by vendors as a trade secret since disclosure of the reports would provide competitors with insight regarding the software’s performance. Will software vendors now be required to disclose their bug lists to all prospective customers in

the future in order to protect themselves from breach of the implied warranty of no hidden defects? And, even if the vendor decides to disclose its bug list, what type of disclosure will suffice? The Comments state that, “Disclosure of a material hidden defect occurs when a reasonable transferee would understand the existence and basic nature of a defect.” Although the easiest way for the vendor to make such disclosure might be to post its bug list (or a portion thereof) on its website, the reporters reject this method, stating, “Disclosure ordinarily should involve a direct communication to the transferee, if feasible. A mere posting of defects on the transferor’s website generally should be insufficient.” If “a mere posting” is insufficient, does it become sufficient if the transferor notifies the transferee prior to, or at the time of, contracting that a list of known, material bugs was available on the transferor’s website, or will Section 3.05 require the transferor to hand a copy of the list to its transferee or to attach the list to the agreement?

### **Use of automated disablement**

Section 4.03(b) of the Software Principles provides that a transferor may not use automated disablement “if the process results in the loss of rights granted in the agreement or the loss of use of other software or digital content.” The Comments to Section 4.03 make it clear that this section is intended to apply in both the remedial and other contexts. By way of example, the reporters provide that the section is intended to apply where an agreement provides for a limited period of use so that the transferor has built a “time bomb” into the software to disable its operation at the end of that limited period. Automated disablement is permissible under Section 4.03(b) in such circumstance unless it will result in the loss of use of other software or digital content. Similarly, the transferee may agree to periodically dial in to the transferor’s system to verify that the transferee’s system configuration has not materially changed and if it

has, the transferor may deactivate access to or use of the software, subject to subsection (b). Subsection 4.03(b) also applies if the transferor's system periodically connects to the transferee's system to verify system configuration and deactivates access if the system has changed. However, if the automated disablement harms the transferee's system in any of these instances, the transferee is entitled to recover direct, incidental, and consequential damages, notwithstanding any disclaimer of these damages in the agreement (Section 4.03(e)).

Section 4.03(c) however, provides that a transferor may not use automated disablement as a remedy for breach, if the agreement is a standard-form transfer of generally available software or if the transaction is a consumer agreement.

Where a transferor has a right to cancel a software contract for breach under Section 4.04 (discussed below), and subject to subsection (c), Section 4.03(d) carves out the following very narrow circumstance in which automated disablement will be permitted: (1) an authorization for automated disablement is provided for in the agreement; (2) the term authorizing automated disablement is conspicuous; (3) the transferor provides timely notice of the breach and its intent to use automated disablement, and provides the transferee with a reasonable opportunity to cure the breach and the transferee has not cured the breach; and (4) the transferor has obtained a court order permitting it to use automated disablement.

Failure to meet the above conditions will subject the transferor to direct, incidental and consequential damages caused by the automated disablement, notwithstanding any agreement to the contrary, and the obligations of the parties under Section 4.03 cannot be waived.

### Reasonable notice of cancellation

Section 4.04(b) of the Software Principles seeks to eliminate a generally used

provision in many standard-form agreements that permits the transferor to cancel an agreement without notice in the event of a material breach of the agreement by the transferee. Although Section 4.04(a) provides that an aggrieved party may cancel a contract on a material breach of the whole contract if the breach has not been cured or waived and Section 3.12(a) provides that the parties can agree that there is no right to cure a breach, Section 4.04(c) provides that cancellation is not effective "unless the canceling party gives reasonable notice of cancellation to the party in breach." Although the Comments reinforce that the "notice must be reasonable both as to time and content and should take into account whether the party giving the notice is a business or consumer," no illustrations are included. As a result it is not clear what types of actions will constitute "reasonable notice of cancellation" for purposes of this section.

### Contractual limitations of remedy

As with UCC Article 2, Section 4.01 of the Software Principles provides that if a transferor breaches its agreement, the transferee is entitled to a minimum adequate remedy. The section allows for contractual freedom to limit remedies except in the cases of the implied warranty of no hidden material defects and unauthorized automated disablement. Thus, consequential damages may be limited or excluded except in the cases involving breach of the implied warranty of no hidden material defects or unauthorized use of automated disablement, and this rule applies even if circumstances cause an exclusive or limited remedy to fail of its essential purpose. However, Section 4.01(c) provides that limitation of consequential damages for personal injury in the case of consumer software is *prima facie* unconscionable. According to the Comments, this means that the party seeking enforcement of the consequential damages limitation in this context must produce enough evidence of

the limitation's reasonableness to escape an adverse decision and to require the other party to produce its own evidence.

Finally, Section 4.01(b) provides that where circumstances cause an exclusive or limited remedy to fail of its essential purpose, the injured party may recover a remedy as provided in the Software Principles or under applicable law. The Comments note that a limited remedy fails of its essential purpose if the transferor is unable or unwilling to provide the transferee with conforming software within a reasonable period of time, even if the transferor is using and has used best or good faith efforts to repair the software and is willing to continue trying to repair the software.

### Choice of law and choice of forum provisions

Section 1.13 of the Software Principles provides that the parties to a standard-form transfer of generally available software may by agreement select the law of a domestic or foreign jurisdiction to govern their rights and duties if their transaction bears a reasonable relationship to the selected jurisdiction. The Comments to this section note that the parties cannot circumvent the public policy of the jurisdiction whose law would otherwise govern the agreement. Absent a choice of law provision, the rights and duties of the parties to a standard-form transfer of generally available software are determined (1) in the case of a consumer agreement, by the law of the jurisdiction where the consumer is located, and (2) in all other cases, by the law of the jurisdiction where the transferor is located. The Software Principles are silent regarding choice of law provisions in other software agreements, and the Comments note that "otherwise applicable law ... continues to govern all other choice-of-law issues."

Section 1.14, which governs forum selection provisions in all software agreements, generally provides that these provisions are enforceable "unless the choice is unfair or

unreasonable.” The section elaborates that a forum choice may be unfair or unreasonable if (1) the forum is unreasonably inconvenient for a party; (2) the agreement regarding the forum was obtained by misrepresentation, duress, abuse of economic power, or other unconscionable means; (3) the forum does not have power under its domestic law to entertain the action or award remedies that would otherwise be available; or (4) enforcement of the forum-selection clause would be repugnant to public policy. The Comments note that the Software Principles have adopted a unitary standard that applies to all transfers “because courts should not enforce a choice-of-forum provision that is unfair or unreasonable regardless of whether the term appears in a negotiated or standard-form agreement.” Nevertheless, the reporters note that “courts should be more willing to enforce as fair and reasonable negotiated forum-selection clauses between sophisticated businesses.”

If you have questions about this *Alert*, please contact one of the attorneys listed above. ■

## NOTES

1 The ALI was established in 1923 to promote the clarification and simplification of American common law and has drafted Restatements of the Law in a number of substantive areas. These Restatements set forth the black letter law derived from a comprehensive review of case law, indicate trends in the common law, and occasionally recommend what a rule of law should be. In areas where the case law is less extensive, the ALI

has authored Principles projects. Instead of restating the law, a Principles project reviews the current law and then recommends best practices. The ALI characterizes Principles projects as “expressing the law as it should be, which may not reflect the law as it is.”

2 Although ALI is expected to approve the Software Principles, there is some indication that there may be a last-minute attempt to postpone their adoption.

3 As of March 1, 1995, the Restatements had been cited by U.S. courts 129,533 times. Joseph Devine, *Restatements of the Law*, at <http://ezinearticles.com/?Restatements-of-the-Law+id=1914543>.

4 The Software Principles include some rules that apply only to “standard-form transfers of generally available software,” which are defined as records regularly used to embody terms of agreements of the same type involving a small number of copies of software to an end user, or the right to access to a small number of users, if the software is generally available to the public under substantially the same terms.

5 NCCUSL is a nonprofit association that consists of commissioners appointed in each state to discuss and debate in which areas of the law there should be a uniformity among the states and to draft model acts, called “Uniform Acts,” for adoption by the states.

6 Software is defined as consisting of “statements or instructions that are executed by a computer to produce certain results.” Software Principles, Section 1.01(j)(1).

7 Software Principles, Section 1.01(j)(1). The reporters note in the Comments, however, that courts facing legal issues involving digital art or databases can still look to the Software Principles by analogy, if appropriate.

8 Software Principles, Section 1.01(g).

9 The Comments state that the Software Principles apply to open-source software if the transferor requires the transferee to agree to maintenance or integration services or any other consideration, such as making the transferee’s source code available to third parties. The reporters note that the open-source movement raises novel issues and that some rules that apply to proprietary software “apply awkwardly” to open-source software. Nevertheless, the reporters conclude that the Software Principles can accommodate open-source agreements, subject to the following carve-outs for open-source licenses that do not involve any payment

of money to the transferor: the intellectual property indemnity in Section 3.01 and the implied warranty of no material defects in Section 3.05(b), both of which are discussed later in this article.

10 “End user” is defined as any person or entity, including large or small businesses, but excluding resellers.

11 Software Principles, Section 2.01(b)(1).

12 In such a case, the terms of the contract are terms (whether or not in a record), to which both parties agree, terms that appear in the records of both parties, and terms supplied by the Software Principles or other law. Software Principles, Section 2.01(b)(2).

13 The Reporter’s Notes to Section 2.02 include citations to a handful of cases that have dealt with the claims of incomprehensibility.

14 Software Principles, Section 2.03(c) provides that an agreement modifying a contract will not be enforceable (a) in the event of fraud, duress, or another invalidating cause or (b) if the contract being modified is in a record that includes a clause that excludes modification except by an authenticated record, and the modification is either oral or is not authenticated by the party that contests the modification, unless the party asserting the modification has reasonably relied on a waiver of the no-oral-modification clause.

15 The Comments cite misappropriation of trade secrets as an example of what the term “like right” covers.

16 The Comments provide that parties who have “knowledge or skill peculiar” to the software include software troubleshooters and maintenance craftspeople, who have never before been deemed to warrant or indemnify against noninfringement.

17 Software Principles, Chapter 3, Summary Overview.

18 Software Principles, Section 3.04(a).

19 Software Principles, Sections 3.06(c) and (d). The implied warranties of merchantability and fitness can also be excluded or modified by course of performance, course of dealing, or usage of trade. Section 3.06(f).

20 The Comments provide that, “Negligence on the part of transferors in failing to discover defects is not covered by the Section and is the subject of product-liability law.”