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SOFTWARE LICENSES

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I. Introduction

§ 18:1. Licenses are long-term transactions

In its most basic form, a software license relationship looks much like a standard business transaction. The licensee pays a stated consideration and, in return, the licensee receives one copy of the software from the licensor or other authorized source. The licensee installs the software on its computer system. The licensee's single authorized user immediately grasps how to use it. The licensor receives the occasional testimonial letter from the licensee, but otherwise never hears from the licensee again.

In reality, most software licenses do not resemble neat, cut-and-dried transactions of this kind. Often, a great many real-world issues complicate the transaction. To name but a few:

- *Installation and Implementation Issues*. At the very outset, licensors and licensees can have trouble installing and implementing the software. While some stand-alone systems may avoid many of the issues associated with installation and implementation, systems that must integrate with licensee's environment and existing systems can be complex and extremely customized. Each individual licensee typically will have its own computer systems with its own specific combinations of hardware (motherboards, CPUs, network connections, other add-in cards), and software (operating systems, network operating systems, drivers, other application software). If the licensor does not fully analyze the licensee's environment and existing systems and the licensee does not include the appropriate contractual protections, installation and implementation can be a problematic stage in the software licensing process.
- *Training Issues*. Software is not always intuitive to use. Licensees' employees will typically require some level of training. Moreover, as time goes on and the software is upgraded and modified, new employees may need to be trained.
- *Bug Fixes*. It is commonly accepted in the software industry that there is no such thing as bug-free software. Even software that is bug-free under initial use conditions may have problems as equipment is upgraded and other application programs are added. Who will bear the risks associated with such bugs is often a significant issue.
- *Maintenance and Support*. Almost all software licenses of a commercial nature will involve the provision by the licensor of maintenance and support services on an ongoing basis to provide licensee with software upgrades, enhancements, and other improvements, as well as error corrections, and general telephone assistance regarding the use of the software.

§ 18:2. The license as business relationship

A more realistic way of viewing a software license is as an ongoing relationship. From the time of execution of the license agreement until the time the license expires, the licensor and licensee will encounter a variety of situations relating to the software. Each party, at each point along the way, will have its own specific requirements. The license agreement negotiations between the parties should take into account those situations and each party should attempt to include contractual provisions that address their particular requirements.

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II. Basic Law: The Uniform Commercial Code

§ 18:3. Application to software license agreement

Many software license transactions will be covered by Article 2 of the Uniform Commercial Code (UCC), despite the fact that most license documents, usually drafted by licensors, go to great pains to disclaim any transfer of ownership in the software or any copy thereof to the licensee.

Many courts have deemed software license agreements as being governed by Article 2 of the UCC. Applying a "predominant element" test, they examine the transaction in its entirety to identify its most significant element. If the predominant element is the sale of goods, with the rendering of services being only incidental (even when the software is being custom-developed), then the agreement is deemed to involve a transaction in goods and therefore to be subject to Article 2.[1] Judges apparently prefer the familiarity of the UCC to the less-developed body of law that might otherwise apply.[2] A few courts, however, have held that custom-software development contracts were for services, not goods, and therefore were not governed by the UCC.[3]

The UCC contains general provisions governing a sale of goods transaction, as well as some specific provisions (e.g., implied warranties). As discussed below, the parties can "write around" the UCC by including appropriate contractual provisions that provide the protections they require. Considering the uncertainty of whether the UCC will apply to a particular transaction, each party to the license agreement should consider including the warranties they require in the license agreement itself rather than relying on the applicability of the UCC implied warranties. The following sections summarize the provisions of the UCC that may be applicable to a software license agreement, assuming the transaction is characterized predominantly as a sale of goods and that the provisions below have not been disclaimed in the license agreement.

[FN1] *See, e.g.,* Advent Systems Ltd. v. Unisys Corp., 925 F.2d 670, 673–76, 13 U.C.C. Rep. Serv. 2d 669 (3d Cir. 1991) (under Pennsylvania law, definition of "goods" is wide-ranging; software as distributed is tangible, analogous to musical performances distributed on compact discs); RRX Industries, Inc. v. Lab-Con, Inc., 772 F.2d 543, 545–46, 41 U.C.C. Rep. Serv. 1561 (9th Cir. 1985); Ask Technologies, Inc. v. Cablescope, Inc., 51 U.C.C. Rep. Serv. 2d 1028 (S.D. N.Y. 2003) (contract for sale of computer hardware, software, and installation was subject to U.C.C. Art. 2 where bulk of contract's value was attributable to hardware); ePresence, Inc. v. Evolve Software, Inc., 190 F. Supp. 2d 159, 47 U.C.C. Rep. Serv. 2d 132 (D. Mass. 2002) (contract for licensed software and maintenance services concerned sale of both goods and services; as contract's terms made clear, software programs themselves were essence of contract and California's enactment of the U.C.C. applied to parties' transaction); State v. Kelley, 206 Conn. 323, 537 A.2d 483 (1988); Chatlos Systems, Inc. v. National Cash Register Corp., 479 F. Supp. 738, 27 U.C.C. Rep. Serv. 647 (D.N.J. 1979), aff'd in part, remanded in part, 635 F.2d 1081, 30 U.C.C. Rep. Serv. 416 (3d Cir. 1980); Triangle Underwriters, Inc. v. Honeywell, Inc., 457 F. Supp. 765, 767, 24 U.C.C. Rep. Serv. 1088 (E.D. N.Y. 1978), aff'd in part, rev'd in part on other grounds, 604 F.2d 737, 26 U.C.C. Rep. Serv. 1162 (2d Cir. 1979); Delorise Brown, M.D., Inc. v. Allio, 86 Ohio App. 3d 359, 620 N.E.2d 1020, 1021–22, 22 U.C.C. Rep. Serv. 2d 485 (8th Dist. Cuyahoga County 1993); Systems Design and Management Information, Inc. v. Kansas City Post Office Employees Credit Union, 14 Kan. App. 2d 266, 788 P.2d 878, 881–83, 11 U.C.C. Rep. Serv. 2d 775 (1990) (software in suit was "goods"; buyer purchased only a reproduction of the programmer's skill, and was interested only in the outcome of running the program and whether it would perform the functions for which purchased); Communications Groups, Inc. v. Warner Communications, Inc., 138 Misc. 2d 80, 527 N.Y.S.2d 341, 6 U.C.C. Rep. Serv. 2d 636 (N.Y. City Civ. Ct. 1988) (denying motion to dismiss UCC claim; custom-software contract was for goods, not services); Neilson Business Equipment Center, Inc. v. Italo V. Monteleone, M.D., P.A., 524 A.2d 1172, 1174–75, 3 U.C.C. Rep. Serv. 2d 1721 (Del. 1987) (citing cases; UCC was applicable to sale of computer system with software to be customized for user's needs). *Cf.* Adobe Systems Inc. v. One Stop Micro, Inc., 84 F. Supp. 2d 1086, 53 U.S.P.Q.2d 2003 (N.D. Cal. 2000) (licensor of typefaces sued Adobe for breach of contract when Adobe removed licensor's typefaces from Adobe software ceased to grant license extensions for typefaces to Adobe's licensee, arguing that the court should read requirement that Adobe must continue to include licensor's typefaces in Adobe's software based on course of conduct between parties as permitted under Article 2 of U.C.C.; U.C.C. held inapplicable because sale of goods was not involved in that in Illinois an agreement that does not involve a transfer of title cannot be Article 2 sale); Adobe Systems, Inc. v. Stargate Software Inc., 216 F. Supp. 2d 1051, 48 U.C.C. Rep. Serv. 2d 489 (N.D. Cal. 2002) (Adobe licensed rather than sold educational software through reseller and end user license agreements; "first sale" defense was not available in Adobe's copyright infringement action against distributor for reselling educational software to retail customers).

[FN2] *See* Advent Systems, 925 F.2d at 673–76 (holding that benefits of certainty and other policy reasons support applying well-established UCC principles to software).

[FN3] E.g., Multi-Tech Systems, Inc. v. Floreat, Inc., 47 U.C.C. Rep. Serv. 2d 924 (D. Minn. 2002) (contracts relating to party's contribution of knowledge and expertise to design and development of product containing software was not sale of software in tangible medium subject to U.C.C.; evidence of oral agreement as well as parties' conduct was therefore material in determining whether modification or rescission of contract occurred); Ringtrue, Inc. v. McWethy, 235 Wis. 2d 275, 2000 WI App 116, 616 N.W.2d 524 (Ct. App. 2000) (contract to design and furnish software program was predominantly for services; U.C.C. warranties held inapplicable); Micro-Managers, Inc. v. Gregory, 147 Wis. 2d 500, 434 N.W.2d 97, 7 U.C.C. Rep. Serv. 2d 1375 (Ct. App. 1988) (affirming judgment against software development customer; contract for initial development of software was for services, not goods, and UCC did not apply), *following* Data Processing Services, Inc. v. L.H. Smith Oil Corp., 492 N.E.2d 314, 1 U.C.C. Rep. Serv. 2d 29 (Ind. Ct. App. 1986).

§ 18:4. Express warranties under the UCC

An express warranty is defined in the UCC: "Any affirmation of fact or promise made by the seller which relates to the goods *and becomes part of the basis of the bargain* creates an express warranty that the goods shall conform to the affirmation or promise."[1] In particular, "[a]ny description of the goods which is made part of the basis of the bargain creates an express warranty that the goods shall conform to the description."[2]

Absent a proper integration clause, the affirmation of fact can be external to the sales agreement, e.g., in sales literature or sales-force oral description.[3] "It is not necessary to the creation of an express warranty that the seller use formal words such as 'warrant' or 'guarantee' or that he have a specific intention to make a warranty, but an affirmation merely of the value of the goods or a statement purporting to be merely the seller's opinion or commendation of the goods does not create a warranty."[4]

[FN1] UCC § 2-313(2)(a) (emphasis supplied).

[FN2] UCC § 2-312(1)(b).

[FN3] *See, e.g.*, Latham and Associates, Inc. v. William Raveis Real Estate, Inc., 218 Conn. 297, 589 A.2d

337, 342, 14 U.C.C. Rep. Serv. 2d 394 (1991) (affirming judgment in favor of buyer; vendor's misrepresentation that it would develop a software system suitable for the plaintiff's needs constituted an express warranty that would be enforced notwithstanding disclaimer of warranties). *See* Caudill Seed and Warehouse Co., Inc. v. Prophet 21, Inc., 123 F. Supp. 2d 826, 43 U.C.C. Rep. Serv. 2d 1 (E.D. Pa. 2000), on reconsideration in part, 126 F. Supp. 2d 937, 43 U.C.C. Rep. Serv. 2d 849 (E.D. Pa. 2001) (software contractor's promise to replace or repair construed as express warranty; purchaser's action for breach not barred by license's limitation of liability clause).

[FN4] UCC § 2-313(3).

§ 18:5. UCC implied warranties

The UCC provides that sellers are deemed to make a variety of implied warranties unless a proper disclaimer is used. However, most vendors' standard form software license agreements contain language disclaiming some, if not all, of these warranties:

1. *Warranty of Title*. Under UCC § 2-312, a seller of goods implicitly warrants that the title transferred is good and free from liens or encumbrances of which the buyer has no knowledge. The implied warranty of title can only be disclaimed "by specific language or by circumstances which give the buyer reason to know that the seller does not claim title, that the seller is purporting to sell only the right or title as the seller or a third person may have, or that the seller is selling subject to any claims of infringement or the like."[1] Courts generally construe this provision strictly, and tend not to give effect to imprecise general disclaimers.[2]

2. *Warranty of Non-infringement*. The implied warranty of non-infringement arises in every sale of goods by "a seller that is a merchant regularly dealing in goods of the kind."[3] A merchant is "a person that deals in goods of the kind or otherwise holds itself out by occupation as having knowledge or skill peculiar to the practices or goods involved in the transaction or to which the knowledge or skill may be attributed by the person's employment of an agent or broker or other intermediary that holds itself out by occupation as having the knowledge or skill."[4] A buyer who furnishes the seller with specifications, however, must hold the seller harmless for claims arising out of the seller's compliance with the specifications.[5]

3. *Warranty of Merchantability*. A seller who is "a merchant with respect to goods of [the] kind [being sold]" (see the previous paragraph for a definition of "merchant") is deemed to make an implied warranty of merchantability.[6] "Merchantability" is defined as meaning, inter alia, that the goods in question pass without objection in the trade "under the contract description" (e.g., absent agreement a spreadsheet program probably cannot be sold as a word processor), are fit for the "ordinary purposes" for which goods of that description are used, and are adequately contained, packaged, and labeled as the agreement may require.[7] The implied warranty of merchantability can be excluded or modified by language which mentions merchantability and, if in writing, is "conspicuous."[8]

4. *Warranty of Fitness for a Particular Purpose*. The implied warranty of fitness for a particular purpose arises "[w]here the seller at the time of contracting has reason to know any particular purpose for which the goods are required and that the buyer is relying on the seller's skill or judgment to select or furnish suitable goods …."[9] A disclaimer of fitness for a particular purpose must be in a conspicuous writing.[10]

5. *Warranty from Course of Dealing or Usage*. The UCC provides that "[u]nless excluded or modified …, other implied warranties may arise from course of dealing or usage of trade."[11]

[FN1] UCC § 2-312(3).

[FN2] *See, e.g.*, Sunseri v. RKO-Stanley Warner Theatres, Inc., 248 Pa. Super. 111, 374 A.2d 1342, 22 U.C.C. Rep. Serv. 41 (1977) (disclaimer that seller is transferring only such ownership interest as he has is ineffective as a disclaimer of the implied warranty of title).

[FN3] UCC § 2-312(3).

[FN4] UCC § 2-104(1) (emphasis supplied).

[FN5] UCC § 2-312(2).

[FN6] UCC § 2-314(1).

[FN7] UCC § 2-314(2).

[FN8] UCC § 2-316(2); *see also* discussion of conspicuousness requirement in § 18:48.

[FN9] UCC § 2-315.

[FN10] UCC § 2-316(2); *see also* discussion of conspicuousness requirement in § 18:48.

[FN11] UCC § 2-314(3).

§ 18:6. Incidental and consequential damages

One of the major concerns of any software licensor is the prospect of consequential damages arising from defects in the software. Section 2-715(2)(a) of the UCC defines the consequential damages available to a buyer as including "any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise."[1]

Section 2-719(3) provides, however, that "[c]onsequential damages may be limited or excluded unless the limitation or exclusion is unconscionable."[2] Most software vendors' standard license agreements contain language excluding both consequential and incidental damages.

[FN1] UCC § 2-715(2)(a).

[FN2] UCC § 2-719(3).

§ 18:7. Limitation of remedies

Section 2-719 of the UCC provides that parties to a sales contract "may limit or alter the measure of damages recoverable under this Article, as by limiting the buyer's remedies to return of the goods and repayment of the price or to repair and replacement of non-conforming goods or parts …."[1] If the agreement expressly so states, resort to a specified remedy is exclusive.[2] However, the same section provides that "[w]here circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided in this Act,"[3] possibly including incidental and consequential damages.[4] An exclusive remedy can be deemed to fail of its essential purpose if "goods which buyer purchases are not substantially defect free, and in addition seller is unwilling or unable to conform goods to contract."[5]

Most courts have upheld exclusions of consequential damages (absent unconscionability) even after an exclusive remedy fails of its essential purpose.[6] Not all courts take that position, however. In one opinion, the Ninth Circuit held that "the default of the seller [was] so total and fundamental that its consequential damages limitation was expunged from the contract."[7] That court even went so far as to say that "[u]nconscionability is irrelevant in determining whether to invalidate a consequential damages limitation."[8]

[FN1] UCC § 2-719(1)(a). *See* i.Lan Systems, Inc. v. Netscout Service Level Corp., 183 F. Supp. 2d 328, 68 U.S.P.Q.2d 1832, 46 U.C.C. Rep. Serv. 2d 287, 106 A.L.R.5th 743 (D. Mass. 2002) (even if software purchaser could establish breach of sales agreement, software clickwrap license agreement limited liability of software seller to purchase price of software; purchaser was not entitled to specific performance or relief under state consumer protection law).

[FN2] UCC § 2-719(1)(b).

[FN3] UCC § 2-719(2).

[FN4] UCC § 2-719(2).

[FN5] Office Supply Co., Inc. v. Basic/Four Corp., 538 F. Supp. 776, 34 U.C.C. Rep. Serv. 857 (E.D. Wis. 1982); Chatlos Systems, Inc. v. National Cash Register Corp., 479 F. Supp. 738, 27 U.C.C. Rep. Serv. 647 (D.N.J. 1979), aff'd in part, remanded in part, 635 F.2d 1081, 30 U.C.C. Rep. Serv. 416 (3d Cir. 1980) (holding that remedy limited to correction of defects that appeared within 60 days after furnishing of computer program had failed of its essential purpose).

[FN6] *See, e.g.,* Caudill Seed and Warehouse Co., Inc. v. Prophet 21, Inc., 123 F. Supp. 2d 826, 43 U.C.C. Rep. Serv. 2d 1 (E.D. Pa. 2000), on reconsideration in part, 126 F. Supp. 2d 937, 43 U.C.C. Rep. Serv. 2d 849 (E.D. Pa. 2001) (software licensor claimed that licensee could not recover for breach of warranty because license agreement limited remedies to repair or replacement measures and disclaimed indirect, consequential, or resulting damages; damages disclaimer was inoperative under Pennsylvania law where licensor's intentional or negligent acts stymied licensee's efforts to take advantage of exclusive remedy); Office Supply Co., Inc. v. Basic/Four Corp., 538 F. Supp. 776, 788, 34 U.C.C. Rep. Serv. 857 (E.D. Wis. 1982) (even after failure of exclusive remedy, buyer is limited to expectation damages if exclusion of incidental and consequential damages was not unconscionable); Chatlos Systems, Inc. v. National Cash Register Corp., 479 F. Supp. 738, 27 U.C.C. Rep. Serv. 647 (D.N.J. 1979), aff'd in part, remanded in part, 635 F.2d 1081, 30 U.C.C. Rep. Serv. 416 (3d Cir. 1980).

[FN7] RRX Industries, Inc. v. Lab-Con, Inc., 772 F.2d 543, 547, 41 U.C.C. Rep. Serv. 1561 (9th Cir. 1985) (citation omitted).

[FN8] RRX Industries, 772 F.2d at 547 n.4. *See also* Ragen Corp. v. Kearney & Trecker Corp., 912 F.2d 619, 625 (3d Cir. 1990) (failure of exclusive remedy negated damages disclaimer); Caudill Seed, 123 F. Supp. 2d at 832 (same); Amsan, LLC v. Prophet 21, Inc., 45 U.C.C. Rep. Serv. 2d 1089 (E.D. Pa. 2001) (same defendant, same judge, same holding as Caudill Seed opinion).

§ 18:8. The UCC as creator of fact issues

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Article 2, in its present form, is thought by some to be too much of a "blunt instrument," in the words of a respected Silicon Valley attorney. It should be clear from the summary above that many provisions of Article 2 leave much, perhaps too much, to be determined after the fact if the parties do not cover the right bases in their agreement.

It is almost a certainty that in a software licensing dispute, trial counsel will attempt to show the existence of a genuine issue of material fact on any of a variety of points. A quick, inexpensive summary judgment could easily be impossible. The parties would then enjoy the delights of the discovery process and of trial.

The UCC thus could be considerably less than ideal for use in governing a negotiated software license relationship. As a result, counsel drafting license agreements normally attempt to "write around" it. One approach to doing so is discussed in §§ 18:22 to 18:78 below.

III. Laws Affecting Software Licensing

§ 18:9. The Uniform Computer Information Transactions Act (UCITA)

In the 1990s, the National Conference of Commissioners on Uniform State Laws (NCCUSL) undertook a major project, spearheaded by Professor Raymond T. Nimmer of the University of Houston School of Law, to develop a proposed new Article 2B for the UCC, covering software licensing and other information-technology transactions. Political opposition caused the proposed new Article to be recast as the standalone Uniform Computer Information Transactions Act (UCITA). Even UCITA, however, continues to run into stiff opposition from the plaintiffs' bar, consumer groups, some large corporations, and various other constituencies who want to be able to hold software companies' feet to the fire. At this writing, UCITA has been enacted only in Maryland[1] and Virginia.[2] Some states, such as North Carolina, West Virginia, and Iowa, have passed "bomb shelter" legislation to protect their citizens by avoiding choice of law in Maryland or Virginia.[3]

[FN1] Md. Code Ann., Com. Law §§ 22-101 to 22-816.

[FN2] Va. Code Ann. §§ 59.1-501.1 to 59.1-509.2.

[FN3] N.C. Gen. Stat. § 66-329, W. Va. Code § 55-8-15, Iowa Code § 554D.125. The Iowa statute reads: "A choice of law provision in a computer information agreement which provides that the contract is to be interpreted pursuant to the laws of a state that has enacted the uniform computer information transactions Act, as proposed by the national conference of commissioners on uniform state laws, or any substantially similar law, is voidable and the agreement shall be interpreted pursuant to the laws of this state if the party against whom enforcement of the choice of law provision is sought is a resident of this state or has its principal place of business located in this state. For purposes of this section, a *"computer information agreement"* means an agreement that would be governed by the uniform computer information transactions Act or substantially similar law as enacted in the state specified in the choice of laws provision if that state's law were applied to the agreement."

§ 18:10. Tort liability and the economic loss doctrine

Software customers who sue their vendors sometimes plead tort claims such as fraud, misrepresentation, or professional negligence. The usual reason for doing so is to avoid a bar to recovery under a contract theory, e.g., a contractual disclaimer of warranties or a limitation of liability, or to take advantage of a longer statute of limitation in tort.

Absent personal injury or damage to property outside the contemplation of the parties, however, in most jurisdictions such tort claims will be difficult or impossible to assert successfully, primarily because of the economic loss doctrine. That doctrine provides that "[w]here a purchaser's expectations in a sale are frustrated because the product he bought is not working properly, his remedy is said to be in contract alone, for he has suffered only 'economic' losses."[1] Some courts broadly reject "tort" actions or "products liability" actions, while others apply the economic-loss doctrine more narrowly to negligence claims.[2]

Some jurisdictions will permit a tort action to proceed on a fraud theory. Even in those jurisdictions, however, it may be necessary for a plaintiff to prove fraud in the inducement, in which the customer is tricked into entering into the agreement in the first place, as opposed to so-called fraudulent misrepresentation claims that are factually indistinguishable from breach-of-warranty claims.[3]

In some jurisdictions, however, proof of misrepresentation can be enough to permit recovery of "reliance" damages, i.e., expenses incurred in reliance on a contractual commitment that was not met, under a promissory-estoppel theory, notwithstanding contractual disclaimers of warranties and limitations of liability.[4] Misrepresentation might take the form of making unqualifiedly positive statements about what the software will be able to do, while withholding information about as-yet unsolved problems in getting the software to do it.[5]

In the past, the courts were not especially receptive to claims of professional malpractice against computer programmers or their employers.[6] In recent years, however, some courts have been more willing to allow such recovery.[7]

[FN1] Kennedy v. Columbia Lumber and Mfg. Co., Inc., 299 S.C. 335, 384 S.E.2d 730 (1989), quoted in Neibarger v. Universal Cooperatives, Inc., 439 Mich. 512, 520, 486 N.W.2d 612, Prod. Liab. Rep. (CCH) P 13215, 18 U.C.C. Rep. Serv. 2d 729 (1992), and in Huron Tool and Engineering Co. v. Precision Consulting Services, Inc., 209 Mich. App. 365, 532 N.W.2d 541, 26 U.C.C. Rep. Serv. 2d 703 (1995) (affirming, in pertinent part, summary judgment that software customer's fraud claim was indistinguishable from its breach of warranty claim and thus was barred by economic-loss doctrine).

[FN2] *See, e.g.,* Transport Corp. of America, Inc. v. International Business Machines Corp., Inc., 30 F.3d 953, 956, Prod. Liab. Rep. (CCH) P 14034, 24 U.C.C. Rep. Serv. 2d 471 (8th Cir. 1994) (affirming summary judgment against purchaser in favor of manufacturer of disk drives; applying Minnesota law); Detroit Edison Co. v. NABCO, Inc., 35 F.3d 236, 239–41, Prod. Liab. Rep. (CCH) P 14016, 24 U.C.C. Rep. Serv. 2d 850, 1994 FED App. 0304P (6th Cir. 1994) (affirming summary judgment against electric utility, in favor of pipe supplier, on products-liability claim arising from explosion of defective pipe; under Michigan law, tort claims for damage to other property are barred by economic loss doctrine if those losses are direct and consequential losses that were within the contemplation of the parties and that, therefore, could have been the subject of negotiations between the parties); Aloe Coal Co. v. Clark Equipment Co., 816 F.2d 110, 117, Prod. Liab. Rep. (CCH) P 11387, 25 Fed. R. Evid. Serv. 441, 3 U.C.C. Rep. Serv. 2d 966 (3d Cir. 1987) (applying Pennsylvania law; negligence); Bethlehem Steel Corp. v. Chicago Eastern Corp., 863 F.2d 508, Prod. Liab. Rep. (CCH) P 12004, 27 Fed. R. Evid. Serv. 557, 7 U.C.C. Rep. Serv. 2d 399 (7th Cir.

1988) (affirming judgment on the pleadings in favor of supplier under Illinois law); Colonial Park Country Club v. Joan of Arc, 746 F.2d 1425, 1428 (10th Cir. 1984) (applying New Mexico law; products liability); Purvis v. Consolidated Energy Products Co., 674 F.2d 217, 222 (4th Cir. 1982) (applying South Carolina law; strict liability); Public Service Co. of New Hampshire v. Westinghouse Elec. Corp., 685 F. Supp. 1281, Prod. Liab. Rep. (CCH) P 11949, 7 U.C.C. Rep. Serv. 2d 1422 (D.N.H. 1988) (applying New Hampshire law; strict liability and negligence); Frey Dairy v. A.O. Smith Harvestore Products, Inc., 680 F. Supp. 253, Prod. Liab. Rep. (CCH) P 11832, 6 U.C.C. Rep. Serv. 2d 440 (E.D. Mich. 1988), decision aff'd, 886 F.2d 128, Prod. Liab. Rep. (CCH) P 12386, 9 U.C.C. Rep. Serv. 2d 925 (6th Cir. 1989) (applying Michigan law; all tort remedies); Corporate Air Fleet of Tennessee, Inc. v. Gates Learjet, Inc., 589 F. Supp. 1076 (M.D. Tenn. 1984) (applying Tennessee law; strict liability); Morrow v. New Moon Homes, Inc., 548 P.2d 279, 285–86, 19 U.C.C. Rep. Serv. 1 (Alaska 1976) (strict liability); Salt River Project Agr. Imp. and Power Dist. v. Westinghouse Elec. Corp., 143 Ariz. 368, 694 P.2d 198, 209–10, 40 U.C.C. Rep. Serv. 418 (1984) (abrogated by, Phelps v. Firebird Raceway, Inc., 210 Ariz. 403, 111 P.3d 1003 (2005)) (strict liability); Richard O'Brien Companies v. Challenge-Cook Bros., Inc., 672 F. Supp. 466, Prod. Liab. Rep. (CCH) P 11613, 5 U.C.C. Rep. Serv. 2d 73 (D. Colo. 1987) (applying Colorado law; strict liability and negligence); Long Mfg., North Carolina, Inc. v. Grady Tractor Co., 140 Ga. App. 320, 231 S.E.2d 105, 108 (1976) (strict liability); Adkison Corp. v. American Bldg. Co., 107 Idaho 406, 690 P.2d 341, 345–46, 39 U.C.C. Rep. Serv. 98 (1984) (implied warranty and negligence); Prairie Production, Inc. v. Agchem Division-Pennwalt Corp., 514 N.E.2d 1299, 1304–06, Prod. Liab. Rep. (CCH) P 11640, 5 U.C.C. Rep. Serv. 2d 83 (Ind. Ct. App. 1987) (negligence); Nelson v. Todd's Ltd., 426 N.W.2d 120, 123, Prod. Liab. Rep. (CCH) P 11826, 89 A.L.R.4th 1 (Iowa 1988) (strict liability); National Crane Corp. v. Ohio Steel Tube Co., 213 Neb. 782, 332 N.W.2d 39, 36 U.C.C. Rep. Serv. 779 (1983) (strict liability and negligence); Central Bit Supply, Inc. v. Waldrop Drilling & Pump, Inc., 102 Nev. 139, 717 P.2d 35, 36, 1 U.C.C. Rep. Serv. 2d 118 (1986) (strict liability and negligence); Hagert v. Hatton Commodities, Inc., 350 N.W.2d 591, 39 U.C.C. Rep. Serv. 102 (N.D. 1984) (strict liability); Star Furniture Co. v. Pulaski Furniture Co., 171 W. Va. 79, 297 S.E.2d 854, 859 (1982) (strict liability).

[FN3] Hartmarx Corp. v. JBA Intern., Inc., 2002 WL 406973 (N.D. Ill. 2002) (presence of non-reliance clause in software license agreement did not automatically preclude licensee from pursuing claim against licensor for fraudulent inducement); Huron Tool and Engineering Co. v. Precision Consulting Services, Inc., 209 Mich. App. 365, 532 N.W.2d 541, 26 U.C.C. Rep. Serv. 2d 703 (1995) (affirming, in pertinent part, summary judgment that software customer's fraud claim was indistinguishable from its breach of warranty claim and thus was barred by economic-loss doctrine).

[FN4] VMark Software, Inc. v. EMC Corp., 37 Mass. App. Ct. 610, 642 N.E.2d 587, 590–92, 38 A.L.R.5th 799 (1994) (increasing award of damages to customer on promissory-estoppel theory).

[FN5] *See* VMark, 642 N.E.2d at 590–592.

[FN6] Chatlos Systems, 479 F. Supp. at 740 n.1 (declining invitation to create new tort of computer malpractice); Triangle Underwriters, Inc. v. Honeywell, Inc., 457 F. Supp. 765, 770–71, 24 U.C.C. Rep. Serv. 1088 (E.D. N.Y. 1978), aff'd in part, rev'd in part on other grounds, 604 F.2d 737, 26 U.C.C. Rep. Serv. 1162 (2d Cir. 1979) (rejecting malpractice theory).

[FN7] Diversified Graphics, Ltd. v. Groves, 868 F.2d 293, 295–96 (8th Cir. 1989) (professional standard of care properly applicable to computer system consultants; professional standards of accountants are substantial evidence concerning applicable standard of conduct); Data Processing Services, Inc. v. L.H. Smith Oil Corp., 492 N.E.2d 314, 318–19, 1 U.C.C. Rep. Serv. 2d 29 (Ind. Ct. App. 1986) (programming firm held liable under professional malpractice theory).

§ 18:11. Export controls

Any export of goods or "technical data," including software, requires a license under regulations promulgated by the Department of Commerce[1] or set out in the International Traffic in Arms Regulations (ITARs),[2] administered by the Department of State. Exports of encryption software are regulated by the ITARs, for example.

Many software exports can be made under a "general" license that does not require formal application or approval. Other exports require a "validated" license for which a formal application must be submitted to and approved by the appropriate agency.[3]

Readers should use caution in investigating the export license status of proposed exports. An export can be something as simple as providing a copy of software or technical data to a foreign national. Substantial penalties and even imprisonment can follow from unlicensed exports.[4]

[FN1] *See* 15 C.F.R. §§ 768 to 799.2.

[FN2] 22 C.F.R. Title 22, Ch. I, Subchapter M.

[FN3] A detailed discussion of the export control regulations can be found in §§ 6:1 et seq.

[FN4] *See* 50 U.S.C.A. App. § 2410.

§ 18:12. Antitrust considerations

U.S. antitrust law prohibits a variety of business arrangements as harmful or potentially harmful to competition. A useful summary of some of the antitrust implications of software licensing agreements can be found in the Competition and Intellectual Property in The U.S.: Licensing Freedom And The Limits Of Antitrust.[1] Case law precedent for a number of years associated intellectual property rights (i.e. a patent) to be an indicator of market power. This market power presumption was especially noted in licensing arrangements where a license for the patent-protected right was tied to a requirement to purchase an unprotected good or service. Market power is one of the key considerations in determining if an action is in violation of the Sherman Act under an antitrust claim. In the January 2005 case *Independent Ink*,[2] the Federal Circuit—which handles all direct patent appeals in the United States—held that Supreme Court precedent[3] compelled it to conclude that a patent does raise a presumption of market power in an IP tying case. In vacating and remanding the case, the Supreme Court expressly overruled this precedent holding that:

In the years since A. B. Dick, four different rules of law have supported challenges to tying arrangements. They have been condemned as improper extensions of the patent monopoly under the patent misuse doctrine, as unfair methods of competition under § 5 of the Federal Trade Commission Act, 15 U. S. C. § 45 as contracts tending to create a monopoly under § 3 of the Clayton Act, 15 U. S. C. § 13a, and as contracts in restraint of trade under § 1 of the Sherman Act.[4]

Over the years, this Court's strong disapproval of tying arrangements has substantially diminished, as the Court has moved from relying on assumptions to requiring a showing of market power in the tying product.[5]

Another question that arises occasionally is whether a licensor has any obligation to license all comers. At least two courts, reviewing the case law, have held that ordinarily a software company is free to license its software to whomever it chooses (although one of the courts noted in dicta that the software proprietor could not use its copyright or patent rights to enforce unlawful ties).[6]

Section 4 of the Clayton Act (15 U.S.C.A. § 15) authorizes a private cause of action by "any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws …" An obstacle in the path of a software licensee seeking redress under antitrust laws against a software licensor—such as monopoly pricing or illegal tying arrangements—is the near certainty that the court will consider the licensee an indirect purchaser who, under the 1977 decision of the United States Supreme Court in *Illinois Brick*,[7] lacks standing under § 4 of the Clayton Act (15 U.S.C.A. § 15) to bring a private action against a seller who engages in anticompetitive practices in the sale of goods and services. According to the *Illinois Brick* court, the legislative purpose in creating a group of private attorneys general to enforce the antitrust laws under § 4 is better served by holding direct purchasers to be injured to the full extent of the alleged overcharge paid by them than by attempting to apportion the overcharge among all that may have absorbed part of it.

Thus, when a software company such as Microsoft sells its product through retailers and subject to an end user license agreement, the federal antitrust laws will not provide a remedy for purchasers seeking to recover damages for alleged monopolistic pricing because they are subject to the *Illinois Brick* indirect purchaser rule.[8] In a number of cases, purchasers of Microsoft software sought to overcome *Illinois Brick* by suing under state antitrust laws. In some jurisdictions, however, those laws often specifically provide for interpretation in accordance with federal courts under the federal antitrust laws under the manufacturer's end user license agreement. Purchasers of software under Microsoft's end user license agreements through retailers or pre-installed on original computer equipment have been considered indirect purchasers who lack standing to sue under state antitrust laws despite arguments that (1) the state statute's use of the term "consumer" dictated a different result,[9] (2) an end user licensee was in privity with Microsoft and thus a direct purchaser,[10] (3) a purchaser of Microsoft's software had standing as a direct licensee,[11] or (4) the state statute defines the terms "trade" and "commerce" to include any trade or commerce directly or indirectly affecting the people of the state.[12] It should be noted, however, that the antitrust statutes in several states expressly authorize actions for damages by indirect purchasers,[13] and the United States Supreme Court has ruled that such provisions are not preempted by federal law.[14]

[FN1] R. Hewitt Pate's, Assistant Attorney General, *Competition and Intellectual Property In The U.S.: Licensing Freedom And The Limits Of Antitrust*, a Department of Justice paper presented at a 2005 EU Competition Workshop in Florence, Italy. This paper cites to Antitrust Guidelines for the Licensing of Intellectual Property, issued in April, 1995 by the Department of Justice and the Federal Trade Commission (for additional details about United States approach to anti-trust considerations in licenses.)

[FN2] Independent Ink, Inc. v. Illinois Tool Works, Inc., 396 F.3d 1342, 73 U.S.P.Q.2d 1705, 2005-1 Trade Cas. (CCH) P 74680 (Fed. Cir. 2005), cert. granted, 545 U.S. 1127, 125 S. Ct. 2937 (2005) and vacated and remanded, 547 U.S. 28, 126 S. Ct. 1281, 77 U.S.P.Q.2d 1801, 2006-1 Trade Cas. (CCH) P 75144 (2006) and cert. denied, 547 U.S. 1002, 126 S. Ct. 1462 (2006).

[FN3] *See, e.g.*, Jefferson Parish Hospital Dist. No. 2 v. Hyde, 466 U.S. 2, 16 (1984); International Salt Co. v. U.S., 332 U.S. 392, 68 S. Ct. 12, 75 U.S.P.Q. 184 (1947) (abrogated by, Illinois Tool Works Inc. v. Independent Ink, Inc., 547 U.S. 28, 126 S. Ct. 1281, 77 U.S.P.Q.2d 1801, 2006-1 Trade Cas. (CCH) P 75144 (2006)).

[FN4] Illinois Tool Works Inc. v. Independent Ink, Inc., 547 U.S. 28, 34, 126 S. Ct. 1281, 77 U.S.P.Q.2d 1801, 2006-1 Trade Cas. (CCH) P 75144 (2006) (reference cite is Henry v. A.B. Dick Co., 224 U.S. 1, 32 S. Ct. 364 (1912) (overruled in part by, Motion Picture Patents Co. v. Universal Film Mfg. Co., 243 U.S.

502, 37 S. Ct. 416 (1917))).

[FN5] Illinois Tool Works, 547 U.S. at 35.

[FN6] In re Independent Service Organizations Antitrust Litigation, 203 F.3d 1322, 53 U.S.P.Q.2d 1852, 2000-1 Trade Cas. (CCH) P 72795 (Fed. Cir. 2000) (Xerox's decision to refuse to license copyrighted software did not violate antitrust laws; antitrust laws do not negate right of patent or copyright holders to exclude others from their property at least in absence of illegal tying); Microsoft Corp. v. Computer Support Services of Carolina, Inc., 123 F. Supp. 2d 945, 2001-1 Trade Cas. (CCH) P 73184 (W.D. N.C. 2000) (Microsoft clearly has right to determine who can reproduce its software and right to determine fees it will charge its own licensees; Microsoft's right to license and distribute its own intellectual property—and not antitrust laws—was really at issue); Townshend v. Rockwell Intern. Corp., 55 U.S.P.Q.2d 1011, 2000-1 Trade Cas. (CCH) P 72890, 2000 WL 433505 (N.D. Cal. 2000); Tricom, Inc. v. Electronic Data Systems Corp., 902 F. Supp. 741, 36, 36 U.S.P.Q.2d 1778, 1995-2 Trade Cas. (CCH) P 71188 (E.D. Mich. 1995) (citing cases; granting summary judgment dismissing antitrust claim that EDS should be required to license its engineering graphics software to competing service provider, but noting in dicta that EDS could not tie grant of software license to use of EDS's services); Service & Training, Inc. v. Data General Corp., 963 F.2d 680, 686–87, 23 U.S.P.Q.2d 1102, 1992-1 Trade Cas. (CCH) P 69810 (4th Cir. 1992) (affirming judgment of copyright infringement; holding that Data General's policy of licensing its MV/ADEX diagnostic software only to customers performing their own maintenance and not to third party maintenance providers was not an unlawful tying arrangement because “Data General may lawfully license MV/ADEX to whomever it chooses”).

[FN7] Illinois Brick Co. v. Illinois, 431 U.S. 720, 97 S. Ct. 2061, 1977-1 Trade Cas. (CCH) P 61460 (1977).

[FN8] *See, e.g.*, Dickson v. Microsoft Corp., 309 F.3d 193, 2002-2 Trade Cas. (CCH) P 73858 (4th Cir. 2002) (plaintiffs representing classes of purchasers of licenses to use Microsoft's operating system, word processing, and spreadsheet software were barred from seeking damages under Illinois Brick indirect purchaser rule).

[FN9] Vacco v. Microsoft Corp., 260 Conn. 59, 793 A.2d 1048, 2002-1 Trade Cas. (CCH) P 73632 (2002) (allowing only those consumers who purchase directly from antitrust defendant to bring suit under Connecticut Antitrust Act ensures that Act remains harmonious with federal antitrust statutes).

[FN10] Vacco v. Microsoft Corp., 260 Conn. 59, 793 A.2d 1048, 2002-1 Trade Cas. (CCH) P 73632 (2002) (Connecticut Antitrust Act; focus is on underlying economic transaction between direct purchaser and antitrust defendant, not on whether plaintiff and defendant were in contractual privity under licensing agreement).

[FN11] Pomerantz v. Microsoft Corp., 50 P.3d 929, 2002-1 Trade Cas. (CCH) P 73669 (Colo. Ct. App. 2002) (Colorado antitrust statute; relationship between purchaser of Microsoft product through end user license agreement was insufficient to make consumer direct purchaser since immediate economic transaction was between consumer and retailer); Berghausen v. Microsoft Corp., 765 N.E.2d 592, 2002-1 Trade Cas. (CCH) P 73627 (Ind. Ct. App. 2002) (Indiana Antitrust Act; damage absorbed by direct licensee who did not directly pay licensor for use of software was no less difficult to ascertain than that suffered by indirect purchaser); Davidson v. Microsoft Corp., 143 Md. App. 43, 792 A.2d 336, 2002-1 Trade Cas. (CCH) P 73599 (2002) (Maryland Antitrust Act; complaint contained no allegations that relationship between plaintiffs and direct purchasers—the original computer equipment manufacturers—satisfied exceptions to Illinois Brick rule); Minuteman, LLC v. Microsoft Corp., 147 N.H. 634, 795 A.2d 833 (2002) (New Hampshire antitrust statute; fact that plaintiffs were licensees of Microsoft's product did not change fact that they did not purchase products directly from Microsoft and therefore could not be considered direct purchasers for purposes of Illinois Brick); Siena v. Microsoft Corp., 796 A.2d 461, 2002-1 Trade Cas. (CCH) P 73666 (R.I. 2002) (Rhode Island antitrust statute; although plaintiffs purchased and paid for Microsoft product, no consideration passed directly to Microsoft from either plaintiff, Microsoft having received compensation via circuitous route of distributors and vendors and not plaintiffs who were ultimate consumers in line of distribution).

[FN12] Arnold v. Microsoft Corp., 2002-1 Trade Cas. (CCH) P 73598, 2001 WL 1835377 (Ky. Ct. App. 2001) (Kentucky Antitrust Act; phrase “directly or indirectly” referred to scope of Act's jurisdiction and did not purport to define class entitled to bring action under Act).

[FN13] *See, e.g.,* Ala. Code Ann. § 6-50-60; Cal. Bus. & Prof. Code § 16750; D. C. Stat. § 28-4509); Hawaii Rev. Stat. Ann. § 480.3; Ill. Rev. Stat. Ann. ch 38, ¶60-7); Kan. Stat. Ann. § 50-161; Mich. Cons. Laws Ann. § 325D.57; Minn. Stat. § 325D.57; Miss. Code Ann. § 75-21-9; S.D. Cod. Laws Ann. § 37-1-33; Wis. Stat. Ann. § 133.18.

[FN14] California v. ARC America Corp., 490 U.S. 93, 109 S. Ct. 1661, 1989-1 Trade Cas. (CCH) P 68537 (1989).

§ 18:13. Bankruptcy issues

Bankruptcy of a party imposes a new set of constraints on a license relationship.

§ 18:14. Bankruptcy issues—Automatic stay

Section 362 of the Bankruptcy Code automatically stays all action that was or could have been commenced against the bankruptcy debtor prior to commencement of the case in bankruptcy, including judicial and non-judicial action.[1]

A party in interest can file a request for relief from the stay for cause, among other reasons.[2] If a request for relief is filed, the stay terminates automatically in 30 days unless the bankruptcy court orders the stay to continue in effect after notice and a hearing.[3] The bankruptcy court can grant such relief as is necessary to prevent irreparable damage to the interest of an entity in property if such interest will suffer such damage before there is an opportunity for notice and a hearing.[4]

An individual injured by any willful violation of the automatic stay “shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages.”[5]

[FN1] *See* 11 U.S.C.A. § 362(a).

[FN2] 11 U.S.C.A. § 362(d).

[FN3] 11 U.S.C.A. § 362(e).

[FN4] 11 U.S.C.A. § 362(f).

[FN5] 11 U.S.C.A. § 362(k)(1).

§ 18:15. Bankruptcy issues—Rejection of the license agreement

Section 365 of the Bankruptcy Code in essence lets a bankruptcy trustee (or debtor-in-possession) decide whether the debtor will continue to be bound by its executory contracts and unexpired leases. Subject to the court's approval:

- The trustee can decide to assume an executory contract or unexpired lease,[1] subject to curing any existing defaults and providing adequate assurance of future performance under the contract or lease.[2]
- Alternatively, the trustee can reject the contract or lease. A rejected contract or lease is treated as having been breached immediately before the date of the commencement of the bankruptcy case[3]—which has the practical effect of immunizing the debtor from liability for the breach of contract, and frequently relegates the other party to the status of an unsecured claimant for damages.[4]

[FN1] 11 U.S.C.A. § 365(a).

[FN2] 11 U.S.C.A. § 365(b).

[FN3] 11 U.S.C.A. § 365(g).

[FN4] 11 U.S.C.A. § 502(g)(1).

§ 18:16. Bankruptcy issues—Assignment of agreements

Normally, if a bankruptcy trustee (or debtor-in-possession) assumes an executory contract or unexpired lease and provides adequate assurance of future performance, then s/he can assign it to another party that is able to perform under the agreement—e.g., sell the contract or lease to raise cash. The trustee has this power regardless whether the contract or lease contains a no-assignment clause or applicable law prohibits assignment.[1]

The trustee may not assign the contract or lease, however, if (a) "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession," and (b) the other party does not consent to the assignment.[2] That exception has been held to prevent bankruptcy debtors from assigning licenses. As explained by one California federal district court in 1994, "subsection 365(f) operates to delete a non-assignability clause from a contract and render it 'silent' regarding assignment, but subsection 365(c) restores the non-assignability if applicable law holds such 'silent' contracts to be non-assignable."[3] Where patent and copyright licenses are concerned, the court noted, "applicable law" governing assignability of a license agreement is federal law, to the exclusion of contrary state-law provisions, and federal law prohibits assignment of patent or copyright licenses without licensor consent.[4]

[FN1] 11 U.S.C.A. § 365(f)(1).

[FN2] 11 U.S.C.A. § 365(c).

[FN3] In re CFLC, Inc., 174 B.R. 119, 120–21, 26 Bankr. Ct. Dec. (CRR) 175 (N.D. Cal. 1994), decision aff'd, 89 F.3d 673, 29 Bankr. Ct. Dec. (CRR) 520, 36 Collier Bankr. Cas. 2d (MB) 297, 39 U.S.P.Q.2d 1518 (9th Cir. 1996) (affirming patent owner's objection to debtor's proposed assignment of nonexclusive license), citing Matter of Midway Airlines, Inc., 6 F.3d 492, 495, 24 Bankr. Ct. Dec. (CRR) 1228, 29 Collier Bankr. Cas. 2d (MB) 914, Bankr. L. Rep. (CCH) P 75472 (7th Cir. 1993) and In re Pioneer Ford Sales, Inc., 729 F.2d 27, 29, 11 Bankr. Ct. Dec. (CRR) 1303, 10 Collier Bankr. Cas. 2d (MB) 524, Bankr. L. Rep. (CCH) P 69740 (1st Cir. 1984).

[FN4] Unarco Industries, Inc. v. Kelley Co., Inc., 465 F.2d 1303, 175 U.S.P.Q. 199 (7th Cir. 1972) (holding that assignability of patent license is controlled by federal law); *see also* Harris v. Emus Records Corp., 734 F.2d 1329, 222 U.S.P.Q. 466 (9th Cir. 1984) (applying Unarco rationale in holding that federal law prohibits assignment of copyright license without consent of copyright owner); PPG Industries, Inc. v. Guardian Industries Corp., 597 F.2d 1090, 13 Ohio Op. 3d 260, 202 U.S.P.Q. 95, 49 A.L.R. Fed. 878 (6th Cir. 1979) (following Unarco; patent license nonassignable without consent); In re Alltech Plastics, Inc., 71 B.R. 686, 3 U.S.P.Q.2d 1024 (Bankr. W.D. Tenn. 1987) (applying Unarco; holding that bankruptcy trustee did not have power to assign patent license absent consent from licensor); all cited in CFLC, Inc., 174 B.R. at 121–22.

§ 18:17. Bankruptcy issues—Continued possession of "intellectual property"

Until the 1988 Bankruptcy Code amendments, a licensee of intellectual property was largely out of luck if the licensor went into bankruptcy proceedings. Under section 365 of the Code, if the bankruptcy debtor is a licensor under an executory license agreement, then the licensor can reject the license agreement and terminate the licensee's rights under the agreement.[1] Two courts had held that this provision permitted a licensor to reject its license agreement and prevent the licensee from using the licensed technology.[2]

In response, Congress enacted the 1988 amendments to the Code. Under new section 365(n), if the trustee rejects an executory contract under which the debtor is a licensor of a right to "intellectual property," then the licensee can elect either:

- to treat the contract as terminated, or
- to retain its rights under the contract and any "agreement supplementary to such contract" (e.g., a source code escrow agreement) to the intellectual property, including embodiments of the intellectual property (e.g., licensed copies of computer software).[3]

Thus, a software licensee can retain its right to use the licensed software; it can also retain its right to obtain a copy of source code from an escrow agent pursuant to an escrow agreement that is supplementary to the license agreement.

The term "intellectual property" is broadly defined in section 101 of the Bankruptcy Code as a trade secret; an invention, process, design, or plant protected under the Patent Act; a patent application; a plant variety; a work of authorship protected under the Copyright Act; or a mask work protected under the Semiconductor Chip Protection Act.[4] Trademarks were intentionally excluded from the definition, because "[trademark license] contracts raise issues beyond the scope of this legislation."[5]

To retain its rights, however, the licensee must continue to pay royalty amounts that come due (while on the other hand the licensor is permitted to escape any maintenance obligations it may have).[6] A licensee is unlikely to avoid such payment obligations just because the obligations are called something other than a "royalty." As the Ninth Circuit explained:

Section 365(n) has struck a fair balance between the interests of the bankrupt and the interests of a licensee of the bankrupt's intellectual property. The bankrupt cannot terminate and strip the licensee of rights the licensee had bargained for. The licensee cannot retain the use of those rights without paying for them. It is essential to the balance struck that the payments due for the use of the intellectual property should be analyzed as "royalties," required by the statute itself to be met by the licensee who is enjoying the benefit of the bankrupt's patents, proprietary property, and technology.[7]

[FN1] *See* discussion at § 18:15, supra.

[FN2] Rejection of license agreements as "executory contracts" was approved in at least two cases that provided the impetus for the 1988 Bankruptcy Code amendments, discussed in the text. *See* Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 12 Bankr. Ct. Dec. (CRR) 1281, 12 Collier Bankr. Cas. 2d (MB) 310, 226 U.S.P.Q. 961, Bankr. L. Rep. (CCH) P 70311 (4th Cir. 1985) (reversing district court and reinstating bankruptcy-court order permitting debtor-licensor to reject license agreement granting licensee a nonexclusive right to use patent-pending metal-coating process); In re Logical Software, Inc., 66 B.R. 683, Bankr. L. Rep. (CCH) P 71639 (Bankr. D. Mass. 1986) (approving software licensor's rejection of exclusive distribution license, even though distributor likely would be put out of business).

[FN3] 11 U.S.C.A. § 365(n).

[FN4] 11 U.S.C.A. § 101(35A); *see* In re Matusalem, 158 B.R. 514, 521–22, 29 U.S.P.Q.2d 1519, Bankr. L. Rep. (CCH) P 75480 (Bankr. S.D. Fla. 1993) (dictum; observing that secret process and formulas used to make rum products were "intellectual property" and therefore rejection of franchise agreement would not terminate franchisee's right to use same; denying debtor's motion to reject franchise agreement on other grounds).

[FN5] S. Rep. No. 100-505, 100th Cong., 2d Sess. 7 (1988), reprinted in [1989] U.S. Code Cong. & Admin. News 3200.

[FN6] 11 U.S.C.A. § 365(n)(2).

[FN7] In re Prize Frize, Inc., 32 F.3d 426, 428, 25 Bankr. Ct. Dec. (CRR) 1615, 31 Collier Bankr. Cas. 2d (MB) 1422, 31 U.S.P.Q.2d 1861, Bankr. L. Rep. (CCH) P 76039 (9th Cir. 1994) (emphasis supplied).

§ 18:18. Bankruptcy issues—No ipso-facto termination

Section 365(e) of the Bankruptcy Code in effect renders void most so-called ipso facto clauses. Section 365(e) states that neither an executory contract or unexpired lease of the debtor, nor any right or obligation thereof, can be terminated or modified at any time after the commencement of the bankruptcy case solely because of a provision in such contract or lease that is conditioned on:

- the insolvency or financial condition of the debtor at any time before the closing of the case;
- the fact of commencement of the case under this title; or
- the appointment of or taking possession by a trustee in a bankruptcy case or a custodian before such commencement.[1]

[FN1] 11 U.S.C.A. § 365(e).

§ 18:19. Consumer protection laws—The Magnuson-Moss Act

The federal Magnuson-Moss Act[1] and the implementing FTC regulations[2] deal with warranties offered to consumers in respect of "consumer products," defined as "any tangible personal property which is distributed in commerce and which is normally used for personal, family or household purposes."[3]

Some software almost certainly qualifies as a consumer product. The legislative history of the Act indicates that ambiguities are to be resolved in favor of coverage,[4] with similar language in the FTC regulations.[5]

In all likelihood, therefore, warranties offered to consumers with such products must comply with the Magnuson-Moss Act. Some key points of that statute include:

- *Guidelines for "Full" Warranties*. Under Magnuson-Moss, warranties offered to consumers for consumer products must either meet minimum federal guidelines for "full" warranties" or must be described as "limited" warranties.[6]
- *No Disclaimer of Implied Warranties*. Disclaimers of implied warranties are prohibited in sales of consumer products to consumers if any written warranty at all is made.[7]
- *Limits on Duration of Implied Warranties*. A warrantor offering a full warranty may not impose any limitation on the duration of any implied warranty.[8] (As a result, few software licensors are likely to want to offer a "full" warranty for consumer products offered to consumers, and so must label their warranties as "limited" warranties.)
- *Required Language*. The implementing FTC rules require specific language to be used in many consumer-product warranties.[9]
- *Pre-Sale Availability of Warranty Text*. Under the FTC rules, a retail vendor of consumer products must make the full text of the warranty available to prospective buyers prior to sale, either by "displaying in close proximity to each warranted product" and/or by "furnishing it upon request …."[10] Also under the FTC rules, a warrantor must provide the retail vendor with written materials that the retailer can use to comply with its obligations, e.g., by providing copies of the written warranty with every warranted consumer product.[11]
- *Mail-Order Sales*. In mail-order sales of consumer products, warranties must either be disclosed in catalogs or the customer must be told that the warranties may be obtained free of charge upon written request, along with an address for making such a request.[12]
- *Warranty Registration Cards*. When return of an owner registration card is a condition precedent to the warranty that fact must be clearly disclosed in the warranty.[13]

Buyers harmed by a vendor's failure to comply with the Magnuson-Moss Act can bring suit in any state or federal court. A successful plaintiff can recover, in addition to damages, "the aggregate amount of costs and expenses (including attorneys' fees based on actual time expended) determined by the court to have been reasonably incurred by the plaintiff for or in connection with the commencement and prosecution of such action …."[14]

No reported cases are known to have addressed the substance of the Magnuson-Moss Act in the context of computer software.

[FN1] Magnuson-Moss Act, 15 U.S.C.A. §§ 2301 et seq.

[FN2] *See* 16 C.F.R. §§ 701 et seq.

[FN3] 16 C.F.R. § 2301(1).

[FN4] *See* S. Rep. No. 9151, 93d Cong., 1st Sess. 11 (1973).

[FN5] *See* 16 C.F.R. § 700.1(a).

[FN6] *See* 15 U.S.C.A. § 2303(a).

[FN7] *See* 15 U.S.C.A. § 2308(a).

[FN8] *See* 15 U.S.C.A. § 2304(a)(2) and § 2304(e).

[FN9] *See, e.g.,* 16 C.F.R. § 701.3(a)(7), 16 C.F.R. § 701.3(a)(8), 16 C.F.R. § 701.3(a)(9), 15 U.S.C.A. § 2308(b),

[FN10] 16 C.F.R. § 702.3(a).

[FN11] 16 C.F.R. § 702.3(b).

[FN12] 16 C.F.R. § 702.3(c)(2)(i).

[FN13] 16 C.F.R. § 701.4.

[FN14] 15 U.S.C.A. § 2310(d)(2).

§ 18:20. State consumer protection laws

A number of states have "lemon laws" that may govern the sale of consumer-product computer software. California's Song-Beverly Act,[1] for example, sets a minimum duration of 60 days for implied warranties of merchantability and, if not disclaimed, of fitness for a particular purpose.[2] State consumer fraud or protection acts may be the basis for an action seeking damages for a licensor's misrepresentations concerning its software.[3] However, a purchaser of software at retail that is subject to an end user license agreement may not be able to state a claim under such laws if (1) there is no direct transaction between the licensee and the licensor[4] or (2) the claim relates to monopolistic conduct not expressly prohibited under state consumer fraud or protection acts.[5]

[FN1] Cal. Civ. Code § 1790.

[FN2] Cal. Civ. Code §§ 1791.1(c).

[FN3] *See, e.g.,* Hartmarx Corp. v. JBA Intern., Inc., 2002 WL 406973 (N.D. Ill. 2002) (licensee stated fraudulent misrepresentation claim and was entitled to proceed under Illinois Consumer Fraud Act; licensee asserted that licensor fraudulently induced entry into agreement by misrepresenting functionality of software as well as licensor's ability to customize software to meet licensee's needs and assist licensee in implementing its new system). *C.f.,* Arizona Cartridge Remanufacturers Ass'n, Inc. v. Lexmark Intern., Inc., 290 F. Supp. 2d 1034, 68 U.S.P.Q.2d 1786 (N.D. Cal. 2003), aff'd, 421 F.3d 981, 77 U.S.P.Q.2d 1995 (9th

Cir. 2005) (neither Lexmark's Prebate program, granting single-use license for its laser printer toner cartridges in exchange for reduced price, its threats of litigation to enforce license, nor its use of lock-out chip disabling printers using refilled cartridges in violation of single-use license, was misleading or unfair business practice in violation of California law; because of Lexmark's patent rights, it had right to impose conditions on sale of its patented product and to restrict purchaser's ability to repair it—which was in essence single-use license accomplished); Moore v. Microsoft Corp., 293 A.D.2d 587, 741 N.Y.S.2d 91, 48 U.C.C. Rep. Serv. 2d 76 (2d Dep't 2002) (complaint against software licensor for deceptive trade practices under N.Y. Gen. Bus. Law was barred by software's end user license agreement containing clear disclaimers, waivers of liability, and limitations of remedies).

[FN4] Vacco v. Microsoft Corp., 260 Conn. 59, 793 A.2d 1048, 2002-1 Trade Cas. (CCH) P 73632 (2002) (plaintiff obtained Windows 98 operating system software pre-installed on personal computer purchased at retail; allowing plaintiff to recover would lead to problems apportioning recovery among all potential plaintiffs and at least two layers of parties—computer manufacturers who pre-installed software and retailers who sold computers—had injuries that were more closely related to licensor's conduct).

[FN5] Arnold v. Microsoft Corp., 2002-1 Trade Cas. (CCH) P 73598, 2001 WL 1835377 (Ky. Ct. App. 2001) (Kentucky Consumer Protection Act did not extend to plaintiff's allegations of monopolistic practices and predatory pricing by software licensor); Davidson v. Microsoft Corp., 143 Md. App. 43, 792 A.2d 336, 2002-1 Trade Cas. (CCH) P 73599 (2002) (Maryland Consumer Protection Act did not apply to antitrust violations).

§ 18:21. Foreign-law considerations

Licensors seeking to do transnational transactions should keep in mind the varying requirements of foreign law. Different jurisdictions impose different rules in connection with local-language requirements, licensee termination, and “competition law” (antitrust law), to name a few examples.[1]

[FN1] A discussion of selected foreign law issues can be found in §§ 6:1 et seq.

IV. Software License Agreement Provisions

§ 18:22. Software acceptance

Software acceptance is an area sometimes overlooked in license agreements. Acceptance is an important event that upon its occurrence typically limits the rights and remedies available to the licensee of the Software. Therefore, licensees will want to ensure that the contract has a provision that contains an appropriate process for the licensee to test and evaluate the software it's obtaining to ensure the Software satisfies the licensee's requirements. It's a process that is particularly important to the licensee, who may be licensing the software to solve a particular problem or gain certain functionality. If such functionality is not present, the licensee may not want the software and should be able to return it to the licensor for a refund.

Licensors may be resistant to an acceptance process, particularly if the software is an “off the shelf” type product that the licensee installs themselves or is offered for a low price. In such cases, the licensor typically expects the licensee to rely on the performance warranty and any remedies that may be offered related to the warranty. In lieu of an acceptance process a licensor could offer a free trial period for easy to implement software, whereby at the end of the trial period the licensee must either return the software or pay the license fees for continued use. This works well in situations where the software is licensed per user or per device and can be loaded by the licensee on a single computer or accessed via the licensor's website for the trial. If the trial is a success, then the licensee may obtain additional licenses for more users or devices without the need for additional evaluation.

The acceptance process should address both the criteria for acceptance (success), and the remedies available to the licensee if the software fails to meet the acceptance criteria.

§ 18:23. Software acceptance—Acceptance criteria

One of the most important elements of any acceptance process is defining the acceptance criteria. Often the licensor has put together documentation related to the use of its software. The licensee should consider if such documentation sufficiently describes its performance and functionality expectations for the software. The licensee may want to create a list of its performance, interoperability and functionality expectations (describing what the software will actually do for the licensee), and gain agreement from the licensor that such list be made a part of the acceptance criteria. Creating such a list also can reveal issues early in the contracting process. For instance, the licensee may be under the impression that the software will be able to collect data from the licensee's accounting system, only to find out from such discussions that this is not the case or that certain functionality is still being developed or unavailable. Such an exercise is an opportunity for both the licensor and licensee to ensure that they have the same understanding and that expectations are clear.

§ 18:24. Software acceptance—Acceptance process

Testing of the Software will likely occur at various phases of the implementation, especially for more complex implementations. Certain functionality can be confirmed for specific modules and interfaces during implementation. The foregoing may be outlined in the project plan, and should be outlined in the Agreement if failure of a particular event during implementation would ultimately deem the project a failure and require termination of the contract. For instance if the licensee expects certain functionality to be working before the remaining modules are implemented, this should be stated in the contract with the express right to terminate and obtain a refund of sums paid by the licensee. Each contract should have a process for testing all components together in a live production environment before actual acceptance occurs. The licensee should consider how much time it would need to see the Software in production to verify that all the Software is operating in conformance with the acceptance criteria. It should be clear when the testing period begins. Often go-live is used to start such testing periods, however, the licensee should consider if there are other tasks that must be completed before it is able to perform such testing (e.g., end-use training).

Once the testing period begins the licensee should note any performance issues and relay those to the licensor. The contract should outline how such issues need to be relayed (e.g., in writing by e-mail, fax, or some other mechanism), and the licensor should require the end-use to notify the licensor of any non-conformances to the acceptance criteria within the testing period. The licensor should insist that the only kinds of non-conformances that matter are those that are material. In other words, those that are significant enough such that the licensee could not be expected to accept the Software with such problems. If the licensor is notified of a material nonconformance, the parties should outline in the contract how much time the licensor has to correct the non-conformities and the licensor should be expected to correct such non-conformities at no charge to the licensee.

Once the remedy period has ended, the licensee should have an additional period of time to retest the Software to ensure that it now conforms with the acceptance criteria. If the Software again fails to conform to the acceptance criteria, the licensee will want to ensure that at this point it has the right to either terminate the contract or allow the licensor additional time to correct. If the licensee elects to grant the licensor more time to correct, it should not give up its right to terminate and be allowed to retest the Software once the licensor submits the corrections.

The contract can permit the cycle of nonconformity identification, correction and retesting to continue indefinitely, but the licensor would be wise to limit the number of times this can occur. At some juncture the licensor needs to know the Software has been accepted by the licensee and the licensor may have revenue recognition issues if acceptance is greatly delayed.

§ 18:25. Software acceptance—Remedies

In the event the Software fails to meet the acceptance criteria and the licensee terminate the relationship, the contract should state the refund that the licensee is entitled. From the licensee's perspective, a full refund of all sums paid is what is most desired because the licensor has ultimately failed to deliver what was promised. The impact to the licensee typically has a further reaching impact on the organization; the organizations plans suffer a significant set back and the resources expended to that point a loss. From the licensor perspective, mitigation of losses at such a termination is also desirable. The licensor will want to consider limiting the licensee's termination and refund rights where possible. For instance, some projects involve numerous modules or components, if the licensor could limit termination to only those modules or components that fail the acceptance testing process, the refund of any sums paid may be limited to those sums attributable to those modules or components. This may also be desirable to the licensee, provided the licensee is certain that it would be willing to accept just those successful modules.

To further limit the licensor's risk, the licensor may want to limit the refund to the license fees only. The investment in professional services during implementation can be a significant cost to the licensor. In some cases this may be acceptable to the licensee, particularly where the licensor is providing something unique to the licensee (not normally done for the licensor's customers), and both parties have recognized the uncertainty of success. Such might be the case where there are multiple interfaces between the licensor's Software and other systems or applications with which the licensor is unfamiliar.

§ 18:26. Software acceptance—Responsibilities triggered by acceptance

The event of acceptance under the contract is often used to trigger a payment and sometimes other obligations. Often a determination needs to be made as to when the performance warranty begins may be triggered by acceptance, particularly if the performance warranty is limited in time (e.g., 90 days from acceptance). Acceptance may also used as the date when maintenance and support formerly begin, and may also be the date when the licensee's ongoing support payment obligations begin.[1]

[FN1] The commencement of support payment obligations are often subject to negotiation, as described in § 18:63.

§ 18:27. License grant

Software licenses grant the licensee the right to “use” the software under certain terms and conditions.[1] Software can be licensed for a limited period of time, often referred to as a term license, or for an unlimited period of time, often referred to as a “perpetual” license.

[FN1] The copyright holder has many exclusive rights with regard to the copyrighted work (the right to reproduce copies or phono records of the work, the right to prepare derivative works, the right to distribute copies of the work, the right to perform the work publicly, and the right to display the work publicly). 17 U.S.C.A. § 106. Interestingly, with regard to software that is protected by copyright, the right to exclusively "use" the copyrighted work is not one of the copyright holder's rights.

§ 18:28. License grant—Length of license

A term software license grants the licensee the right to use the software for a limited period of time (e.g., three years), after which time the license to use the software expires and the licensee must discontinue its use of the software, unless provision is made in the license agreement for renewal of the license term. A term license can also be created by including a provision in the software license agreement providing for an initial term, followed by automatic renewal of the agreement for annual terms unless either party provides notice of termination prior to the renewal date. Each renewal period is often either a period equal in length to the original term, or a standard period of time such as one year. Software licensees should be particularly careful when licensing software under a term license unless the licensee is clearly not going to require use of the software beyond the license term. Once the application becomes incorporated into the licensee's business operations on an ongoing basis and is required beyond the initial term, the licensee is at a distinct disadvantage with regard to the renegotiation of the terms of the new license. To protect against this situation, licensees can negotiate the option to renew the term license in its sole discretion, and negotiate license fees for such renewal terms in advance. One advantage of a term license from a licensee's perspective is that software licensors are often more willing to provide performance warranties for the application for the entire term of the license, rather than for the limited period of time that often accompanies a perpetual license.

A perpetual software license gives the licensee the right to continue to use the software indefinitely, unless or until the software license agreement is terminated as a result of a breach of contract, or as may otherwise be provided in the software license agreement. The perpetual software license is typically more expensive than a term license but provides the licensee with more stability because the application will be available for its use for as long as it desires to continue using the application, provided the application continues to be supported and updated by the licensor to the extent required to continue to make the software useful to the licensee.

§ 18:29. License grant—Users

The software license agreement grants the licensee the right to use the software, but the description of the license should also include any additional restrictions on the use of the software as required by the licensor's business model and the licensee's needs. Depending of the function of the software, the licensor may determine that the software can only be used by a limited number of users at any one given time (concurrent user license) or may only be used by a limited number of named individuals (named user license). In addition, the licensor may want to limit the number of potential individual that may use the software. For example, the licensor may limit use of the software solely to employees of the legal entity that executes the software license agreement. Thus, any affiliates or subsidiaries of the party executing the license agreement would be required to execute its own agreement and pay a separate license fee. Another common license restriction is to limit use of the software to certain equipment identified in the license agreement. The agreement may even identify the actual serial number of the equipment with which the software can be used. Such licenses can be problematic for licensees as the licensee will inevitably need to upgrade or replace the equipment with which it uses the software to meet changing standards in the industry. Thus, the licensee should attempt to include language in such an agreement allowing it to upgrade or replace the designated equipment without incurring an additional license fee. Software is also licensed by the number of MIPS (millions of instructions per second), or by the number of units processed (e.g.—annual study volumes), or any other metric that relates to the value that the licensee gets from the use of the software.

§ 18:30. License grant—Other license grant elements

The majority of software license grants include language that the license is non-exclusive and nontransferable.

The term “non-exclusive” is necessary from the licensor's perspective as most licensors want to be able to license the same product to multiple licensees. The exception to this would be a scenario where the licensee has paid the licensor to develop an application that gives it a competitive edge in the marketplace, in which event the licensee may want to limit the licensor's ability to license the product to other licensees, especially competitors of the original licensee.

The term “nontransferable” in the license grant section prohibits the licensee from transferring the license rights to another party, including affiliates and subsidiaries. This provision often must be considered in conjunction with the assignment clause in the license agreement as many assignment clauses may allow for assignment of the agreement in certain limited circumstances.

Some licenses include a geographic limitation, such as “within the location designated” or even “worldwide.” Such phrases are especially important to licensees that have operations in many geographical locations. Licenses can also be granted that are “irrevocable.” This term may appear in a license grant for an application that the licensee has paid the licensor to develop, thus affording it additional protection against the loss of the license.

It is also common to see language in the license grant section making the grant of the license subject to the payment of the license fees and/or the terms of the contract in general. This language helps to protect the licensor in the event the licensee does not pay for the license or is otherwise in breach of the contract. The licensee should argue that the termination provision covers this concern sufficiently and will usually afford a reasonable period of time to cure any breach of contract before the licensee loses its license.

§ 18:31. License grant—List of prohibited uses

A licensor's standard form license agreement typically contains a long list of uses that are specifically not granted under the license agreement. These provisions commonly include a statement that the licensee is not allowed to decompile, reverse engineer, or disassemble the software to a human perceivable form. This language is important to the licensor because such actions would allow the licensee to access the source code. Such access is generally a major concern to the licensor as it would allow for modification of the software and access to the proprietary code used to create the application. Although there has been some debate as to whether the U.S. Copyright Act preempts a provision prohibiting a licensee from decompiling, reverse engineering, or disassembling the software to a human perceivable form, the U.S. Court of Appeals for the Federal Circuit held that such a provision was enforceable.[1]

The licensor may want to make clear that the license does not give the licensee permission to sublicense, lease, rent, loan, time-share, or operate as a service bureau. These statements are really just an inverse statement of the license grant. The license grant gives the licensee limited use rights. This language merely states that the licensee is not granted certain use rights not included in the license grant. As these are important points to the licensor, such language is commonly included in the contract, although it is arguable whether such language is actually required to achieve the licensor's objective of limiting the use rights to those granted in the license.

The licensor may also want to include language prohibiting the licensee from removing, modifying or obscuring any copyright, trademark or other proprietary rights notices that appear on the software. This language is generally not contested as the licensor has a legitimate interest in making sure its proprietary rights notices appear on the original and any copies of the software and documentation that are made by the licensee.

[FN1] Bowers v. Baystate Technologies, Inc., 320 F.3d 1317, 1325 (Fed. Cir. 2003).

§ 18:32. Software warranties

The warranty section of the license agreement is an important section for both the licensee and licensor. The licensee will want to obtain representations from the licensor that the software and services provided by the licensor will be of a character and quality that the licensee expects. The licensor will want to avoid making any representations in the warranty section that it cannot fulfill or that could end up costing the licensor significantly. The parties may also decide to include a provision in the warranty section that sets forth the procedure and requirements for notifying the licensor of a warranty breach, the licensor's obligations in such an event, and the remedies that are available to the licensee if the warranty breach cannot be cured. The licensor will also want to disclaim any other warranties or representations that are not included in the warranty section of the agreement, especially any representations made during the sales process. The licensor may also want to consider making the remedies stated in this section, if any, the licensee's sole and exclusive remedies for the breach of warranty.

§ 18:33. Software warranties—Specific warranties[1]

The specific warranties vary from deal to deal, but may include: no viruses; date compliant (i.e., Year 2000 issues); no disabling code; hardware specified meets the anticipated/stated business needs; services will conform to requirements; licensor is the lawful owner of the software; software and/or services will comply with applicable laws; compliance with security requirements, etc.[2]

[FN1] An example of the warranty section of a software licensing agreement might be:

11. Licensor's Representations and Warranties. Licensor represents and warrants to Client that:

(a) each item of Software media shall be new and shall be free from defects in manufacture, materials, and design, and each item of Software shall operate in conformance with the Acceptance Criteria for a period of one (1) year from the applicable Acceptance date of such Software ("Initial Warranty Period") and thereafter so long as Client has paid the applicable Support Services fees;

(b) no portion of the Software contains, at the time of delivery, any "back door," "time bomb," "Trojan horse," "worm," "drop dead device," "virus," or other computer software routines or hardware components designed to (i) permit access or use of either the Software or Client's computer systems by Licensor or a third party not authorized by this Agreement, or (ii) disable, damage or erase the Software or Client's software, hardware or data;

(c) the Software and the design thereof shall not contain disabling code or similar preprogrammed preventative routines which prevent Client from exercising the rights granted to them under this Agreement or from utilizing the Software for the purpose for which it was designed;

(d) Licensor is the lawful owner of the Software, or, to the extent Licensor is not the lawful owner of the Software, it has all rights necessary for it to license the Software to Client pursuant to the terms of this Agreement;

(e) the Software does not and shall not infringe any copyright, trademark, patent or other proprietary right of a third party or misappropriate any trade secret of a third party;

(f) neither the execution of this Agreement nor its performance will directly or indirectly violate or interfere with the terms of another agreement to which Licensor is a party, nor will Licensor enter into any agreement the execution or performance of which would violate or interfere with this Agreement;

(g) Licensor is not currently the subject of a voluntary or involuntary petition in bankruptcy, does not currently contemplate filing any such voluntary provision, and is not aware of any claim for the filing of an involuntary petition;

(h) the Software shall comply with all applicable laws and regulations where such non-compliance would have an adverse material impact upon Client or its use of thereof;

(i) the Software will correctly process date data for dates before and after January 1, 2000, including but not limited to leap-year recognition;

(j) Services will conform to the requirements set forth in this Agreement and any applicable SOW and will be performed in a professional and workmanlike manner by adequately trained and experienced personnel;

(k) Licensor shall comply with Client's safety and security guidelines and the requirements of all applicable laws, ordinances, and regulations of the United States or any state, country, or other governmental entity in the performance of Services;

(l) any hardware configuration recommended by Licensor will be sized accordingly to enable Client's intended use of the Software and will be compatible with the Software;

(m) unless expressly set forth in writing in an SOW, the Software shall not contain any open source software and shall not be an alpha or beta version; and

(n) Licensor makes the following general representations and warranties: (i) this Agreement has been validly executed and delivered by Licensor and that this Agreement constitutes the legal, valid and binding obligation of Licensor enforceable against Licensor in accordance with its terms, subject to bankruptcy, insolvency, reorganization and other laws affecting creditors' rights generally, and with regard to equitable remedies, to the discretion of the court before which proceedings to obtain those remedies may be pending; (ii) Licensor has all requisite corporate power and authority to enter into this Agreement and to carry out the transactions contemplated by this Agreement, and that the execution, delivery and performance of this Agreement and the consummation of the transactions contemplated by this Agreement have been duly authorized by all requisite corporate action on the part of Licensor; and (iii) there are no pending or threatened lawsuits, actions or any other legal or administrative proceedings against Licensor which, if adversely determined against Licensor, would have a material adverse affect on Licensor's ability to perform its obligations under this Agreement.

[FN2] See also §§ 18:38 to 18:47.

§ 18:34. Software warranties—Performance warranty

This warranty is one of the most important warranties from the licensee's perspective. Most licensors are willing to grant some sort of performance warranty. The performance warranty provides that the software will function, in all material respects, in accordance with a description of the software for a specified period of time.

§ 18:35. Software warranties—Performance warranty—Description

The licensor will most likely want to limit the description of the software to its then-current published user documentation for the application. The licensee may also want to include the descriptions included in the contract itself, which could include exhibits created by the parties describing certain functionality which is important, or unique, to the licensee, as well as any response to a request for proposal from the licensor.

§ 18:36. Software warranties—Performance warranty—Commencement date

The performance warranty can commence at several different times. The licensor will want the warranty to begin as soon as possible, preferably upon delivery of the software. Another common date used for commencement of the performance warranty is the date upon which the licensee begins using the software in a meaningful manner, which should be specifically defined in the contract. The licensee will want to have the warranty commence upon acceptance of the software pursuant to the acceptance testing provision contained elsewhere in the agreement. The licensee will benefit from this commencement date because it is not using warranty time to work out the initial problems with the software.

§ 18:37. Software warranties—Performance warranty—Length

The licensor will want to limit the length of the performance warranty, typically 90 days. The licensee will want to negotiate the longest period of time possible, preferably one year. The licensee may also want to negotiate that this warranty will stay in effect for as long as the licensee pays the licensor for maintenance and support services. If the license is a term license, the licensor and licensee typically agree that this warranty will last for the duration of the term.

§ 18:38. Software warranties—Media warranty

The parties usually can agree that the media upon which the software is supplied will be free from defects. However, this only applies to the physical media itself, such as the CD-ROM upon which the software is shipped. As issues with the media will arise fairly quickly in the process, the time period during which this warranty applies can usually be limited to 90 days without the licensee taking on too much risk.

§ 18:39. Software warranties—Right to license

This warranty provides that the licensor has all rights necessary to grant the license that is contained in the software license agreement, whether it is the owner of the software or whether it has obtained those rights from a third party. This is usually not a contested provision in the license agreement. If the licensor is not willing to agree to a provision of this nature, the licensee should be very cautious about proceeding with the license. In the alternative, some licensees may be satisfied with an indemnification provision protecting the licensee from any third-party claim that the software infringes a third party's proprietary right, and requiring the licensor to provide it with alternative software in the event it is unable to use the originally licensed version due to such a claim.[1]

[FN1] *See* infringement indemnification discussion in § 18:75.

§ 18:40. Software warranties—Viruses

The licensee may want to include a warranty that the licensor will not supply it with software that contains a virus. However, from the licensor's perspective, it is not completely within its control as to whether the software contains a virus. For one thing, not all viruses are detectable, especially when they are first released. A compromise provision that is usually acceptable to both parties provides that the licensor has not intentionally introduced a virus into the software and that it will scan the software and any updates provided via maintenance and support for viruses.

§ 18:41. Software warranties—Disabling code

This warranty addresses code, intentionally inserted into the software by the licensor that, through some mechanism, such as the passage of time (a "time bomb"), disables the software, unless the licensor performs some act that overrides the disabling code. The licensee will want to require that the software does not contain any such disabling code as this would give the licensor the power to allow the software to become disabled in the event of a dispute between the parties. This would be especially problematic if the software was a mission critical application. Some courts have taken a negative view of the practice of inserting such code into a software application.[1]

[FN1] *See, e.g.,* Werner, Zaroff, Slotnick, Stern & Askenazy v. Lewis, 155 Misc. 2d 558, 588 N.Y.S.2d 960 (N.Y. City Civ. Ct. 1992); Clayton X-Ray Co. v. Professional Systems Corp., 812 S.W.2d 565 (Mo. Ct. App. W.D. 1991).

§ 18:42. Software warranties—Beta and open-source code

Except for certain limited circumstances, the licensee of the software will want to include a warranty that the software it is licensing is not beta software or software containing open source code. Open source software licensee must comply with certain special terms as a condition of the license, which may include the obligation to disclose any modifications it makes if the licensee chooses to distribute the software. Users should clearly understand the obligations of an open source software licensee prior to integrating it with any existing systems. This is especially true if the licensee is incorporating the open source software with a development project.

§ 18:43. Software warranties—Compatibility

The licensee will want to include a warranty in the license agreement that the software licensed from the licensor will be compatible with certain other software, hardware and products, especially if the licensee is obtaining a system from the licensor. The software and products with which the software must be compatible will vary from agreement to agreement, but typically will include, at a minimum, the other products and software supplied to the licensee by the licensor under the license agreement, whether manufactured by the licensor or a third party. The licensor and licensee will typically negotiate whether the software will be compatible with other products and software not supplied by the licensor. The licensee may want to consider whether it expects interoperability of the software with certain preexisting systems of the licensee.[1]

§ 18:44. Software warranties—Date data compliance

While Y2K concerns are not as significant as they once were, the issue of date data still remains, particularly for applications that perform calculations based on date data entered into the system. The licensee will want to include a representation that the software will perform date-related operations correctly, especially operations which include date values from different centuries, and, in addition, will sort date-related data and input information in correct chronological order, correctly recognize all past, present, and future leap years, and store internal date-related information in a manner that is unambiguous as to century.

§ 18:45. Software warranties—Compliance with laws

Certain software applications are licensed to assist the licensee to comply with certain laws and regulations. In addition, the licensee may expect that the software contain certain functionality that is updated regularly in line with legal and regulatory changes so that the use of the software continues to comply with applicable laws and regulations. For example, if an application was licensed to report certain information to the federal government in the format dictated by federal regulation, the licensee would want a warranty that if the format requirements changed, the software would contain the new format prior to the time the licensee was required to change the format. Software licensees in highly regulated industries (i.e., healthcare, financial) should be particularly concerned about this warranty.

§ 18:46. Software warranties—Services

Users may want to include a warranty that the services related to the software will be performed in a profession and workmanlike manner, by adequately trained individuals, and that the services will conform to the descriptions contained in the agreement. This is particularly important for complicated implementations with high price tags attached.

§ 18:47. Software warranties—Business method patent protection

While it is beyond the scope of this chapter, a particular concern for licensees of software is the growing amount of litigation surrounding infringement of business method patents. Certain applications implicitly require the use of certain business processes that have been provided protection under patent law.[1] While this is not an infringement by the software application itself, the licensee may find that in order to use the software for its intended purpose, it must obtain a license from the business method patent holder to use the associated business method.

[FN1] *See, e.g.,* State Street Bank & Trust Co. v. Signature Financial Group, Inc, 149 F.3d 1368, 47 U.S.P.Q.2d 1596 (Fed. Cir. 1998).

§ 18:48. Disclaimers, limitations, and exclusions—Limitations

The licensor will want to include a statement that the warranties that it has provided in the software license agreement are the only warranties made by the licensor in connection with the software and are expressly in lieu of any other warranties, express or implied including, without limitation, any warranty of merchantability or fitness for a particular purpose. The disclaimer of certain warranties under the UCC (e.g., merchantability and fitness for a particular purpose) have requirements of being "conspicuous" that must be met.[1] Additional warranty limitations include:

1. If the software is modified, altered, or in any way changed by anyone other than the licensor, the licensor will not want the applicable warranties to not apply. The licensee will want to limit this to the extent the modification actually causes the warranty nonconformance.
2. Any error in the software must be reproducible by the licensor in order for the applicable warranty to apply.
3. If the software is combined with any third party products, the licensor will want to ensure that the applicable warranties will not apply to any nonconformance caused by such combination.
4. The licensor will want to ensure that it is not responsible for any warranty non-conformance caused by the licensee's use of the software in a manner for which it was not intended.

[FN1] The warranty disclaimer is often in all-caps bold-faced type in the hope that a court will deem it sufficiently "conspicuous." Achieving conspicuousness can sometimes be problematic. *Compare* Office Supply Co., Inc. v. Basic/Four Corp., 538 F. Supp. 776, 34 U.C.C. Rep. Serv. 857 (E.D. Wis. 1982) (warranty disclaimer upheld, even though not conspicuous, where buyer knew of limitations prior to signing contract) and Jaskey Finance and Leasing v. Display Data Corp., 564 F. Supp. 160, 36 U.C.C. Rep. Serv. 26 (E.D. Pa. 1983) (disclaimer not rendered inconspicuous by location on reverse side of contract; citing cases), with Sierra Diesel Injection Service, Inc. v. Burroughs Corp., Inc., 874 F.2d 653, 658–59, 8 U.C.C. Rep. Serv. 2d 617 (9th Cir. 1989), opinion amended and superseded on denial of reh'g, 890 F.2d 108, 9 U.C.C. Rep. Serv. 2d 1236 (9th Cir. 1989) (warranty disclaimer on reverse side of several contract documents in all-caps, and in bold-faced type on some documents, was not sufficiently conspicuous in view of unsophisticated status of purchasers) and Burroughs Corp. v. Chesapeake Petroleum & Supply Co., Inc., 282 Md. 406, 384 A.2d 734 (1978) (disclaimer on reverse side was ineffective).

§ 18:49. Breach of warranty

The parties can agree to include various obligations of the parties in the event of a warranty breach, the most common of which are notice, opportunity to cure, and remedies.

§ 18:50. Breach of warranty—Notice

In the event of a warranty breach, the licensee will be required to notify the licensor of the issue. As most licensees and licensors do not normally communicate with each other pursuant to the notice provision of the contract, the parties should consider allowing communication regarding such issues to be conducted through less formal channels, such as e-mail, provided the individuals that are authorized to make such communications are spelled out.

§ 18:51. Breach of warranty—Opportunity to cure

Most licensees and licensors agree that there is no such thing as bug-free software. Both parties enter into a license agreement expecting some issues, which, with any luck, will be worked out during the acceptance testing phase of the relationship. However, bugs do appear even after software has been accepted, or, if the parties do not include acceptance testing, the warranty period may be the time when most issues are discovered. For most software licensees, a breach of contract claim for breach of warranty is not a great result. Most licensees want software that works as warranted and would rather require the licensor to fix and problems before it is forced to pursue legal action. Conversely, the licensor is well aware that there are going to be some issues with its software and usually welcome the opportunity to correct the error before it is considered in breach of contract.

The length of time that the licensor has to cure a warranty breach is often a highly contested provision. The parties may want to refer to the general termination provision to resolve this issue, which often includes an opportunity to cure, although the licensee may feel that this time period (typically 30 days) is too long for a warranty breach which causes the software to be completely down.

The licensor's concern with including a period of time to cure a warranty breach is that there are a wide variety of issues that may cause the warranty breach and the licensor may not feel comfortable agreeing that it will be able to correct every warranty issue within a specified period of time. The licensee's concern is that if there is no definite time period agreed upon, the correction process could go on indefinitely and it may be difficult to determine when the cure period is over and its cause of action for breach of contract is available.

One common suggestion to resolve this issue is to include language that, once the licensee notifies the licensor of the warranty issue, the parties will mutually agree upon a period of time for the licensor to resolve the issue. However, it may be difficult in the midst of a dispute to agree upon this time period, and, in addition, the enforce-ability of a contractual term requiring the parties to agree to this time period may be questionable. Another approach is to give the licensor a "reasonable" period of time to cure the warranty breach, but to set an outside limit that cannot be exceeded, such as 30 days. Thus, for less significant issues, the parties would expect the cure period to be much shorter than 30 days. In the event of a major malfunction, the licensor could reasonably expect to use the 30 day maximum to cure the defect. In any event, the parties could rely on a maximum of 30 days to correct the warranty issue.

§ 18:52. Breach of warranty—Remedies

In the event that the licensor cannot cure the warranty breach within the cure period, the parties may include language in the contract regarding the remedies that will be available to the licensee. The licensor will want to limit its exposure in this area, while the licensee will want to include certain remedies that will be available to it, being careful not to limit itself to the stated remedies in the event additional damages are suffered and would otherwise be recoverable.

The licensor will commonly agree to include language that the licensee's remedy is for the licensor to repair or replace the software, at licensor's option. Some licensors will go another step and state that this will be the licensee's sole and exclusive remedy for any breach of warranty. If the parties wish to use this language, they should be fully aware of how the applicable law treats the situation where the licensor is unable to repair or replace the software. Is the licensee out of luck? Will the remedy be deemed to have failed of its essential purpose, and, if so, what does the applicable law provide in such circumstances? For this reason, the parties may also consider some sort of monetary remuneration in the event the software cannot be repaired or replaced. Of course, if the licensee is going to agree to a sole and exclusive remedy in this area, it is going to have to be fairly certain that the remedy it agrees to will be adequate in most instances.

The licensee wants to make sure that, if the licensor is unable to cure a warranty nonconformance, it will have remedies available to it that will make it whole. First, it will want to consider a refund of any one-time fees it paid to the licensor up-front. These will typically include perpetual license fees, and implementation and consulting services fees. Depending on how far into the contract the parties are, it may seem unfair to allow the licensees to receive a refund of these fees, especially if the licensee has received some beneficial use of the software prior to the warranty issue. Therefore, the licensee will often concede that the refund of these amounts should be prorated based on the life expectancy of the software (typically, five years is agreeable to the parties). The licensee will also want to be sure that if it has prepaid any recurring fees, such as maintenance and support fees, it will receive a refund of the unused amount. Finally, the licensee will not want to agree that its remedies are its sole and exclusive remedies unless it is fairly certain that it will not have reason to pursue additional damages in the event of an uncured warranty breach.

§ 18:53. Maintenance and support services—Description of services

The maintenance and support terms can be set out in the license agreement or addressed in a separate agreement. The licensor may wish to separate the two so that a breach of its support obligations does not affect the license agreement, and vice versa. Conversely, the licensee will want to integrate into the contract all obligations that comprise the transaction. For example, the licensee would not want to find itself in a situation where it must continue to pay under a separate support agreement even though the license agreement has been terminated for a licensor breach. Software maintenance and support generally includes the services described in the sections to follow.

§ 18:54. Maintenance and support services—Description of services—Error correction

One main service provided under maintenance and support is the correction of errors. The agreement should clearly define what will be considered an error. In many instances, the parties can use the same language they used in the warranty section as part of the performance warranty (typically, this will include a failure to conform to the descriptions set forth in one or more of the following: the licensor's user documentation and specifications, the agreement documents and warranties, any additional descriptive material created by the parties themselves, including any response from the licensor to the licensee's request for proposal). Also, the parties can use the same exceptions in this area as were agreed upon in the warranty section.

§ 18:55. Maintenance and support services—Description of services—Updates and enhancements

The licensor will want to have the ability to exercise some control with regard to what code it will be required to supply as part of maintenance and support, and what code will require a separate license fee. Licensors will want to recoup their costs by charging a license fee when the version or release includes substantial collections of new functionality that were developed at a significant cost. Also, the licensor will want to avoid language in the contract requiring it to provide optional or new modules that aren't included in the standard product. The licensee, on the other hand, will want to obtain assurances in the contract that it will be receiving something of value in this area, rather than be faced with a license fee every time a new version or release is released. This is often an extremely tricky area of the contract but the language should state, in effect, that the licensor can charge a separate fee for releases considered to be separate products or releases that contain substantial collections of new functionality. The licensee may also want to negotiate a discount for any release requiring it to pay an additional license fee as part of its maintenance and support benefits. The licensor and the licensee should also determine whether installation of new releases will be covered by maintenance and support services.

§ 18:56. Maintenance and support services—Description of services—Telephone and e-mail support

The licensor will also provide access to licensor personnel by way of telephone or e-mail to answer questions pertaining to the use of the software and troubleshooting problems the licensee may be experiencing. Some licensors attempt to limit the number of people that can make calls for telephone support or send e-mails, and require that such individuals be adequately trained in the use of the software to avoid unnecessary calls and e-mails.

§ 18:57. Maintenance and support services—Description of services—Documentation

The licensee should insist that with each error correction and update to the software, the licensor supply it with updated documentation reflecting the changes that have occurred.

§ 18:58. Maintenance and support services—Description of services—User groups and knowledge databases

Many licensors, as part of support services, allow the licensee to access user groups and knowledge databases to assist the licensee with issues that other licensees may have already addressed.

§ 18:59. Maintenance and support services—Description of services—Hours of service

Most licensors offer varying levels of maintenance and support services, which may include standard business hour coverage and 24x7 plans. While standard business hours coverage may be sufficient in some instances, with any application that is considered mission critical, 24x7 coverage is preferred. Some 24x7 coverage may include off-hours coverage by way of pager.

§ 18:60. Maintenance and support services—Description of services—Severity levels and response time

It is beneficial to both parties to define different levels of issues that may be reported to the licensor. Most licensors have three or four different categories (e.g., critical, major, minor). The parties should determine a fairly specific definition for each severity level. The licensor can use these severity levels to determine which issues should be given the highest priority.

In addition to defining severity levels, the licensee will want to establish maximum time periods for the licensor to perform certain maintenance and support obligations. Typically, the parties will include a provision that for certain severity levels, the licensor agrees to respond to the licensee's notification of a problem within a certain period of time. In addition, the licensee should attempt to include time periods for supplying a work-around, and time periods for supplying a permanent correction. In the event the licensor is unable to meet any of these time periods, the licensee and licensor may negotiate certain credits to be given to the licensee, usually some percentage of that month's maintenance and support fee.

§ 18:61. Maintenance and support services—Description of services—On-site support

The parties may also want to specify under what circumstances, if any, the licensor is required to provide maintenance and support services on-site at the licensee's location. Usually, the licensor will want to charge extra for this service, but the licensee will want it to be provided at no additional charge in the event the licensor is not able to remedy the issue remotely.

§ 18:62. Maintenance and support services—Description of services—Identifying supported software

The parties should clearly define what software will be covered by the maintenance and support services that the licensor will be providing. The licensor will want to be sure to include language limiting how many releases it will support prior to the current release without charging an additional fee.

§ 18:63. Maintenance and support services—Description of services—Commencement, term, and renewal

The licensor will likely want the maintenance and support services term to start as soon as possible, typically on delivery or installation. The licensee will want to delay the commencement of maintenance and support services, or at least delay having to pay for such services, until the software has been tested, accepted, and the performance warranty period has expired. As licensee receives the error correction services under the performance warranty, that part of maintenance services would be redundant prior to expiration of the performance warranty. However, maintenance and support services provide more than the performance warranty covers, such as the provision of enhancements. For each license agreement, the parties will need to negotiate an equitable date for the commencement of such services.

For a perpetual software license, maintenance and support services are typically provided pursuant to successive one year terms, although some licensors provide services on a month-to-month basis. In exchange for a lower fee, the licensee may agree to a longer initial term, such as three years.

The parties may agree to a renewal mechanism for the maintenance and support services after the initial term. Most licensors include an automatic renewal for successive one year terms unless either party gives notice that it does not want to renew. This can create a dangerous situation for the licensee as it is not guaranteed continuity of maintenance and support services. At the end of any given renewal term, the licensor could give notice that it does not want to renew, leaving the licensee with an unsupported application. The licensee may want to consider adding language to this provision that the licensor will not exercise its option to cancel maintenance and support services until a stated number of years have expired.

§ 18:64. Maintenance and support services—Description of services—Cost

Most licensors price their maintenance and support services as a percentage of the license fee paid for the supported software, with the percentage falling within a range of 15-25%, depending on the services being provided. The licensee may agree to allow the licensor to increase its maintenance and support fee on an annual basis after the initial term, but limit the increase to a certain percentage, or the Consumer Price Index. The parties may also want to address the situation whether the licensee does not renew maintenance and support services, and later requests to be covered again. The licensor will normally require that the licensee pay a fee equal to the fees that the licensee would have paid had it had continuous coverage, plus an additional “reinstatement” fee. The reinstatement fee is intended to discourage licensees from cancelling maintenance and support services to save money, with the option of resuming coverage if the licensor offers something the licensee wants.

§ 18:65. Maintenance and support services—Description of services—Requirement for license

Some licensors require, as a condition of the software license, that the licensee pay for, and receive, maintenance and support services. There are varying arguments as to why this is required. The most convincing of which is that the licensor must have access to and update the software in order for it to continue to operate properly. No licensor wants its software being used in a manner that does not work properly. The licensee is likely to see this requirement as an attempt to increase the licensor's revenues. While most licensees aren't interested in avoiding maintenance and support services for their software, the licensee will want to resist making it a mandatory requirement. The most significant concern for the licensee would be a situation where the maintenance and support services being provided are substandard or inadequate to the extent that it no longer feels such services are worth the fee being charged. In such an instance, the licensee may not have a choice but to continue to pay for and receive maintenance and support services to avoid losing its license.

§ 18:66. Infringement indemnification

The licensee of any software program will want assurances that the software product provided by the licensor does not infringe or misappropriate any patent, copyright, trade secret or other intellectual property right of a third party. The most common way to address this concern is by way of an indemnification clause, whereby the risks associated with claims made by a third party with respect to the infringement or misappropriation of intellectual property rights associated with the software are transferred to the licensor. Indemnification provisions are typically viewed as insurance against what should be an unlikely event. However, the licensee should not overlook the importance of such protection, in that if such a claim were made the cost to licensee would be significant, and the potential for such a claim against a licensee is increasing with the number of intellectual property infringement actions on the rise.

§ 18:67. Infringement indemnification—Who is protected

The licensee will want the indemnification clause to cover all entities and persons closely associated with the organization. It is not uncommon for the indemnities to include the licensee and its affiliates, successors, officers, directors, shareholders, employees, and agents.

§ 18:68. Infringement indemnification—What IP rights are covered?

Indemnification clauses typically cover third party claims asserting that the software infringes on a copyright of the third party. The licensee should consider what other types of third party claims of infringement or misappropriation could be made against licensee with respect to its use of the software. Most infringement actions arise out of patent or trade secret rights, so it is important for a licensee to ensure those actions are also covered by the indemnification provision. It is not uncommon for the licensee to request that the indemnification extend to claims of any patent, copyright, trade secret or other proprietary right of a third party.

The licensor may want to limit the scope of its indemnification obligation by listing the specific types of violations covered.

§ 18:69. Infringement indemnification—U.S. vs. worldwide

The scope of licensor's indemnification obligation can be narrowed by limiting the coverage to claims that the software infringes U.S. intellectual property rights. A licensee may be willing to accept such a limitation if it has no plans to use the software outside the United States or if the licensor does not allow the use of its software outside the United States. Otherwise, the licensee may have a legitimate concern that it could be the subject of an infringement claim based on the infringement of a patent or copyright of a country established outside the United States. If the licensee is permitted to use the software outside of the United States, the licensee should consider seeking worldwide coverage, and the licensor will want to evaluate to what extent it is willing to offer such coverage. The licensee and licensor may be able to agree on a specific list of countries, and may create such a list based on what parts of the world the licensee foresees using the software and what parts of the world the licensor markets its software.

§ 18:70. Infringement indemnification—Other intellectual property rights

While patents, copyrights and trade secrets are commonly covered by intellectual property indemnification provisions, there is a possibility (although small) that an infringement or misappropriation claim be based on some other form of proprietary rights. For instance, the claim could allege an infringement of another party's trademark, mask work, plant variety certificate, or good will. It is difficult to know exactly what the infringement claim will be based upon, and therefore, it is wise for a licensee to seek indemnification coverage to generally capture claims made as to the infringement of any other proprietary rights of a third party.

§ 18:71. Infringement indemnification—Duty to defend

An offer to indemnify another party does not automatically give rise to a duty to defend. Therefore, unless the licensor undertakes a duty to defend, the licensor would be expected to defend the licensee against the claim through the appointment of an attorney or reimbursement of defense costs. In contrast, if the licensor has only agreed to indemnify (and not specifically agreed to undertake defense of the licensee), the obligation to indemnify would only arise when the indemnity sustains and actual loss.[1] This means the that licensee must make payment on an underlying claim, judgment or settlement to trigger the licensor's duty to reimburse the licensee. If the indemnification agreement provides for indemnification against liability, the licensor's obligations arise as soon as liability is fixed.[2]

[FN1] Larson Mach., Inc. v. Wallace, 268 Ark. 192, 600 S.W.2d 1 (1980) (stating indemnitee must show actual loss by payment or satisfaction of judgment or by other payment under compulsion); F. J. Schindler Equipment Co. v. Raymond Co., 274 Pa. Super. 530, 418 A.2d 533 (1980) (holding indemnitee must pay damages to third party).

[FN2] *See* Trim v. Clark Equipment Co., 87 Mich. App. 270, 274 N.W.2d 33 (1978) (noting indemnitee need only show potential liability to injured parties and that settlement is reasonable); Williams v. Johnston, 92 Idaho 292, 442 P.2d 178 (1968) (right to indemnification arises when liability to third party is established).

§ 18:72. Infringement indemnification—Notification of the claim

Unless the indemnification clause contains an express requirement that the licensee give the licensor notice of the claims against the licensee, the licensee may not be required to give the licensor notice of the claims.[1] The licensor offering indemnification to a licensee should condition its obligation to indemnify the licensee upon the prompt notification from the licensee of any such claim for which the licensee seeks indemnification. Without it, the licensor's defense of the claim could be prejudiced. If however, the parties contractually establish that proper notice is a condition precedent to liability under the indemnification provision, a licensee's failure to give notice to the licensor may bar the licensee's claim.[2]

[FN1] ELRAC, Inc. v. Cruz, 182 Misc. 2d 523, 699 N.Y.S.2d 647 (N.Y. City Civ. Ct. 1999). *But see* Rothey v. Walker Bank & Trust Co., 754 P.2d 1222 (Utah 1988) (noting that while notice is not generally necessary to invoke the indemnitor's liability, rules of estoppel may apply); Morris v. Schlumberger, Ltd., 445 So. 2d 1242 (La. Ct. App. 3d Cir. 1984), writ denied, 449 So. 2d 1345 (La. 1984) (equitable principles of equity apply where contract is silent on issues of tender and notification).

[FN2] American Home Assur. Co. v. International Ins. Co., 90 N.Y.2d 433, 661 N.Y.S.2d 584, 684 N.E.2d 14, 16 (1997) (stating absent a valid excuse, a failure to satisfy notice requirement vitiates the policy); McLin v. Leigh, 74 Ohio App. 3d 127, 598 N.E.2d 731 (2d Dist. Montgomery County 1991). *But see* Alcazar v. Hayes, 982 S.W.2d 845, 850 (Tenn. 1998) (rejected by, Clementi v. Nationwide Mut. Fire Ins. Co., 16 P.3d 223 (Colo. 2001)) (noting modern trend considers whether the insurer has been prejudiced by untimely notice).

§ 18:73. Infringement indemnification—Settlement

If the licensor has accepted its indemnity obligations, the licensor generally retains the right to control settlement of the claims. And, because the licensor carries the primary risk, it should insist on controlling the proceedings and any settlement of the dispute (so long as the licensee is not disadvantaged by the settlement). In other words, the licensee should ensure that the licensor cannot attribute wrongdoing to the licensee. If the licensor has denied its obligations or failed to approve settlement of the claim, the licensee generally has the right to enter into a reasonable settlement without consultation with the licensor.[1] This holds true even where the indemnity agreement provides that the licensor cannot consummate a settlement without the licensee's consent.[2] In general, however, the licensee owes a duty of good faith to the licensor. Any act by the licensee that prejudices the licensor's rights will release the licensor's obligations to the extent of the prejudice.[3]

[FN1] Sequa Coatings Corp. v. Northern Indiana Commuter Transp. Dist., 796 N.E.2d 1216, 1230 (Ind. Ct. App. 2003), decision clarified on reh'g, 800 N.E.2d 926 (Ind. Ct. App. 2003); ELRAC, Inc. v. Cruz, 182 Misc. 2d 523, 699 N.Y.S.2d 647 (N.Y. City Civ. Ct. 1999).

[FN2] Luton Min. Co. v. Louisville & N.R. Co., 276 Ky. 321, 123 S.W.2d 1055, 1060 (1938).

[FN3] New Amsterdam Cas. Co. v. Lundquist, 293 Minn. 274, 198 N.W.2d 543, 549 (1972) (indemnitee had duty to minimize loss and communicate offers of settlement); Wolthausen v. Trimpert, 93 Conn. 260, 105 A. 687, 690 (1919) (noting indemnitee's duty to act in good faith and use ordinary care).

§ 18:74. Infringement indemnification—Cooperation

Indemnity obligations can also be conditioned on cooperation of the licensee. Both the licensor and licensee should be on the same side of the dispute and aiding each other in the defense. The licensor should be willing to pay any expenses the licensee incurs in assisting it with such defense.

§ 18:75. Infringement indemnification—Exclusions

The licensor may seek to limit its indemnification obligation by excluding certain types of claims. For example, the licensor rightly should not be responsible for infringement claims based on (a) the licensee's use of a version of the Software other than the current version of the Software if such infringement would have been avoided by the use of the current version and licensor made such current version available to the licensee, or (b) a modification of the Software by licensee not based on the Software's documentation or otherwise directed or approved by licensor. The licensor may also wish to exclude from its indemnification obligations any claim of infringement that is based upon (1) the combination of the Software or any item of the Software with any product, software, machine, or device which is not delivered by licensor, (2) customizations to the Software based on licensee's specifications, or (3) the use of the Software other than in compliance with the Documentation provided by licensor. The licensee will need to consider if the foregoing are appropriate based on a number of factors. For instance, if the products to be used with the Software are items that the licensee is expected to obtain on its own, but are required to use the Software, the limitation in subpart “(1)” above, may not be appropriate. The limitation in subpart “(2)” may not be appropriate if the licensor ultimately owns the customizations to the Software, despite the fact that the licensee initially requested them. In addition, if the licensor is doing all the programming, they are in a better position than the licensee to know if what is being created infringes another party's intellectual property. Finally, subpart “(3)” above may be problematic for the licensee if the Documentation is less than comprehensive or if the licensor has told the licensee that they can do or use the Software for or in a certain way that is not described in the Documentation.

§ 18:76. Infringement indemnification—Infringement claim remedies

If due to the infringement action an injunction is sought or obtained against use of the Software, certain remedies may be made available to the licensee. These remedies should be stated in the license agreement. These remedies should include an option for the licensor is to modify or replace such Software to provide the licensee with comparable quality and functionality, or for the licensor to obtain the right for the licensee to continue its use of the Software (often involving the payment of a fee to the third party claimant). Such remedies may be fine for the licensee, provided they are provided promptly so that the licensee doesn't experience a period of non-usage, and provided the licensee is not required to pay any additional sums to the licensor or third-party claimant for the modification, replacement or continued usage. If the remedy is not promptly provided, the licensee's business may be negatively impacted. The licensee may also want to state a specific time-frame for the licensor to provide the licensee with a remedy. Where the licensor is offering to provide the foregoing remedies at its expense, the licensor may also want to ensure that it alone decides which remedy it will provide to the licensee. Some of the remedies may be cost prohibitive, depending on the situation.

Another remedy that should be included is termination of the licensee's use of such Software with a refund of sums paid by the licensee. The licensor will want to limit the scope of what is terminated as much as possible and the amount of the refund. For instance, if the Software is made up of many components or a number of different modules, licensor may want the ability to terminate licensee's right to use the Software (all of it) or just the affected portion thereof. The licensee will need to consider if this type of remedy also meets its needs, such that if only a portion of the Software were terminated, would it be practical for the licensee to continue to use the rest of the Software without the terminated portion. In some cases this can be resolved by stating that if only a portion of Software is terminated, then any other Software reasonably rendered ineffective as the result of said infringement shall also be terminated. In other cases, nothing but a complete termination of all the Software will makes sense for the licensee.

In the event of a termination of licensee's usage of all or a portion of the license fees and professional service fees related to the Software is typically refunded to the licensee. Depending on the licensee's bargaining strength, sometimes even additional fees for costs incurred by the licensee to find another vendor can be included. The licensee will want to keep in mind what costs it might incur in replacing such terminated Software and the potential useful life of the Software. Often parties will agree on an amortization schedule in discussing the refund of the license fees, that reduces the amount of refund over time.

§ 18:77. Infringement indemnification—Limitations of liability

The licensor may further seek to limit its indemnification obligation to the payment of the amounts awarded against the licensee by a court of final jurisdiction or agreed to by the licensor in settlement of the claim. The licensor may further seek to have the licensee share in the risk of loss by limiting the amounts paid by the licensor to the license fees paid by licensee for the software subject to the claim. The licensee should resist any dollar caps on the damages to be paid by the licensee to ensure against the possibility that it will need to pay any of the damages awarded in court or agreed upon in settlement, and seek to have the licensor's indemnification obligations excluded from any limitations on damages. The licensor can often mitigate the unlimited cap on damages by insisting that its indemnification obligations and the remedies stated thereunder are licensee's sole and exclusive remedies for an infringement claim.

§ 18:78. Infringement indemnification—Survival

A licensee will want to ensure that the obligation of intellectual property indemnification survives beyond termination of the Agreement. The fact that the licensee no longer has a license to use the Software, does not eliminate the possibility of an infringement claim brought against the licensee. However, the licensor should only be responsible for indemnifying the licensee from infringement claims that are based on the licensee's usage of the Software while the Agreement was in effect, and may want to limit its post-termination intellectual property indemnification obligations in this manner.

V. Shrink-wrap and Click-wrap License Agreements

§ 18:79. Background

Shrink-wrap and click-wrap licenses are ubiquitous in the software industry. In the early days of the personal-computer industry, mass-market transactions (e.g., over-the-counter or mail-order) almost always involved computer program disks that were packaged in a sealed envelope packed inside the product box, with the envelope having license-agreement terms printed on it, together with a legend that breaking the seal constitutes assent to those terms. Nowadays, the most common form of license agreement is probably the so-called click-wrap agreement: To install the software, the user must click on a button indicating that the user agrees to the terms and conditions of a license agreement.

§ 18:80. The *Step-Saver* case: shrink-wrap unenforceable

In the *Step-Saver* case,[1] a software vendor made a number of sales to a value-added reseller (VAR). In the first transaction, the vendor sent the VAR a copy of the software to try out. The trial copy was in the vendor's standard packaging with shrink-wrap license terms. The court held that, in this transaction, the shrink-wrap license terms formed part of the contract and therefore the warranty-disclaimer language was effective.[2]

Subsequent transactions between the vendor and the VAR involving the software, however, were made by telephone order, with no pre-sale mention of shrink-wrap license terms. The court held that in those transactions, the shrink-wrap license terms did not constitute conditions to the licensor's acceptance of the contract under UCC § 2.207(1), but instead were proposed additional terms to a sales contract under UCC § 2-207(b). Thus, the shrink-wrap license terms did not become part of the contract, and therefore the warranty-disclaimer language was not given effect.[3]

[FN1] Step-Saver Data Systems, Inc. v. Wyse Technology, 939 F.2d 91, 15 U.C.C. Rep. Serv. 2d 1 (3d Cir. 1991).

[FN2] Step-Saver Data Systems, Inc., 939 F.2d at 101–02.

[FN3] Step-Saver Data Systems, Inc., 939 F.2d at 101–02; *see also* Arizona Retail Systems, Inc. v. Software Link, Inc., 831 F. Supp. 759, 22 U.C.C. Rep. Serv. 2d 70 (D. Ariz. 1993) (same holding on similar facts).

§ 18:81. The *ProCD* case: shrink-wrap license enforceable

A markedly different result was reached by the Seventh Circuit in the *ProCD* case.[1] In that case, the defendants bought, over the counter, a copy of a CD-ROM telephone directory containing thousands of telephone numbers. They copied the data to a hard disk drive and made the data—but not the plaintiff's search-engine software—available on the Internet. The CD ROM vendor sued, claiming copyright infringement and breach of the shrink-wrap license agreement.

The district court granted summary judgment for the defendants, holding that:

The copyright claim was defeated by the Supreme Court's Feist decision that the white pages of the telephone directory are not sufficiently original to be copyrightable;

Under the Step-Saver rationale, the shrink-wrap license terms were not binding on the defendants, who had not had an opportunity to consider and attempt to bargain over those terms before buying the CD ROM;

The result was not changed by the facts that the CD ROM package had a small notice on the outside that license terms were contained within the package;

Nor was the result changed by the fact that the defendants had purchased additional CD ROMs after the first one, because the shrink-wrap license terms within the package might have changed by the time they made their subsequent purchases;

In any event, the plaintiff's breach-of-contract claim was preempted by the Copyright Act.

The Seventh Circuit reversed. In an opinion by Judge Easterbrook, the appellate court held that “[s]hrinkwrap licenses are enforceable unless their terms are objectionable on grounds applicable to contracts in general (for example, if they violate a rule of positive law, or if they are unconscionable).”[2]

[FN1] ProCD, Inc. v. Zeidenberg, 86 F.3d 1447, 39 U.S.P.Q.2d 1161, 29 U.C.C. Rep. Serv. 2d 1109 (7th Cir. 1996) (granting summary judgment in favor of copyright infringement defendants).

[FN2] ProCD, 86 F.3d at 1449.

§ 18:82. The *ProCD* case: shrink-wrap license enforceable—Deferring "lock-in" of the contract

The Seventh Circuit distinguished *Step-Saver* as involving a transaction between merchants that was governed by section 2-207 of the UCC, which was irrelevant to a consumer transaction.[1] The court held that under the Wisconsin UCC, the terms of a sales contract between a software vendor and a consumer are not necessarily "locked in" at the time the consumer purchases a copy of software. In other words, the contract is not finalized merely because money changes hands. The court drew an analogy to contracts in other areas, e.g., insurance policies, concert tickets, and sales of consumer goods, in which money changes hands before all terms of the contract are communicated to the purchaser.[2]

[FN1] ProCD, 86 F.3d at 1452.

[FN2] ProCD, 86 F.3d at 1450–53.

§ 18:83. The *ProCD* case: shrink-wrap license enforceable—Short-form package notices

The Seventh Circuit rejected the notion that, for shrink-wrap license terms to be enforceable, all license terms must be printed on the outside of the box so that the purchaser can read them before making a purchase. Judge Easterbrook pointed out that notice of the existence of license terms was provided on the outside of the packaging of the CDs; that the individual defendant had the express right to return the package for a refund if he did not agree with those terms; and that the defendant had in fact clicked on an "I agree" button indicating his assent to the license terms.[1]

[FN1] ProCD, 86 F.3d at 1453.

§ 18:84. The *ProCD* case: shrink-wrap license enforceable—Click-through "signatures"

Perhaps most significantly, the Seventh Circuit validated a common practice among software vendors, namely requiring users to signify assent to license terms by, e.g., clicking on an "I agree" button. The court said that under Uniform Commercial Code:

> A vendor, as master of the offer, may invite acceptance by conduct, and may propose limitations on the kind of conduct that constitutes acceptance. A buyer may accept by performing the acts the vendor proposes to treat as acceptance.
>
> And that is what happened. ProCD proposed a contract that a buyer would accept by using the software after having an opportunity to read the license at leisure. This Zeidenberg did. He had no choice, because the software splashed the license on the screen and would not let him proceed without indicating acceptance.
>
> So although the district judge was right to say that a contract can be, and often is, formed simply by paying the price and walking out of the store, the UCC permits contracts to be formed in other ways. ProCD proposed such

a different way, and without protest Zeidenberg agreed.

Ours is not a case in which a consumer opens a package to find an insert saying “you owe us an extra $10,000” and the seller files suit to collect. Any buyer finding such a demand can prevent formation of the contract by returning the package, as can any consumer who concludes that the terms of the license make the software worth less than the purchase price. Nothing in the UCC requires a seller to maximize the buyer's net gains.[1]

[FN1] ProCD, 86 F.3d at 1452–53 (paragraphing supplied).

§ 18:85. The *ProCD* case: shrink-wrap license enforceable—Price discrimination as economic justification

The Seventh Circuit cited an economic rationale in support of its position. It observed that ProCD used its shrink-wrap licensing regimen as a vehicle for price discrimination, so that it could sell its telephone-directory data to consumers at a lower price than to businesses (which presumably would be willing to pay more). The court warned that if software companies are not permitted to use low-cost, standardized, shrink-wrap contracts licenses to enforce such price-discrimination schemes, the result will eventually be higher prices.[1]

[FN1] ProCD, 86 F.3d at 1449–52.

§ 18:86. The *ProCD* case: shrink-wrap license enforceable—A restrictive view of federal preemption

In *ProCD*, the Seventh Circuit also reversed the district court's holding that state contract law would be preempted by the federal Copyright Act to the extent that state law would make enforceable the anti-copying provisions of the shrink-wrap license. Some observers were surprised by the holding, given that in recent years a number of other courts, including the Supreme Court, have taken an expansive view of what can safely be done with copyrighted works.[1] The *ProCD* court took the view that the reach of the Copyright Act's federal preemption does not extend to private contracts:

[State-law rights] “equivalent to any of the exclusive rights within the general scope of copyright” [and thus preempted by 17 U.S.C.A. § 301] are rights established by law—rights that restrict the options of persons who are strangers to the author.

Copyright law forbids duplication, public performance, and so on, unless the person wishing to copy or perform the work gets permission; silence means a ban on copying. A copyright is a right against the world. Contracts, by contrast, generally affect only their parties; strangers may do as they please, so contracts do not create “exclusive rights.”

Someone who found a copy of [ProCD's] SelectPhone (trademark) on the street would not be affected by the shrink-wrap license—though the federal copyright laws of their own force would limit the finder's ability to copy or transmit the application program.[2]

[FN1] *See* § 2:16 (copyright protection for computer programs) and § 4:11 (including discussion of preemption principles).

[FN2] ProCD, 86 F.3d at 1454 (paragraphing supplied).

§ 18:87. Subsequent shrink-wrap/click-wrap case law—Cases holding agreements enforceable

M.A. Mortenson Co., Inc. v. Timberline Software Corp., 140 Wash. 2d 568, 998 P.2d 305, Prod. Liab. Rep. (CCH) P 15893, 41 U.C.C. Rep. Serv. 2d 357 (2000): The Washington Supreme Court reviewed the prior case law and held that a printed shrink-wrap license agreement was enforceable. The court took note of "extensive testimony and exhibits before the trial court [that] demonstrate an unquestioned use of such license agreements throughout the software industry." M.A. Mortenson Co., Inc., 140 Wash. 2d at 585, 998 P.2d at 314.

Caspi v. Microsoft Network, L.L.C., 323 N.J. Super. 118, 732 A.2d 528 (App. Div. 1999): The New Jersey court dismissed the complaint on the basis of a forum-selection clause in a "browse-wrap" agreement. The appellate court focused almost exclusively on the propriety of the forum-selection clause per se; as to the click-through mechanics of the agreement, the court merely noted that "plaintiffs and the class which they purport to represent were given ample opportunity to affirmatively assent to the forum selection clause" and that they "retained the option of rejecting the contract with impunity." Caspi, 732 A.2d at 531 (citation and internal quotation marks omitted).

Hill v. Gateway 2000, Inc., 105 F.3d 1147, R.I.C.O. Bus. Disp. Guide (CCH) P 9183, 31 U.C.C. Rep. Serv. 2d 303 (7th Cir. 1997):[1] The Seventh Circuit expanded its *ProCD* holding in *Hill*. A customer ordered a computer by telephone; the computer arrived in a box also containing license terms, including an arbitration clause, "to govern unless the customer return[ed] the computer within 30 days." Hill, 105 F.3d at 1148. The customer was not required to view or expressly assent to these terms before using the computer. More than 30 days later, the customer brought suit based in part on Gateway's warranty in the license agreement, and Gateway petitioned to compel arbitration. The court held that the manufacturer, Gateway, "may invite acceptance by conduct," and that "[b]y keeping the computer beyond 30 days, the Hills accepted Gateway's offer, including the arbitration clause." Hill, 105 F.3d at 1149, 1150. Although not mentioned in the decision, the customer, by seeking to take advantage of the warranty provisions contained in the license agreement, thus could be fairly charged with the arbitration clause as well.

Westendorf v. Gateway 2000, Inc., 41 U.C.C. Rep. Serv. 2d 1110 (Del. Ch. 2000), judgment aff'd, 763 A.2d 92 (Del. 2000): The court dismissed the lawsuit because of the arbitration clause set forth in Gateway's in-the-box agreement.

Register.com, Inc. v. Verio, Inc., 126 F. Supp. 2d 238, 63 U.S.P.Q.2d 1957 (S.D. N.Y. 2000), aff'd as modified, 356 F.3d 393, 69 U.S.P.Q.2d 1545 (2d Cir. 2004):[2] The plaintiff posted license terms on its Web site, alongside a statement that "[b]y submitting this query [to the plaintiff's database], you agree to abide by these terms." 126 F. Supp. 2d at 248. The court held that, "in light of this sentence at the end of Register.com's terms of use, there can be no question that by proceeding to submit [a query], Verio manifested its assent to be bound by Register.com's terms of use, and a contract was formed and subsequently breached."

Brower v. Gateway 2000, Inc., 246 A.D.2d 246, 252, 256, 676 N.Y.S.2d 569, 572, 37 U.C.C. Rep. Serv. 2d 54 (1st Dep't 1998): The court held that Gateway's in-the-box agreement was enforceable, but the arbitration clause was unconscionable because it specified ICC rules that were unjustifiably expensive for the amount in controversy.

Peerless Wall and Window Coverings, Inc. v. Synchronics, Inc., 85 F. Supp. 2d 519, 41 U.C.C. Rep. Serv. 2d 462 (W.D. Pa. 2000), order aff'd, 234 F.3d 1265 (3d Cir. 2000): The court followed what it described as "the weight of authority" and granted summary judgment for a software vendor on the basis that a paper shrink-wrap license was enforceable. See 85 F. Supp. 2d at 524 (citing cases).

[FN1] This paragraph is adapted from Specht v. Netscape Communications Corp., 150 F. Supp. 2d 585, 45 U.C.C. Rep. Serv. 2d 1 (S.D. N.Y. 2001), aff'd, 306 F.3d 17, 48 U.C.C. Rep. Serv. 2d 761 (2d Cir. 2002), discussed below.

[FN2] The description in the text is adapted essentially verbatim from the opinion in the Specht v. Netscape Communications Corp., 150 F. Supp. 2d 585, 45 U.C.C. Rep. Serv. 2d 1 (S.D. N.Y. 2001), aff'd, 306 F.3d 17, 48 U.C.C. Rep. Serv. 2d 761 (2d Cir. 2002), discussed below.

§ 18:88. Subsequent shrink-wrap/click-wrap case law—Cases holding agreements enforceable—Cases holding agreements unenforceable

Specht v. Netscape Communications Corp., 306 F.3d 17, 48 U.C.C. Rep. Serv. 2d 761 (2d Cir. 2002): Affirming the district court's determination that an arbitration clause in a “browse-wrap” license agreement on Netscape's Web site for downloading software was not enforceable, the Second Circuit ruled, first, that the users of a plug-in downloaded from Netscape did not assent to that program's license and arbitration clause since (a) under California law, a consumer's clicking on a download button does not communicate assent to contractual terms if the offer did not make clear that clicking the download button signified assent to those terms and (b) when consumers are urged to download free software at the click of a button, a reference to the existence of a submerged screen is not sufficient to place consumers on constructive notice of those terms. Second, claims relating to the plug-in's license agreement were not subject to the arbitration clause contained in the license agreement for Netscape's browser—Communicator—since (a) the underlying dispute as to Netscape's violation of the Electronic Communications Privacy Act and the Computer Fraud and Abuse Act involved matters clearly collateral to the Communicator license agreement, (b) the Communicator license agreement did not expressly apply to the plug-in, and (c) Communicator's license agreement included a merger or integration clause stating that the license constituted the entire agreement between the parties. Third, any benefit to the owner of a Web site, who alleged that Netscape intercepted information any time an individual who had downloaded the plug-in visited his Web site, a nonsignatory to the plug-in's license agreement, resulting from downloads made by visitors to the Web site was too speculative and tenuous to require the Web site owner to arbitrate his claim.

Klocek v. Gateway, Inc., 104 F. Supp. 2d 1332, 41 U.C.C. Rep. Serv. 2d 1059 (D. Kan. 2000): Gateway fared less well here, because the district court denied Gateway's motion to dismiss. The court criticized the Seventh Circuit's *ProCD* reasoning for failing to explain why the vendor supposedly was the “master of the offer,” asserting that “[i]n typical consumer transactions, the purchaser is the offeror, and the vendor is the offeree.” The *Klocek* court opined that “[w]hile it is possible for the vendor to be the offeror, Gateway provides no factual evidence which would support such a finding in this case. The court therefore assumes for purposes of the motion to dismiss that plaintiff offered to purchase the computer (either in person or through catalog order) and that Gateway accepted plaintiff's offer (either by completing the sales transaction in person or by agreeing to ship and/or shipping the computer to plaintiff).” (Citations omitted.) The *Klocek* court then looked to UCC § 2-207 and found that “Gateway provides no evidence that at the time of the sales transaction, it informed plaintiff that the transaction was conditioned on plaintiff's acceptance of [Gateway's] Standard Terms. Moreover, the mere fact that Gateway shipped the goods with the terms attached did not communicate to plaintiff any unwillingness to proceed without plaintiff's agreement to the Standard Terms.”

Novell, Inc. v. Network Trade Center, Inc., 25 F. Supp. 2d 1218, 1998-2 Trade Cas. (CCH) P 72378, 37 U.C.C. Rep. Serv. 2d 528 (D. Utah 1997), vacated in part, 187 F.R.D. 657 (D. Utah 1999): Novell is the well-known developer, manufacturer, and distributor of the NetWare network operating system. NTC was a Novell distributor that had purchased copies of older versions of NetWare in bulk, at low prices, and had also purchased copies of newer versions directly from Novell, at “upgrade” pricing, and then sold the newer versions to its customers at a profit. Novell, Inc. 25 F. Supp. 2d at 1222. Novell relied on its shrink-wrap license in arguing that NTC was liable for copyright infringement as a contributory infringer. It claimed that NTC's customers were not licensed to use the software. The shrink-wrap license, Novell said, allowed only certain end-users to copy the software onto the hard drive—namely, those who had purchased the software in compliance with Novell's "upgrade" policy. Thus, Novell asserted, NTC's customers, who had not purchased the software in compliance with the upgrade policy, were infringers, and NTC therefore was liable for contributory infringement. Novell, Inc. 25 F. Supp. 2d at 1229–30. The court rejected Novell's argument, adopting what it termed the "majority" position of the *Step-Saver* opinion, as opposed to the "minority" view expressed in *ProCD*. It held that the sales of copies of the software were sales of goods under the UCC, that the shrink-wrap license was therefore ineffective to retain title to the copies in Novell, and consequently that the first-sale doctrine allowed purchasers "to use the software in accordance with its intended use, including unrestricted copying of the software onto their hard drives." Novell, Inc. 25 F. Supp. 2d at 1230–31.

§ 18:89. The UCITA shrink-wrap revisions

The Uniform Computer Information Transactions Act (UCITA), at this writing enacted only in Maryland and Virginia, contains provisions expressly validating click-wrap agreements that provide either for pre-assent review or for a post-rejection right of return. In official comment 5 to Section 112, illustration 1 opines that:

The registration screen for NY Online prominently states: "Please read the License. It contains important terms about your use and our obligations. If you agree to the license, indicate this by clicking the "I agree" button. If you do not agree, click "I decline"." The on-screen buttons are clearly identified. The underlined text is a hypertext link that, if selected, promptly displays the license. A party that indicates "I agree" assents to the license and adopts its terms.[1]

> [FN1] National Conference of Commissioners on Uniform State Laws, Uniform Computer Information Transactions Act § 112, comment 5, illustration 1, http://www.law.upenn.edu/bll/ulc/ucita/ucitafinal00.htm

§ 18:90. Recommendations for click-wrap agreements

In view of the case law, some possible recommendations for companies using click-wrap agreements are:

Give the user the opportunity to review the click-wrap agreement before proceeding with the download, installation, etc. If practicable, make this opportunity available before the user enters a credit card number or otherwise pays any money.

If practicable, make it effectively impossible for the user to proceed with the download, installation, etc., without clicking on an "I agree" button or link. Otherwise, make it conspicuously clear to the user, on the screen, that if s/he chooses to proceed with the download, installation, etc., s/he will be deemed to have assented to the agreement.

In the *Douglas* case, the Ninth Circuit considered whether a service provider may change the terms of its service contract merely by posting a new version on its web site.[1] The district court granted the service provider's motion to compel arbitration under the revised service contract and the plaintiff appealed under a petition for writ of mandamus. The Ninth Circuit follows five factors in assessing whether to grant a writ of mandamus:

1. "The party seeking the writ has no other adequate means, such as a direct appeal, to attain the relief he or she desires."
2. "The petitioner will be damaged or prejudiced in a way not correctable on appeal."
3. "The district court's order is clearly erroneous as a matter of law."
4. "The district court's order is an oft-repeated error, or manifests a persistent disregard of the federal rules."
5. "The district court's order raises new and important problems, or issues of law of first impression."[2]

The Ninth Circuit concluded that the district court had "erred in holding that Douglas was bound by the terms of the revised contract when he was not notified of the changes."[3] The Ninth Circuit in granting the writ of mandamus, and vacating the district court's order to compel arbitration, clearly indicated that effective notice has to be given to a consumer before terms of use (or a service contract) can be amended with an arbitration provision.

The district court had looked at cases where notice was provided either by direct mailing, or by required access to the web site for the service itself. In the Douglas case, the plaintiff claimed that he never went to Talk America's web site as he had authorized automatic deductions for his account.

[FN1] Douglas v. U.S. Dist. Court for Cent. Dist. of California, 495 F.3d 1062 (9th Cir. 2007), cert. denied, 128 S. Ct. 1472 (U.S. 2008).

[FN2] Bauman v. U.S. Dist. Court, 557 F.2d 650, 654–55, 15 Fair Empl. Prac. Cas. (BNA) 279, 14 Empl. Prac. Dec. (CCH) P 7700, 23 Fed. R. Serv. 2d 990 (9th Cir. 1977).

[FN3] Douglas v. U.S. Dist. Court for Cent. Dist. of California, 495 F.3d 1062 (9th Cir. 2007), cert. denied, 128 S. Ct. 1472 (U.S. 2008).