Woman C.P.A.

Volume 48 | Issue 2 Article 10

4-1986

Electronic Data Processing: Negotiating Computer Sales Contracts Know Your Legal Rights

Elise G. Jancura

William J. Day

Electronic Data Processing

Negotiating Computer Sales Contracts

Know Your Legal Rights

Editor:
Elise G. Jancura, CPA, CISA, Ph.D.
The Cleveland State University
Cleveland, Ohio 44102

By William J. Day

Computer systems are an integral part of American business today. Everything from client billing to automobile design is done by computer. However, the law governing computers and computer systems acquisitions has not developed as quickly as the systems themselves. There is no clear body of law which may be termed "computer law." Instead, one must look to general Contract, Tort, Criminal, Copyright and Patent law for the disposition of issues arising out of the acquisition and utilization of computer systems. This article shall discuss only the contractual aspects of systems acquisitions. "Hacking," stealing computer time, and other pertinent issues cannot be discussed effectively within the boundaries of this article.

There are three main components of a computer system:

1. Hardware—the physical system.
2. Operations software—that which comes initially with the hardware and provides the program by which the system will work.
3. Applications software—programs which can be entered into the system after it has been set up. It is necessary to distinguish between these three components because the acquisition of each may be treated differently under the law.

Uniform Commercial Code, Article 2 is the most generally applied body of law with respect to disputes involving acquisitions of computer systems. The UCC is a codification of general contract law and governs the sale of goods. It is necessary to note at the outset that, by definition, Article 2 of the UCC covers only "sales" of "goods." Therefore, the UCC will not be applicable to acquisitions of software above because:

1. It is unclear whether or not computer software fits the definition of "goods."
2. Many such acquisitions today are leases or licensing agreements rather than "sales."

"Goods" Defined

The easiest case is computer hardware. Hardware is obviously a "good" within the UCC 2-105 definition: "Goods mean all things (including specially manufactured goods) which are moveable at the time of identification to the contract for sale. . . ." A hardware system is both moveable and identifiable. Operations software is more difficult to categorize but courts have held that such software, when sold in conjunction with hardware, is more like goods and can fit within the UCC. Application software is a different story. No one is quite certain how to classify it. Certainly, software is not really a "good" in a physical sense. Software may be more like a service since it provides continuous application of ideas developed by others to the user's business problems. "Goods" are generally accepted to be personal property, but software may be deemed intellectual property and, therefore, may not actually be "goods."

Sale or Lease

The second threshold question to determine whether Article 2 of the UCC will apply to a transaction is whether or not the transaction was a "sale." UCC 2-106 defines a "sale" as "passing title from the seller to the buyer for a price." This is quite straightforward—both buyer and seller know when a "sale" has taken place. However, with computer systems rapidly growing obsolete and being replaced by new, improved models, many business people prefer not to buy a system which could be obsolete in a very short time. Instead, many businesses are leasing computer systems. Clearly, a lease is not covered by Article 2 of the UCC. The same is also true of computer software which is licensed for use rather than sold. The UCC may still be applicable to the transaction if the lease is "phony." That is, the lease is, in substance, a financing arrangement to a contract for sale. Other areas of the law, particularly tax cases dealing with true leases, are worthy of review. It is important, therefore, for the parties to clearly define and understand the transaction.

Contract Negotiations

Though it is unclear whether the UCC will apply in all situations, it is a good starting point to use the UCC when negotiating the acquisition of a computer system. In fact, the parties can agree by a clause in the contract,

"Operations" software when sold in conjunction with hardware has been held by the courts to be "goods."

"Application" software may be more like a service and, therefore, deemed not to be "goods."

that the UCC shall apply to any disputes that arise between them. Careful planning and negotiation should resolve disputes before they arise. The following is a brief discussion of what ought to be included in a computer sale contract. This is by no means exclusive. Whatever the parties to any individual agreement feel is important enough to discuss ought to be discussed and probably should be integrated into the written contract.

When acquiring a computer system the cardinal rule is "NEVER sign the vendor's standard sales contract." Such contracts are designed to protect the vendor, often at the expense of the purchaser. They generally contain vague terms, warranty disclaimers, damage limitations, and integration clauses, or entire agreements, even though there is virtually no way a preprinted form can reflect all the negotiation between business parties. Prior to just a few years ago, buyers were reluctant to bring suit against sellers because they felt that they could not possibly win. Those same buyers willingly signed the standard contract forms because they did not know better. Potential buyers can learn two lessons from the experience of their predecessors:

1. Know your rights; and
2. Do not be afraid to assert them.

The buyer must first stand by his right to freely negotiate a contract with the vendor. If a vendor refuses to sign any contract but his own, then find a new vendor. Keep in mind, however, that an agreement should benefit both parties and the vendor has as much right to negotiate for terms favorable to himself as does the buyer.

Where should the contract for the purchase of a computer system start? Ideally, it should start with a complete description of the system—what it must accomplish and how it must work. Any express promise or affirmation of the system's ability, reliability, power, expertise, etc. made by the vendor or his agent (salesperson) ought to be included in the purchase agreement. This performance warranty clause is most important because it is written evidence of the system the purchaser has agreed to purchase and the vendor has agreed to sell. Hopefully, mistakes due to misunderstandings between the parties can be avoided by making reference to this clause. The vendor's express warranties should also be put into writing here because they may be disavowed by the vendor if left out.

Acceptance Testing Clause

The next most important clause for the buyer is an acceptance testing clause. While acceptance of goods normally takes place upon their delivery to the buyer, this clause permits the buyer to delay acceptance of the system until it has been tested and for a reasonable time thereafter. The testing is necessary to determine if the system is the one which was agreed upon, if it works in the manner agreed upon, and if it is able to do what the purchaser intended for it to do. Delay in acceptance until a reasonable time after testing has been completed is necessary to check the system for "bugs" which might not be readily apparent. Why is such a clause necessary? If the buyer discovers that the system received does not comply to the order, he may reject, rather than accept, it (UCC 2-601, 602). Then the seller may, under UCC 2-508, inform the buyer of his intention to cure and may substitute a confirming system within a reasonable amount of time. After acceptance has become effective, the buyer may revoke his acceptance if:

1. A "non-conformity substantially impairs its value to him" and
2. He accepted with knowledge of the defect but with "reasonable assumption" that the defect would be cured and it has not been, or
3. Without discovery of the defect "his acceptance was reasonably induced either by the difficulty of discovery before acceptance or by the seller's assurances." (UCC 2-608).

Thus, it is much simpler for the buyer to reject a system prior to acceptance than to revoke acceptance. For that reason, the buyer should attempt to get a long acceptance period—however, the acceptance period must be "reasonable."

Service and maintenance clauses should be included in the original contract for sale. These should specify what repairs will be done by the vendor and whether the buyer will be charged for them. This assures the parties of a continuing contractual relationship.

Warranties

Each vendor will encourage the buyer to accept disclaimers of warranties, but the buyer should be aware that he is disclaiming some very important rights. First, the buyer will be disclaiming the express warranties which should be written into the sales contract. If the vendor, or his agent, makes any promise or affirmation or gives a description or shows a sample of the system which becomes a "basis of the bargain," he creates an express warranty that the system will conform to that promise, affirmation, description or model (UCC 2-313). These express warranties may be disclaimed by "words or conduct . . . wherever reasonable." (UCC 2316 [1]) Where the express warranties have been written into the contract, the negative words or conduct would be inconsistent and the disclaimer would probably be inoperable.

UCC 2-314 identifies the implied warranty of merchantability. By this, the vendor warrants that the system will operate in the ordinary manner for which such a system is used. In order to disclaim this warranty, the disclaimer must be conspicuous, in writing, and must contain the word "merchantability." (UCC 2-316[2])

A cardinal rule is: "Never sign the vendor's standard sales contract."

The implied warranty of fitness for a particular purpose affords the buyer a great amount of protection where "the seller . . . 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 . . ." (UCC 2-315). In a computer system acquisition, the vendor ought to know "the particular purpose for which the goods are required" and the buyer will be dependent on the seller's skill to a certain extent, so it seems reasonable that the buyer would want to rely on this section should the system not perform as was intended. UCC 2-316[2] permits disclaimer of this warranty if it is conspicuous and in writing. The buyer should think carefully before disclaiming any of these warranties but vendors will probably be reluctant to sell without the disclaimers. An alternative would be to include a "limitation on damages" clause to protect the vendor should the buyer assert his rights upon breach of one of the above mentioned warranties.

Under UCC 2-714, upon seller's breach, buyer may recover damages equaling the difference between the value of the goods accepted and the value they would have had if they had been as warranted plus incidental and consequential damages. Such damages can be very high, so the seller may wish to limit possible damages by contract as permitted by UCC 2-719. Damages can be limited to return of the contract to the buyer, but are more likely to be limited to repair or replacement of the defective system. These can be optional remedies or the parties may expressly agree that they are to be the exclusive remedies. Where the exclusive remedy is repair and repeated repairs have failed to cure the defect, the remedy may be held to fail of its essential purpose, in which case the buyer may recover damages as outlined above (UCC 2-719[2]). Is this limitation of damages good for the buyer? It may be under some circumstances, such as where a minor adjustment will repair the defect in the system. However, the buyer might stand to lose a great deal where an irreparable system is essential to the business operation. In such case, incidental and consequential damages may be the proper award to compensate the buyer for repair costs and lost profits and the buyer should not sign a contract which denies him consequential damages.

These are a few of the items buyers should be aware of when purchasing computer systems. A wise buyer should know what he wants and how much he can give up in negotiation in order to get the concessions that are most important to him. If the warranties are most important to the buyer, then perhaps he ought to agree to a limitation on damages clause. It is for each buyer and seller to make their most acceptable contract.Ω

REFERENCES

Adam, "Contractual, Financial and Tax Issues in Major Procurements," 4 Comp. L.J. 465 (1984).

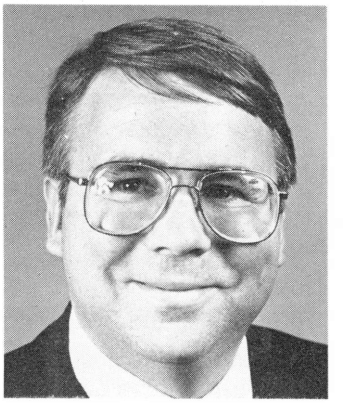
Davidson, "Negotiating Major System Procurements," 3 Comp. L.J. 385 (1982).

Friedman, Marc S., "Representing Vendors in Computer Sales," *American Bar Association Journal*, Vol. 70, September 1984, pp. 152-153.

Greenfield, John W., "Computers: How to Protect Your Rights When You Buy One," *Architectural Record*, April, 1983, pp. 43-45.

Hansen, "Software Distribution Remarketing, and Publishing Agreements," 4 Comp. L.J. 625 (1984).

Harris, "Complex Contract Issues in the Acquisition of Hardware and Software," 4 Comp. L.J. 77 (1983).



William J. Day, CPA, JD, *is assistant professor of accounting and business law at Cleveland State University, Cleveland, Ohio. His undergraduate degree is from Ohio University, Athens, Ohio and his MBA and JD degrees are from Cleveland State University.*