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# CONTRACTING OUT OF ARTICLE 2 USING A “LICENSE” LABEL: A STRATEGY THAT SHOULD NOT WORK FOR SOFTWARE PRODUCTS

*Jean Braucher\**

## I. INTRODUCTION

Legal classification of contracts for software products remains unnecessarily controversial nearly thirty years after the earliest articles on the topic.<sup>1</sup> When the question is whether to apply Article 2 of the Uniform Commercial Code (UCC),<sup>2</sup> there are two legal issues: whether the transaction is a sale, and whether the subject matter is goods.<sup>3</sup> Because treating software products as goods is the easier issue,<sup>4</sup> a useful way to think about the overall question is whether it should be possible to contract out of Article 2 by using a label, that is, by calling the transaction a “license.”<sup>5</sup> The overarching

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1. For some of the early articles, see Susan Nycum, *Liability for Malfunction of a Computer Program*, 7 RUTGERS J. OF COMPUTER TECH. & LAW 1 (1979) (surveying different approaches to liability for errors in computer programs); Andrew Rodau, *Computer Software: Does Article 2 of the Uniform Commercial Code Apply?*, 35 EMORY L.J. 853 (1986) (concluding that Article 2 should apply to software contracts for policy reasons); Bonna Lynn Horovitz, Note, *Computer Software as a Good Under the Uniform Commercial Code: Taking a Byte Out of the Intangibility Myth*, 65 B.U. L. REV. 129 (1985) (dismissing supposed intangibility of software as a reason to exclude software transactions from Article 2); Note, *Computer Programs as Goods Under the U.C.C.*, 77 MICH. L. REV. 1149 (1979) (arguing that sales of computer programs fall within Article 2 of the Uniform Commercial Code (UCC)).

2. U.C.C. Official Text Art. 2 (2000) (amended 2003). The UCC’s sponsors approved proposed amendments to Article 2’s Official Text in 2003 but no state has enacted them.

3. U.C.C. § 2-106(1) (2000) (amended 2003) (defining “sale”); *id.* § 2-105(1) (defining “goods”). Although Article 2’s scope provision, section 2-102, provides that it applies to “transactions in goods,” most of its provisions apply to buyers or sellers and thus seem to require a sale. *Id.* § 2-102; *id.* § 2-103(1)(a), § 2-103(1)(d) (defining “buyer” and “seller”).

4. See *infra* Part III.

5. As will be explained, the best classification of software contracts, both for federal and state law purposes, often may be as both sales of copies and licenses of their use. See *infra* Parts

policy question is whether Article 2, for the issues it addresses, works reasonably well for contracts in software products and should continue to apply.<sup>6</sup> The main argument of this article is that it does work and therefore should apply.

This is not to say that Article 2 answers all the legal issues about software transactions or even software products. Much of the continuing controversy about legal classification of deals in software is caused by intellectual property implications. Clearly, Article 2 does not address issues in conventional intellectual property licensing transactions that give permission to make copies of a copyrighted work for distribution. For transactions involving delivery of software products to customers, however, Article 2 works well for the issues it covers but does not address others. In particular, it does not address whether, for federal intellectual property purposes, end-use customers become owners of copies of software products, with first sale rights to sell those copies as well as rights to copy as necessary for use and archiving.<sup>7</sup> That Article 2 does not answer these federal questions does not suggest, however, that it should not be used on the issues it does address, including contract formation, quality warranties, and damage remedies.

The focus of this article is on the desirability of applying Article 2 to transactions in software products. Furthermore, it attempts to clear away a major distraction, the federal intellectual property law implications of the sale/license distinction.

The controversy about applying Article 2 to software products should not be overstated. Most courts have done so.<sup>8</sup> Even custom software is increasingly treated as governed by the UCC; as Judge Richard Posner put it, referring to a U.S. District Court case applying Article 2 to a license of custom software,<sup>9</sup>

[A]s *Colonial Life* is consistent with the weight of authority

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IV and V.

6. See *infra* notes 8-11 and accompanying text (concerning the emerging consensus in the courts of treating contracts in software products as Article 2 transactions).

7. See *infra* Part IV (discussing classification for federal intellectual property purposes).

8. RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 19 reporter's note on cmt. d (1998) (collecting case law and concluding that mass-marketed software is goods under the UCC while software developed for the customer is services).

9. *Colonial Life Ins. Co. v. Electronic Data Systems Corp.*, 817 F. Supp. 235, 237-39 (D.N.H. 1993) (applying Article 2 to a license of customized software and data processing services because "[t]he essence of the contract was to license . . . a computer software product").

. . . and reaches the right result—for we can think of no reason why the UCC is not suitable to govern disputes arising from the sale of custom software—we’ll follow it.<sup>10</sup>

Despite this emerging consensus in the courts,<sup>11</sup> the sponsors of the Uniform Commercial Code have proposed to roil the waters by excluding undefined “information” from the scope of Article 2.<sup>12</sup> They also propose to add a comment indicating both that application of Article 2 by analogy should still be considered for all software and that some software, such as that in cars, should be directly within Article 2.<sup>13</sup> Since the sponsors have nothing clarifying to say, they would be wiser to remain silent. Better yet, they should put transactions in software products clearly within the scope of Article 2, codifying the usual judicial approach. They might then turn their energy and expertise to articulating legal rules to address the issues in software product transactions on which Article 2 is silent. Eventually, it would be desirable to have a statute stating default use and transfer rights as well as setting limits on use and transfer restrictions in contracts for software products, but it is unnecessary to disturb or tinker with Article 2 to do this.

To facilitate analysis, Part II below gives an example, clearly involving goods, of trying to reclassify a sale by using a license label. Part III addresses the relatively easy issue whether software products meet the definition of goods under Article 2, concluding that they do. Part IV discusses the central intellectual property implications of the classification question, and Part V develops the argument that software product transactions, even if labeled “licenses,” should be treated as sales for purposes of applying Article

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10. *Micro Data Base Systems, Inc. v. Dharma Systems, Inc.*, 148 F.3d 649, 651–54 (7th Cir. 1998) (applying Article 2 to a transaction in customized software under an agreement involving a “license fee”).

11. For other recent cases applying Article 2 to software, *see Wachter Management Co. v. Dexter & Chaney, Inc.*, 282 Kan. 365, 366368-69, 114 P.3d 747 (2006) (in which the Kansas Supreme Court applied Article 2 to licensed software in a transaction also involving maintenance, training, and consulting services); *Youngtech, Inc. v. Beijing Book Co.*, 2006 WL 3903976 (N.J. Super. A.D. 2006) (unpublished opinion treating customized software as covered by Article 2 even though services were involved); *Newcourt Financial USA, Inc. v. FT Mortgage Companies, Inc.*, 161 F. Supp. 2d 894, 897 (N.D. Ill. 2001) (noting that custom software is goods under the UCC, in a case involving licensed custom software and support for that software).

12. U.C.C. § 2-103(1)(k) (2003).

13. *See id.* § 2-103 cmt. 7; *see infra* notes 42-45 and accompanying text for additional discussion of this comment.

2. This approach is functional; Article 2 should apply to transactions in software products because—for the issues it addresses—it works, well enough if not perfectly (and as well as Article 2 works for other products). Also, because many transactions involve hardware as well as software, application of Article 2 to both types of component has the advantage of being an elegantly simple solution to the classification question. While Article 2 does not answer all questions for either hardware or software, it does address state law issues these types of goods have in common.

## II. “LICENSING” GOODS: AN EXAMPLE

Suppose that car dealers started “licensing” cars to customers using contracts headed, “End-User License Agreement” (EULA). Suppose further that dealers used the license label as the basis for a legal argument that these transactions are outside the scope of Article 2 because they are not sales.<sup>14</sup> The judicial response would predictably be negative. Courts would likely come to the following conclusions: If a car dealer wants to disclaim implied warranties,<sup>15</sup> it must do so according to the procedures set forth in Article 2.<sup>16</sup> Furthermore, a dealer must supply material terms before making a contract to avoid the risk that they will not be treated as part of the deal.<sup>17</sup> In addition, if a dealer delivers a car that fails in any respect

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14. See U.C.C. § 2-102 (2000) (amended 2003); see also *supra* note 3 (concerning the language of this section). If the contract is for a period less than the useful life of the car, it might best be classified as a lease under UCC Article 2A. U.C.C. § 2A (2000) (amended 2003). A license either of unlimited duration or for the useful life of the car raises the issue whether to classify the transaction as a sale under Article 2. See *id.* § 2-106(1) (2000) (amended 2003).

15. *Id.* §§ 2-314 to 2-315 (2000) (amended 2003).

16. See *id.* §§ 2-316(2)–(3) (setting forth ways to disclaim implied warranties). Another issue is the scope of the Magnuson-Moss Warranty-Federal Trade Commission Improvement Act, 15 U.S.C. §§ 2301–12 (1975) [hereinafter Magnuson-Moss Warranty Act], which applies to written warranties in connection with sales of consumer products and should apply to software products marketed to consumers.

17. See U.C.C. § 2-207(2) (2000) (amended 2003) (providing that even between merchants any material alteration in delayed terms does not become automatically part of the deal); *id.* § 2-207 cmt. 3 (stating that additional and different terms that are material additions come into the deal only if “expressly agreed to by the other party”); see also *Klocek v. Gateway, Inc.*, 104 F. Supp. 2d 1332, 1339 (D. Kan. 2000) (correcting technical error in analysis in *ProCD, Inc. v. Zeidenberg*, 86 F.3d 1447, 1452 (7th Cir. 1996), which stated that UCC Section 2-207 does not apply to single-form transactions, even though Section 2-207 contains no language which indicates it only applies to “battles of forms” situations); Jean Braucher, *Delayed Disclosure in Consumer E-Commerce as an Unfair and Deceptive Practice*, 46 WAYNE L. REV. 1805, 1821 (2000) (arguing that “[n]othing in the language of Section 2-207 supports the idea that its reach is limited to exchanges of forms—it is not limited to two-form transactions or even to forms at all”).

to conform to the contract, the customer has a right to reject.<sup>18</sup>

Now suppose that the EULA used by car dealers contained some interesting terms limiting use and transfer, stating:

This car is licensed for personal use. You are the only one who may operate it. You may not use it for business purposes. You may not have more than three passengers in the car at any time. You may not comment on or criticize the car. You may not open the hood to see how the engine works or for any other reason. You may not try to repair the car; only authorized dealers may repair the car. You may not sell the car. If you no longer want the car, you must have it compacted or return it to the dealer.

The addition of these “license” terms fails to improve the legal argument that Article 2 does not apply. The transaction should be classified as a sale of a car, governed by Article 2 on the questions that law addresses.

Of course, the enforceability of the use and transfer restrictions is debatable. Article 2 does not address these issues, except perhaps by means of the unconscionability section.<sup>19</sup> The prohibition on opening the hood might violate the federal intellectual property law protection for reverse engineering.<sup>20</sup> The requirement that only authorized dealers may make repairs might also violate federal antitrust law as well as intellectual property law.<sup>21</sup> The prohibitions against having more than three passengers, commenting on or criticizing the car, or selling it might be against public policy under state law.<sup>22</sup> All these issues, however, are distractions from the question whether Article 2 applies to software products. Although Article 2 itself will not necessarily provide answers on these issues, it should still apply to those questions that it does address.

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18. U.C.C. § 2-601 (2000) (amended 2003) (providing for the right to reject tendered goods that “fail in any respect to conform to the contract”).

19. U.C.C. § 2-302 (2000) (amended 2003).

20. Pamela Samuelson & Suzanne Scotchmer, *The Law and Economics of Reverse Engineering*, 111 YALE L.J. 1575, 1584 (2002) (citing Julie E. Cohen & Mark A. Lemley, *Patent Scope of Innovation in the Software Industry*, 89 CAL. L. REV. 1, 6 (2001)) (concerning rights of buyers of patented machines under the first sale principle of patent law to disassemble them to study how they work).

21. See *id.* at 1582–85 (concerning right of disassembly and study); Sherman Antitrust Act, 15 U.S.C. §§ 1–2 (1890) (amended 1990).

22. See RESTATEMENT (SECOND) OF CONTRACTS § 186(1) (1981) (discussing unenforceability on grounds of public policy of promises that restrain trade).

While eventually it would be a good idea to have a federal or state statute that explicitly addresses the enforceability of use and transfer restrictions used commonly in software transactions,<sup>23</sup> courts must use available law in the meantime. But when it comes to issues such as warranties, disclaimers of warranties, contract formation and what terms become part of the contract, buyer's remedies for defective delivery or breach of warranty, and seller's remedies for refusal to take delivery, Article 2 works and should govern.<sup>24</sup> Even if a court were to conclude that Article 2 does not apply directly to a license, it should apply by analogy for these issues.<sup>25</sup>

The car license example could be complicated by having the manufacturer of the car provide the EULA, with the dealer passing it through to end-use customers. The dealer might have a very simple contract stating, "This car is licensed by the manufacturer." The manufacturer's license might be disclosed as follows: The first time the customer gets in the car to drive it, the EULA might appear on the dashboard screen and require a touch "to agree," plus entry of the customer's name or code, before the car could be driven. Under this variation, Article 2 still should apply, at least to the transaction between the dealer and the end-use car customer. If the dealer did not exclude or modify implied warranties according to the requirements of Article 2,<sup>26</sup> the dealer would be liable for them.<sup>27</sup> As

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23. See, e.g., Jean Braucher, *The Failed Promise of the UCITA Mass-Market Concept and Its Lessons for Policing of Standard Form Contracts*, 7 J. SMALL & EMERGING BUS. L. 393, 421–23 (2003) [hereinafter Braucher, *Mass-Market Concept*] (concerning the desirability of having statutory bars to enforcement of mass-market terms prohibiting transfer to the same type of user, comment and criticism, and fair-use reverse engineering).

24. See Radau, *supra* note 1, at 857, 859 (discussing advantages of applying Article 2 to software, including avoiding formalism and the nonuniformity that comes from applying the common law). See also U.C.C. § 1-102, cmt. 1 (2000) (amended 2003) ("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 light of unforeseen and new circumstances and practices."); see also U.C.C. § 1-103 cmt. 1 (2003) (containing similar language).

25. See U.C.C. § 1-102, cmt. 1 (2000) (amended 2003) ("Courts . . . have recognized the policies embodied in an act as applicable in reason to subject-matter which was not expressly included in the language of the act . . . They have done the same where reason and policy so required, even where the subject-matter had been intentionally excluded from the act in general . . . Nothing in this Act stands in the way of the continuance of such action by the courts."); see also U.C.C. § 1-103 cmt. 1 (2003) (containing similar language).

26. See U.C.C. § 2-316(2)–(3) (2000) (amended 2003). A manufacturer who gave a written warranty could not, under the Magnuson-Moss Warranty Act, *supra* note 16, exclude the implied

with car sales (as opposed to the car "license" involved here), the question whether the manufacturer's warranties to the ultimate customer are governed by Article 2 would be in some doubt.<sup>28</sup> At any rate, whether under Article 2 or the common law of contract, EULA terms presented after delivery of the car, and attempting to take away rights to transfer the car and to use it in certain ways, should not become part of the deal.<sup>29</sup>

Another possible variation is that some or all of the software in the car might come with a "license," rather than the entire car being licensed. Again, if Article 2 issues (such as agreement to terms, warranties, remedies) arise, then Article 2 should apply.

### III. SOFTWARE COPIES AS GOODS UNDER ARTICLE 2 OF THE UCC

Obviously, the car licensing examples above are based on current practices of software producers. The use of cars instead of software copies in the examples helps us to see that the license label is used for strategic legal purposes and does not describe some necessary objective reality. In addition, using cars avoids the issue whether the transaction is in "goods."<sup>30</sup> However, this is an issue that needs to be addressed when the transaction is in a copy of a software product, although it is not particularly difficult.

Goods are defined in Article 2 as "all things . . . movable."<sup>31</sup> In

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warranty of merchantability, but it could limit its duration to the duration of an express warranty. 15 U.S.C. § 2308(a)–(b) (1975).

27. U.C.C. § 2-314 (applying an implied warranty of merchantability to all Article 2 sales made by merchants unless excluded or modified); *id.* § 2-315 (applying an implied warranty of fitness for a particular purpose to certain Article 2 sales unless excluded or modified); *id.* § 2-711 (detailing a buyer's remedies for "rightfully reject[ing]" non-conforming goods); *id.* § 2-714 (detailing a buyer's remedies for "any non-conforming of tender" after "the buyer has accepted [the] goods").

28. To address this problem, Amended Article 2 would make manufacturers liable to remote purchasers for obligations undertaken in pass-through warranties. U.C.C. § 2-313A (2003).

29. *See* U.C.C. § 2-207(2) (2000) (amended in 2003). In this example, the manufacturer is attempting to contract directly with the end-user using the car's dashboard screen, eliminating the issue of privity, so that Article 2 § 2-207 should apply directly. Courts often apply Article 2 to manufacturers' warranties even when there is no privity. *See* Braucher, *supra* note 17, at 1824–26. In the hard goods context, manufacturers' terms usually add rights rather than take them away. *Id.* There is even more reason to require advance disclosure where the manufacturer wants to take away transfer and use rights.

30. A car most definitely is a thing moveable at the time of contracting. *See* U.C.C. § 2-105(1) (2000) (amended 2003) (defining goods).

31. *See id.*



all but three states,<sup>32</sup> this is the key operative statutory language concerning whether software products are goods under Article 2. “Thing” is a word of studied imprecision.<sup>33</sup> Moreover, while the modifier “movable” excludes real estate, it is debatable what sort of movability is covered.<sup>34</sup> Even if tangibility is required for a product to be a movable thing (which is not necessarily the case), this hurdle is easily topped.<sup>35</sup> Software copies better be tangible material objects or making unauthorized copies would not be prohibited by copyright law: the Copyright Act defines copies as “material objects . . . from which the work can be perceived . . . either directly or with the aid of a machine . . . .”<sup>36</sup> Digital software copies are machine-readable and thus material objects for purposes of the Copyright Act.<sup>37</sup> There is no good reason not to extend this version of tangibility, assuming tangibility is necessary, to the realm of Article 2. Software copies are perceivable by a machine and in that sense tangible, making them easily “things,” which may not require tangibility. Software copies can be moved in various ways, including on computers and disks and by electronic download.

Furthermore, software copies are distributed as products, like hard goods, or as parts of products that combine software and hardware. Of course some end-use software contracts also include services, such as technical assistance, but this is also true of other types of goods. When both goods and services are involved in one contract, courts face the difficult issue of what law to apply to a mixed transaction, an issue not peculiar to software contracts.<sup>38</sup> As already noted, proposed amendments to Article 2 would exclude

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32. See *infra* notes 46-49 and accompanying text.

33. WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 1226 (Frederick C. Mish ed., Merriam-Webster Inc. 9th ed. 1988) (defining “thing” variously, including as “an object or entity not precisely designated or capable of being designated”).

34. An example where this issue arises is coverage of electricity. See RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 19 cmt. d (1998).

35. Rodau, *supra* note 1, at 862.

36. 17 U.S.C. § 101 (2006).

37. See *MAI Sys. Corp. v. Peak Computer, Inc.*, 991 F.2d 511, 519 (9th Cir. 1993) (finding that even loading software into random access memory (RAM) creates a copy under the Copyright Act); *Vault Corp. v. Quaid Software, Ltd.*, 847 F.2d 255, 260 (5th Cir. 1988) (“Loading a program . . . into a computer’s memory creates a copy of the program.”).

38. See U.C.C. § 2-102 (2000) (amended 2003) (providing that Article 2 applies to “transactions in goods” but not expressly addressing what to do about mixed transactions in goods and services); see also Rodau, *supra* note 1, at 863.

undefined “information” from the definition of goods.<sup>39</sup> The uncertainty of what this exclusion means, if anything, is one of the key reasons the proposed amendments package has not been enacted by any jurisdiction.<sup>40</sup> If information means intangible data, the exclusion adds nothing. No one thinks the sale of the recipe for Coca Cola would be a sale of goods.

The software customer coalition as well as software producers have all opposed the proposed exclusion of information because of its failure to clarify the law.<sup>41</sup> Proposed Comment 7 would only add to the confusion.<sup>42</sup> It states that Article 2, if amended, would “not directly apply to an electronic transfer of information” and cites a case that involved a free download, which is not within Article 2 in any event because no price was charged.<sup>43</sup> The use of the phrase “directly apply” flags that application by analogy is still possible. The comment also states that “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.”<sup>44</sup> The comment thus raises more questions than it answers. Does it matter if the software in a car is “licensed” rather than sold? What if new software is downloaded to the car by the dealer as part of repairs? Would that software be excluded because it was electronically transferred? What is the defensible distinction between downloaded and preloaded software? And what of software preloaded on a

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39. See *supra* notes 12-13 and accompanying text (concerning U.C.C. § 2-103(1)(k) (2003)).

40. The amendments have been introduced in Nevada, Kansas, and Oklahoma but have not been enacted. S.B. 200, 73d Leg. Reg. Sess. (Nev. 2005), available at <http://www.leg.state.nv.us/73rd/bills/SB/SB200.pdf>; H.B. 2454, 2005 Leg., Reg. Sess. (Kan. 2005), available at <http://kslegislature.org/bills/2006/2454.pdf>; H.B. 3129, 50th Leg., 2d Sess. (Okla. 2006), available at [http://webserver1.lsb.state.ok.us/2005-06HB/HB3129\\_int.rtf](http://webserver1.lsb.state.ok.us/2005-06HB/HB3129_int.rtf). See also *infra* notes 46-48 (concerning stealth changes made in Article 2 in Oklahoma). A portion of Amended Article 2 and a few sections of Amended Article 2A were introduced in Oklahoma in 2007 as H.B. 2172; this bill was reported out of committee but remained in limbo as of mid-March 2007.

41. Americans for Fair Electronic Commerce Transactions (AFFECT), Proposed UCITA-related Legislation, <http://ucita.com/legislation.htm#two> (providing reasons for opposition to proposed Amended Article 2 by Americans for Fair Electronic Commerce Transactions, a coalition of software customers including consumers, libraries and businesses) (last visited Feb. 24, 2007); Quentin Riegel, National Association of Manufacturers’ Letter Stating Position on Proposed Amended Article 2, [http://nam.org/s\\_nam/sec.asp?CID=107&DID=105](http://nam.org/s_nam/sec.asp?CID=107&DID=105) (also providing list of “key documents” stating reasons for opposition) (last visited Feb. 24, 2007).

42. See U.C.C. § 2-103 cmt. 7 (2003).

43. *Id.* (citing *Specht v. Netscape Commc’ns Corp.*, 150 F. Supp. 2d 585 (S.D.N.Y. 2001), *aff’d*, 306 F.3d 17 (2d Cir. 2002)). The definition of “sale” in U.C.C. § 2-106(1) requires a price.

44. U.C.C. § 2-103, cmt. 7 (2003).

computer, the most common form of software distribution? Is that like the car example, still directly within Article 2 because the software is delivered loaded on the hardware? And why worry about whether software copies are in or out of Article 2 if ultimately the courts are invited to and likely will apply Article 2 by analogy if it does not apply directly?<sup>45</sup>

Oklahoma is the only state to jump into this briar patch. In a stealth action primarily dealing with Revised Article 1, Oklahoma enacted the exclusion of “information” from the definition of goods under Article 2, although it has not otherwise enacted the proposed Article 2 amendments.<sup>46</sup> In the same stealth maneuver, Oklahoma also excluded “a license of information” from the definition of a “contract for sale,”<sup>47</sup> a non-uniform amendment not part of the proposed Article 2 amendments approved by the UCC’s sponsors.<sup>48</sup> Because “information” is undefined and may only refer to intangible data as opposed to machine-readable products, it is not clear that the exclusion of “a license of information” has the effect of excluding software products from the coverage of Article 2 in Oklahoma.

Two other states, Virginia and Maryland, have enacted the Uniform Computer Information Transactions Act (UCITA) and thus have addressed this issue.<sup>49</sup> Transactions in software products are covered by that statute in those states. Interestingly, UCITA is based in significant part on Article 2 and thus demonstrates the fundamental workability of Article 2 for software contracts.<sup>50</sup>

45. See *supra* note 25 and accompanying text (concerning application of the UCC by analogy).

46. OKLA. STAT. tit. 12A, § 2-105(1) (2004) (excluding undefined “information” from the definition of goods). This change was included in a 2005 bill to enact Revised Article 1. H.B. 2028, 50th Leg. 1st Reg. Sess. at 589 (Okla. 2005). The description of the bill’s purpose concerning this change states only “amending 12A O.S. 2001, Sections 2-103, 2-105, 2-106 and 2-202, which relate to sales . . .” *Id.* at 574.

47. OKLA. STAT. tit. 12A, § 2-106(1) (providing that a contract of sale “does not include a license of information”); H.B. 2028, 50th Leg., 1st Reg. Sess. at 590 (Okla. 2005).

48. See U.C.C. § 2-106 (2003).

49. VA. CODE ANN. §§ 59.1-501.1 to -509.2 (2005), available at <http://leg1.state.va.us/cgi-bin/legp504.exe?000+cod+59.1-501.1>; MD. CODE ANN., COMM. LAW §§ 22-101 to -816 (LexisNexis 2005).

50. See Prefatory Note, Official Text, Uniform Computer Information Transactions Act (2002), available at <http://www.law.upenn.edu/bll/ulc/ucita/2002final.htm> (last visited Feb. 24, 2007) [hereinafter UCITA Official Text] (noting that Article 2 served as a model in part and point of departure for drafting UCITA). Jean Braucher, *New Basics: Twelve Principles for Fair Commerce in Mass-Market Software and Other Digital Products* in Jane K. Winn, ed., CONSUMER PROTECTION IN THE AGE OF THE ‘INFORMATION ECONOMY 179-81 (2006)

However, UCITA tweaks the rules on a number of issues to give more favorable treatment to software producers.<sup>51</sup> Other sellers would no doubt be happy to get the same favorable treatment. The differences between Article 2 and UCITA on issues they both cover have little to do with differences in their subject matter and everything to do with the influence of the software industry on the UCITA drafting process.<sup>52</sup>

#### IV. INTELLECTUAL PROPERTY IMPLICATIONS OF CLASSIFICATION OF SOFTWARE CONTRACTS

The software industry's use of EULAs is only secondarily driven by a desire to escape from Article 2. The main reason for licensing is to try to limit the rights that customers get under intellectual property law when they are deemed owners of copies.<sup>53</sup> Under the Copyright Act, copy owners get first sale rights to sell their copies.<sup>54</sup> Also, copy owners of computer programs get rights to make another copy "as an essential step in the utilization of the computer program in conjunction with a machine . . . or . . . for archival purposes."<sup>55</sup> Federal law does not define a sale for purposes of these rights, and the courts have tended to use state law to answer the issue of transaction type for purposes of applying the provisions on copy owners' rights.<sup>56</sup> This reliance on state law is conceptually problematic: there is no reason to believe Congress meant to delegate to the states the right to define who gets first-sale rights or rights to

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[hereinafter Braucher, *New Basics*] (noting the common history of UCITA, originally conceived as Article 2B of the UCC, in the revision of Article 2). After the American Law Institute pulled out of the project because of dissatisfaction with its technical quality and substantive choices, the National Conference of Commissioners on Uniform State Laws decided to proceed with it as a freestanding uniform law. *See id.* at 181.

51. *See infra* notes 105-110 and accompanying text.

52. Braucher, *New Basics*, *supra* note 50, at 181-82 (summarizing the history of UCITA and discussing its bias toward software producers and against customers).

53. *See* Christian H. Nadan, *Software Licensing in the 21st Century: Are Software "Licenses" Really Sales, and How Will the Software Industry Respond?* 32 AIPLA Q.J. 555, 559-69 (2004) (discussing objective of escaping from the first sale doctrine).

54. 17 U.S.C. § 109(a) (2006) (the owner of a particular copy is entitled without the authority of the copyright owner to sell or otherwise dispose of the possession of that copy).

55. *Id.* § 117(a)(1)-(2).

56. Lothar Determann & Aaron Xavier Fellmeth, *Don't Judge a Sale by Its License: Software Transfers Under the First Sale Doctrine in the United States and the European Community*, 36 U.S.F. L. REV. 1, 29 (2001) (discussing the application of UCC interpretations of the meaning of "sale" when analyzing the question of copy ownership).

copy further.<sup>57</sup> Whether a customer acquires ownership of a copy for copyright purposes should be resolved under federal law in light of federal policies.

Some restrictions on transfer and use of software products are defensible. There are good policy arguments for facilitating price differentiation in the marketing of software products. For example, sellers may charge higher prices for business purposes or for more users while charging lower prices for consumer purposes and fewer users.<sup>58</sup> This value-based pricing means more customers will access the product and producers can reap more profits from their investments in developing software products.<sup>59</sup> To protect price differentiation, it may be necessary to enforce transfer and use restrictions so that customers cannot acquire for one purpose and then use for another higher-priced purpose; customers also should not be able to acquire for one purpose and then transfer to someone in a higher-priced category.<sup>60</sup> It would be desirable to have some form of digital first-sale rights that define what sorts of restrictions on transfer and use should be permissible. End-use customers might be seen as buyers of copies, who get basic transfer and use rights, and, to the extent that they enter into contracts to get greater rights, licensees of those copies as well. Working out the details of a reasonable set of basic digital first-sale rights is beyond the scope of this article.

A difficult issue is what level of remedy, an action for infringement or an action for breach of contract, is needed to facilitate price differentiation.<sup>61</sup> For example, if licensees are “owners” of copies for first sale purposes, they and their transferees would not be infringers if use restrictions were exceeded, assuming

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57. *Id.* at 58-56.

58. See Jean Braucher, *When Your Refrigerator Orders Groceries Online and Your Car Dials 911 After an Accident: Do We Really Need New Law for the World of Smart Goods?* 8 WASH. U. J.L. & POL'Y 241, 253-54 (2002) [hereinafter Braucher, *Smart Goods*] (discussing arguments for price differentiation); see also Michael J. Meurer, *Price Discrimination, Personal Use and Piracy: Copyright Protection of Digital Works*, 45 BUFF. L. REV. 845, 848-49 (1997) (arguing that increasing protections for digital works will facilitate price discrimination, but increased protections are not required to protect copyright holders' profits).

59. Braucher, *Smart Goods*, *supra* note 58, at 254 (explaining the effect of value-based pricing).

60. See *id.*

61. See Nadan, *supra* note 53, at 576-77 (discussing limits of contractual transfer and use restrictions).

they did not exceed Copyright Act rights to copy,<sup>62</sup> but they could be contract breachers, subject to liability for damages.<sup>63</sup> The transaction could be both a sale and license, in which the customer becomes owner of a copy with certain contractual use rights. Under this approach, the customer would be both an owner and a licensee. As owners, customers could sell their copies,<sup>64</sup> but as licensees they would breach their contracts if they sold to someone who made use of the product for a higher-valued use not permitted under the license. Owners of copies have rights to make an additional copy for essential use,<sup>65</sup> but if they wished to make multiple copies for use on different machines or through a network, they would need a license to do so. Again, in this analysis they would be both owners and licensees. The alternative analysis is that they have no rights to transfer or to copy other than rights expressly given by a license, and therefore they and their transferees would be infringers if they exceeded the license. This is probably overkill, making conceptualizing the transaction as both a sale of a copy and a license of its use a better approach.

Accommodation of price discrimination by recognition of the legitimacy of some transfer and use restrictions should not lead to an "anything goes" approach to contractual transfer and use restrictions because some restrictions are anti-competitive.<sup>66</sup> They could be barred by federal law or by state law refusing to enforce contract terms against public policy.<sup>67</sup> A blanket restriction on all transfers is anti-competitive because it can eliminate the beneficial effects of competition from used products.<sup>68</sup> Contractual restrictions on fair

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62. See *id.* at 579–81 (discussing how additional license restrictions on software use bind subsequent users in ways first sale doctrine does not).

63. The original customer would be in breach if it made an unpermitted transfer; the transferee might be in breach if the original customer required an agreement to the license that the transferee then breached. Owners have rights of transfer and limited copying. 17 U.S.C. §§ 109, 117(a)(1) (2006). To exceed the copying permitted to owners of copies, they would need a license from the original seller. See Nadan, *supra* note 53, at 578.

64. 17 U.S.C. § 109 (2006).

65. *Id.* § 117(a)(1).

66. Braucher, *Smart Goods*, *supra* note 58, at 254–57 (discussing the need for limits on contractual restriction of transfer and use).

67. *Id.* at 254–55.

68. *Id.* at 255–56. See also Nadan, *supra* note 53, at 573 (discussing eliminating the availability of used software as a benefit, from the producer's perspective, of avoiding the first sale doctrine using license restrictions).

uses<sup>69</sup> such as criticism and comment are also anti-competitive, keeping important information out of the marketplace.<sup>70</sup> Sweeping restrictions on reverse engineering are also questionable if they have the anti-competitive effect of preventing repair by a customer or third party or adjustment of products to a customer's needs or development of interoperable competing products.<sup>71</sup> Increasingly, fair uses are cut off as a practical matter by digital rights management technology, which cannot be legally circumvented.<sup>72</sup>

The American Law Institute's project on Principles of the Law of Software Contracts<sup>73</sup> suggests there are currently three possible ways to police unreasonable transfer and use restrictions. First, they might be pre-empted by federal law.<sup>74</sup> Second and third, they also might be against public policy or unconscionable under state law.<sup>75</sup> A fourth possibility is that state public policy judgments could be made by state statutes, making certain types of terms unenforceable in general, or unenforceable in mass-market transactions; state statutes also could provide minimum transfer and use rights and provide contract remedies, such as rejection or damages for failure to provide them.<sup>76</sup>

In sum, federal law on transfer and use rights and restrictions is not well developed. Meanwhile, state law should not feel burdened to solve problems of federal law by classifying transactions in state law so as to try to produce particular federal law results. State law should address problems within its scope and leave it to Congress to clarify, if necessary, who has first sale rights. To the extent that federal law leaves issues to contract law, states, of course, can use

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69. 17 U.S.C. § 107 (2006) (describing "fair uses" as also including "news reporting, teaching . . . scholarship, or research").

70. See Braucher, *Smart Goods*, *supra* note 58, at 254.

71. See Samuelson & Scotchmer, *supra* note 20, at 1613–20 (discussing reverse engineering of software for interoperability purposes).

72. See Timothy K. Armstrong, *Digital Rights Management and the Process of Fair Use*, 20 HARV. J. L. & TECH. 49 (2006) (noting this problem and investigating the possibility that new generations of DRM technology might better protect fair use).

73. See AMERICAN LAW INSTITUTE, PRINCIPLES OF THE LAW OF SOFTWARE CONTRACTS (Council Draft No. 1 Nov. 7, 2006).

74. See *id.* at § 1.09.

75. See *id.* at §§ 1.10, 1.11.

76. See Braucher, *Mass-Market Concept*, *supra* note 23, at 421–23 (discussing desirability of targeted regulation of abusive terms in mass-market software contracts); Braucher, *New Basics*, *supra* note 50, at 194–95 (noting desirability of using specific legislation to police unfairness rather than vague doctrines such as unconscionability).

their traditional contract policing powers under the common law or statutes.<sup>77</sup> States could create mandatory or default rules to protect reasonable customer expectations concerning use and transfer of software products. For example, if federal law does not provide any use rights to a customer who “licenses” software, state law might provide a minimum implied license because it would be contrary to reasonable expectations for a customer to pay for a product and not be able to use it.

#### V. SOFTWARE PRODUCT CONTRACTS AS “SALES” FOR ARTICLE 2 PURPOSES

Commercial law typically takes a functional approach to classification. Broadly, this means that classification is made with an eye to whether it produces good results.<sup>78</sup> Furthermore, parties cannot contract out of mandatory rules by relabeling a transaction with a new legal name.<sup>79</sup> Sellers cannot call their deals licenses and escape mandatory obligations of good faith and fair dealing<sup>80</sup> or procedural requirements such as advance disclosure of material terms and disclaimer of warranties in particular ways.<sup>81</sup>

Article 2 defines a sale in terms of the passing of title for a price,<sup>82</sup> but the reference to title is not meant to impose a formal, non-functional approach.<sup>83</sup> Article 2 recognizes that reservation of title is a legal strategy that should be limited in its effect.<sup>84</sup> A title-

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77. See Braucher, *Smart Goods*, *supra* note 58, at 245.

78. See *supra* note 25 (concerning application of the UCC by analogy when a case outside its scope fits within the reason of a rule). This is pure Karl Llewellyn. See KARL LLEWELLYN, *THE BRAMBLE BUSH* 157-58 (1951) (describing the “Grand Tradition” of judging based on “the double maxim: *the rule follows where its reason leads; where the reason stops, there stops the rule*”).

79. An example is calling a transaction a “lease” when it is really a secured sale and thus should be subject to Article 9. See U.C.C. § 1-203(a) (2003) (“whether a transaction in the form of a lease creates a lease or security interest is determined by the facts of each case”); see also *id.* § 1-201(37) (2000) (amended 2003) (containing the same language as the 2003 version).

80. U.C.C. § 2-103(1)(b) (2000) (amended 2003) (defining good faith and fair dealing).

81.<sup>2</sup> *Id.* §§ 2-207, 2-316.

82. *Id.* § 2-106. The price element of the definition has the advantage of excluding open source software that is distributed for free. Article 2, with its implied warranties and damages liability, does not work well for the open source community. See Braucher, *New Basics*, *supra* note 50, at 190.

83. See U.C.C. § 2-401 cmt. 1 (2000) (amended 2003) (explaining that the article does not deal with issues between seller and buyer in terms of whether “title” has passed).

84. *Id.* § 2-401 (providing that any retention or reservation of title by the seller after shipment or delivery is “limited in effect to a reservation of a security interest”).



retention strategy that had been attempted at the time of Article 2's enactment was as a way to have goods sold serve as collateral.<sup>85</sup> Article 2 limited the effect of such a provision to a security interest.<sup>86</sup> When it comes to the effect of a "license" that reserves title to the "licensor," the real question is how to address transfer and use restrictions. A solution is to treat end-use software contracts for software products as both sales under Article 2 and licenses to the extent the contracts set enforceable limits on transfer and use.<sup>87</sup>

Article 2 provides some gloss on transfer restrictions, providing that a buyer may assign all rights unless otherwise agreed.<sup>88</sup> Federal pre-emption and policing based on public policy and unconscionability may set limits on contractual transfer restrictions.<sup>89</sup> Policing for anti-competitive effects, for example of a complete bar on any transfer of a product, can be done under the doctrine of refusal to enforce terms against public policy.<sup>90</sup> The common law supplements the UCC on issues where it is silent.<sup>91</sup> Similarly, contractual use restrictions should be permissible except if pre-empted, contrary to public policy, or unconscionable.<sup>92</sup> As indicated above, new state statutes could be an even better way to set public policy limits on contractual transfer and use restrictions,<sup>93</sup> issues that Article 2 does not address except under the heading of unconscionability.

The key point in a functional approach is that Article 2 addresses well many issues that arise in contracts for software products. Article 2 has a flexible approach to contract formation<sup>94</sup> but sets limits on delayed terms.<sup>95</sup> It provides rules for the creation

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85. *Id.*

86. *Id.*

87. *See supra* notes 57-65 and accompanying text (discussing possibility of this approach under Copyright Act as well).

88. U.C.C. § 2-210(2) (2000) (amended 2003) (providing that the rights of buyers and sellers can be assigned).

89. *See supra* notes 66-75 and accompanying text.

90. *See id.* and *supra* note 22.

91. *See* U.C.C. § 1-103 (2000); U.C.C. § 1-103(b) (2003).

92. *See supra* notes 66-75 and accompanying text.

93. *See supra* note 76 and accompanying text.

94. *See* U.C.C. § 2-204(1) (2000) (amended 2003) (making "any manner sufficient to show agreement" the standard for contract formation).

95. *Id.* § 2-207.

of express warranties<sup>96</sup> and provides implied warranties<sup>97</sup> that can be disclaimed and modified.<sup>98</sup> It also provides rules for tender of delivery and tender of payment.<sup>99</sup> Its remedy scheme provides for exit from transactions when there is a failure to deliver conforming goods,<sup>100</sup> and it provides sellers and buyers with remedies for non-performance and defective performance.<sup>101</sup> If Article 2 did not exist, courts would have to use the common law to fashion rules to govern all these topics. It is no surprise that the courts have turned to Article 2 because it supplies ready-made, workable answers to these common questions.<sup>102</sup>

On some of these issues, UCITA provides different answers, applicable only in Maryland and Virginia.<sup>103</sup> Other states have declined to accept UCITA's more producer-friendly answers, which are a result of capture of the UCITA drafting process by the software industry.<sup>104</sup> UCITA seems to sanction delayed terms, even in online mass-market settings where advance availability is easy to achieve.<sup>105</sup> It also makes it harder for buyers to exit for nonconforming tender,<sup>106</sup> and it reduces the content of the basic implied warranty quality standard.<sup>107</sup> Notably, in the process, it recognizes the need for answers to the same issues addressed in Article 2.<sup>108</sup> UCITA also takes some unreasonable, unbalanced positions on transfer and use rights. It seems to give customers no use rights if the producer does not expressly grant them.<sup>109</sup> It also permits unreasonable contractual

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96. *Id.* § 2-313 (concerning express warranties).

97. *Id.* §§ 2-314, 2-315 (concerning implied warranties of merchantability and fitness for a particular purpose).

98. *Id.* § 2-316 (providing for exclusion and modification of warranties).

99. *Id.* § 2-503 (setting default rules for how and when a seller tenders delivery); *id.* § 2-507 (generally making a buyer's duty to accept and pay for goods conditional on the seller's tender of delivery); *id.* § 2-511 (stating also that "tender of payment is a condition to the seller's duty to tender and complete any delivery").

100. *Id.* § 2-601.

101. *Id.* § 2-703 (listing seller's remedies) and § 2-711 (listing buyer's remedies).

102. *See supra* notes 8-11.

103. *See supra* note 49.

104. Braucher, *New Basics*, *supra* note 50, at 181-82.

105. *See* UCITA Official Text, *supra* note 50, §§ 112, 209.

106. *See id.* § 601(b)(1)-(2) (setting material breach as the standard to refuse a performance).

107. *See id.* § 403 (reducing the content of the implied warranty of merchantability by excluding "pass[ing] without objection in the trade," which is part of UCC section 2-314(2)(a)).

108. *See supra* note 50 and accompanying text.

109. *See* UCITA Official Text, *supra* note 50, at § 307.

limits on transfer rights and on public comment and reverse engineering.<sup>110</sup>

A few of the rules in Article 2 are a bit awkward as applied to software. For example, the risk of loss rules shift the risk to the buyer in certain circumstances<sup>111</sup> where, for software, it might make sense to leave the risk with the seller because making another copy of software involves minimal cost. Furthermore, the default warranty of title provision may assume that title questions are more straightforward than is the case with software copies, with greater risk of infringement claims, but provisions for variation by agreement provide leeway to fashion appropriate contract terms.<sup>112</sup> These problems are minor, however, and do not detract from the overall conclusion that Article 2 works as a framework for contracts in software products. They are no greater than many of the minor problems with Article 2 as applied to other goods.<sup>113</sup> Article 2 is

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110. *See id.* at § 503(2) (in general permitting restrictions on transfer, with a few very limited exceptions for gift transfers with a computer to a public elementary or secondary school, to a public library, or from a consumer to a consumer but not for second-hand sales by a consumer to consumer, even with a computer, or for gifts to any college, even though the transferor does not keep a copy) and § 105(c) (protecting certain public comment but not other public comment, specifically comment by anyone other than an end-user and even end-user comments on products not in final form) and § 118 (protecting only reverse engineering for interoperability of an independently created computer program when the elements studied were not previously readily available, but not protecting reverse engineering to fix bugs, customize to a user's needs or to detect infringement); *see also* Braucher, *New Basics*, *supra* note 50, at 182, and accompanying notes.

111. U.C.C. §§ 2-509, 2-510 (2000) (amended 2003).

112. *Id.* § 2-312(1)(a) (providing the buyer with a warranty of good title). *But see id.* §§ 2-312(2)–(3) (permitting variation by agreement).

113. For example, the section on express warranties sets a vague “basis of the bargain” test for affirmations of fact and promises to be treated as express warranties. *Id.* § 2-313. This test could no doubt be improved upon for all goods, hardware and software alike, to avoid the undesirable possible interpretation that specific reliance by a particular buyer need be proved (which is especially undesirable in the mass-market, where buyers pay for express warranties whether or not they are aware of them). If an amended Article 2 project eventually becomes politically possible, such issues could be addressed along with some of the minor awkwardness of Article 2 as applied to software products. *See supra* notes 111-112 and accompanying text. There are more major problems with Article 2 as applied to some sorts of transactions, such as consumer transactions. The lack of specificity of Article 2 on many issues makes it too expensive for consumers to litigate claims concerning small dollars amounts. *See* William C. Whitford, *Structuring Consumer Protection Legislation to Maximize Effectiveness*, 1981 WIS. L. REV. 1018 (discussing the value of specificity in statutory commands). This is why consumer legislation, such as the Magnuson Moss Warranty Act, *supra* note 16, providing for attorneys' fees to be recoverable when consumers prevail in warranty actions, 15 U.S.C.A. at § 2310(d), is needed as an overlay on Article 2.

famously flexible and open-textured,<sup>114</sup> which is how it manages to cover everything from grain to stock animals to manufactured goods and now software products.

## VI. CONCLUSION

Classification of end-use software contracts as Article 2 sales makes functional sense. Article 2's provisions on what terms become part of the contract, on warranties, and on remedies all work for software product transactions. If Article 2 did not apply, it would be necessary to make up rules on all these topics. This is not to say that Article 2 addresses all of the significant issues concerning contracts for software products. It does not address transfer and use restrictions. Law reformers should save their energy for addressing these new, important issues concerning software and leave Article 2 to address the issues that are common to hardware and software. Furthermore, the issue whether end-use software transactions are "sales" under Article 2 should not turn on possible implications for federal intellectual property law, in particular for the first sale doctrine. It is the job of Congress to clarify federal intellectual property rights.

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114. See Richard Danzig, *A Comment on the Jurisprudence of the Uniform Commercial Code*, 27 STAN. L.REV. 621 (1975).

