A new look at computer contracts

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ABSTRACT

Standard form contracts for computer sales and licenses are typically drafted primarily to protect vendors by limiting their legal liability. These contracts do not usually play a constructive role in the management of a computer project.

Three factors cast doubt on the enforceability of the vendor-protective provisions of these contracts: (a) two recent court decisions refusing to enforce these protective provisions, (b) the application of consumer protection laws to certain computer transactions, and (c) the proliferation of business computer systems among unsophisticated users.

This paper discusses these factors and proposes as an alternative to these standard form contracts a type of contract patterned after system development methodology and designed to educate the customer, provide a management guide for successful computer system acquisition, and reduce the risk of a court’s refusing to enforce the contract.
INTRODUCTION

One of the standards adopted by the data processing industry is the general form of contract used for computer sales, leases, and licenses. Typically, these computer contracts are prepared by the vendor’s legal staff, printed in somewhat small print on the reverse side of an invoice form, and designed to give the vendor maximum protection and limited risks.

Three factors cast doubt on the enforceability of important parts of these standard contracts:

- Two recent court decisions in which the court refused to enforce certain vendor-protective terms,
- The application of consumer protection laws to certain computer transactions, and
- The proliferation of business computer systems among unsophisticated users.

This paper discusses these factors, their potential effect on contracting practices in the computer industry, and an alternate approach to computer contracts.

CURRENT STANDARD FORM CONTRACTS

Almost all standard form contracts attempt to limit vendor warranties to those explicitly stated within the contract. To the extent that these clauses are enforced by a court, they effectively cancel oral sales representations that are not repeated in the contract. They also, if upheld in court, do away with certain warranties implied by the law. For example, the implied warranty of fitness for a particular purpose provides that if a customer relies on the vendor to provide a system that will do a particular job, if he or she tells the vendor of such reliance, and if the vendor accepts this responsibility by providing a system for that purpose, the law will read into the contract a warranty that the equipment will achieve that purpose.

Standard contracts generally contain language that disclaims implied warranties. The same statutes that set up the implied warranties also provide a means to disclaim them, and the vendor contract forms usually do so in the prescribed manner.

Standard contracts also seek to limit the kind and amount of damages for which the vendor can be held liable. For example, liability for consequential and incidental damages is typically disclaimed. Consequential damages include lost business caused by failure of the computer system. Incidental damages include electrical power and air-conditioning expenses incurred to provide the proper environment for the computer and personnel costs associated with attempted computer usage. The usual goal of such limitations is to avoid potential liability for anything more than the price of the computer system.

Until recently, courts have generally enforced these disclaimers and limitations in cases involving commercial parties, saying that the parties are free to bargain whatever shifting of risk they desire. Therefore, vendors could rest comfortably in the belief that their risk of a judgment greatly in excess of the price of the system was minimal.

RECENT COURT DECISIONS

Two recent decisions should cause vendors to think twice about how well their standard form contracts will actually protect them.

The first case, *Glovatorium, Inc. v. NCR*, has received considerable attention in the computer press. The second case, *A & M Produce Co. v. FMC Corp.*, has not received this media attention. As a matter of fact, *A & M Produce Co. v. FMC Corp.* is not even a computer case. However, the principles of the decision appear directly applicable to computer cases and, taken together with the NCR case, cast doubt on the effectiveness of vendor protections found in standard form contracts.

*Glovatorium, Inc. v. NCR*

The NCR case was tried in the Federal District Court for the Northern District of California. The jury found for Glovatorium in the amount of $2.3 million, which included a substantial punitive damage award and NCR appealed to the Ninth Circuit Court of Appeals. The Court of Appeals upheld the award of the jury.

The computer system purchased by Glovatorium, a dry-cleaning company, was an NCR 8200 minicomputer with a software package called SPIRIT. The price of this system was about $50,000; therefore, the award of $2.3 million in total damages was far in excess of the system price and demonstrates the potential risk for a vendor in certain aggravated fact situations. (Large punitive damage awards are not generally given by trial courts and upheld by appellate courts unless the facts showing misrepresentation and other types of fraud are clear and aggravated.)

The standard form contract used by NCR in its sale to Glovatorium contained the standard warranty disclaimers and limitations of liability; however this contract language did not protect the vendor once the facts of fraudulent conduct were proven. The court in effect threw out the protective language and treated the case as though the protective language were not part of the contract.
A & M Produce v. FMC Corp.

The A & M Produce v. FMC Corp. case is, in my opinion, potentially more significant than the NCR case because facts of fraudulent conduct did not play a large role in the case. Instead, the California state court directly considered the validity of warranty disclaimers and limitations of liability for consequential damages. It found this protective contract language of no force or effect, primarily because the judges simply did not think the contract language was fair in light of sales representations made to A & M Produce and the other circumstances of the sale.

FMC sold a tomato weight-sizing machine to A & M Produce for approximately $32,000. FMC sales representatives convinced A & M Produce that the machine was the right type of equipment for them. The sales contract was a standard vendor-prepared document with typical fine-print provisions on the reverse side of an invoice. This contract excluded all warranties except a warranty that the machine was free of defects, and it excluded any liability for consequential damages. In other words, the contract was, in these respects, quite similar to vendor standard form contracts for computers.

When the machine failed to operate satisfactorily, A & M Produce suffered the loss of a large part of the tomato crop. The jury in the Superior Court trial awarded A & M Produce $255,000 plus $45,000 in attorneys’ fees. The Court of Appeal, Fourth District, upheld this verdict.

The courts refused to enforce the warranty disclaimers and limitations of liability, finding that these contract terms involved oppression and surprise and that they reallocated the risks of the bargain in an unreasonable, one-sided manner. Some of the courts’ language is instructive as to how they viewed the standard form contract:

The social benefits associated with freedom of contract are severely skewed where it appears that had the party actually been aware of the terms to which he agreed, or had he any real choice in the matter, he would never have assented to inclusion of the term.

One suspects that the length, complexity and obtuseness of most form contracts may be due at least in part to the seller’s preference that the buyer will be dissuaded from reading that to which he is supposedly agreeing. This process almost inevitably results in a one-sided contract.

Especially where an inexperienced buyer is concerned, the seller’s performance representations are absolutely necessary to allow the buyer to make an intelligent choice among the competitive options available. A seller’s attempt, through the use of a warranty disclaimer, to prevent the buyer from reasonably relying on such representations calls into question the commercial reasonableness of the agreement.

Thus, the court effectively erased the protective terms in the contract. Furthermore, after such terms were erased, the court could substitute its own judgment about risk allocation, performance guarantees, and other important contract matters.

The legal principles set out in the A & M Produce case are directly applicable to computer cases. In fact, the disparity of technical knowledge between vendor and many customers, and the types of aggressive marketing approaches used today in the computer industry, might well cause a court to be even more protective of a computer buyer than of an agricultural machine buyer.

The purpose of this somewhat detailed summary of the NCR and A & M Produce cases is not to demonstrate the kinds of situations in which a court might find a contract unfair and unenforceable. The legal principles set out in past cases—precedents—must be applied afresh to each new fact situation. A few changes in the factual circumstances of a case can make a marked difference in the result. Rather, the purpose of this discussion is to suggest that the standard form vendor contracts used in the computer industry may not provide the vendor the protection sought. If a court throws out all of the carefully drafted vendor-protective language found in most computer contracts and substitutes its own judgment as to what is fair and reasonable, the form contract provides nothing but a false and misplaced sense of security.

APPLICATION OF CONSUMER PROTECTION LAWS TO CERTAIN COMPUTER TRANSACTIONS

During the last 10 years, a number of consumer protection laws have been passed by the federal legislature and various state legislatures. These laws are designed to replace the old “caveat emptor” (let the buyer beware) axiom with the notion that government and laws will aid consumers in getting a fair deal.

The Magnuson Moss Consumer Warranty Act is an example of federal consumer law. This act requires certain disclosures to be made to consumers about warranties. It regulates the content of warranties and sets out certain warranty service requirements. It also provides that the Federal Trade Commission (as well as private individuals) can take action to enforce this law.

In California, the Song Beverly Consumer Warranty Act regulates warranties for the benefit and protection of buyers. There are also many other consumer protection laws presently on the books in California.

Many other states have enacted consumer protection laws. All of these laws tend to define consumer and consumer goods broadly. For example, under federal law, a commercial purchaser of an IBM Selectric typewriter may be considered a consumer purchasing consumer goods. Consequently, a seller may find that consumer protection laws apply to what that seller thought was a commercial transaction.

With the availability of small and relatively inexpensive “personal” computer systems to small business owners and professionals, it is likely that many computer system sales will be classified as consumer sales under federal and state consumer protection laws. One result of such a classification is that standard form computer contracts with their disclaimers of warranty and limitations of liability may be found in violation of these laws and, therefore, unenforceable. Furthermore, computer system vendors may find themselves subject to investigative and enforcement actions by administrative agencies such as the Federal Trade Commission. Anyone who

From the collection of the Computer History Museum (www.computerhistory.org)
has been on the receiving end of these actions knows that they are highly disruptive and expensive to defend against.

It might be said that the NCR and A & M Produce cases reflect the application of consumer protection principles to commercial transactions. The courts in those cases certainly refused to impose what they considered an unfair deal on Glovatorium, Inc., and A & M Produce, the commercial consumers in the cases.

THE PROLIFERATION OF BUSINESS COMPUTER SYSTEMS AMONG UNSOPHISTICATED USERS

The substantial reduction in the cost of computer hardware, the availability of mass-marketed off-the-shelf business systems and application software, and extremely aggressive marketing efforts for small computer systems are resulting in the acquisition of computer systems by a large number of small business and professional users. One characteristic of this marketplace is the lack of user data processing sophistication. Many, if not most, of these customers are first-time computer users, and this characteristic creates its own set of problems.

Implementation of a computer system, even a small system, takes a great deal of preparation, training, and user sophistication. Computer system users must understand and accept their responsibilities in acquiring and implementing a system. For example, users must define needs with a high degree of specificity to ensure that the computer vendor knows what kind of functions the system must perform. Users must establish and conduct an effective implementation program to ensure that business functions can carry on during the shift from manual to computer operation. Last, users must be an integral part of the trouble-shooting team when problems occur. Simply calling up the vendor and reporting that the system does not work will not do.

Unfortunately, first-time, unsophisticated computer users are frequently unaware of these responsibilities and do not understand the significant impact that the computer system will have on their business operations. They do not understand that this impact will probably be relatively far greater than the cost of the system in dollars or that they will have a key participatory role in the success or failure of the system.

One of the tasks facing a vendor in this small-computer marketplace is educating the customers in their role and responsibilities during a computer system acquisition; however, the contracting practices of most vendors fail to consider this task. Contracts emphasize protection of the vendor, not education of the customer and management of the project. Now, as discussed earlier, even this protective function is of doubtful effectiveness.

AN ALTERNATIVE APPROACH TO COMPUTER CONTRACTS

Why not look at a computer system contract from a new perspective? Instead of perceiving it as a legal document that no one but the lawyers really understands and that few people take the trouble to read, why not look at the contract as a management tool—a project management plan designed to educate and guide the vendor and customer toward the goal of successful system implementation?

Legal documents are frequently used to educate and guide people in their affairs. For example, corporate by-laws can describe to the shareholders, officers, and directors their rights, duties, and responsibilities. These documents are relatively short and concise directives that, if followed, ensure conformance with laws and duties. They educate as well as set out legal relationships. Well-drawn estate-planning documents, such as trust documents, describe trustees' responsibilities and beneficiaries' rights and responsibilities. By reading these documents, trustees can see what they must do to sell trust property and buy other property. Likewise, a computer contract can be drafted to guide vendor representatives and customers to successful system installation. Such a document could save all parties time and money by providing a management guide that educates and directs effort.

Computer System Development Methodology

Consider the typical computer system development methodology described in various texts on data processing project management. The phases of such a methodology might be as follows:

1. System definition phase.
2. System design phase.
3. System test and acceptance phase.
4. Conversion, training, and implementation phase.
5. Maintenance and support phase.

Use of such a methodology is not uncommon in large systems, but it is uncommon in small systems where, it is reasoned, the system cost does not warrant a conventional development effort.

Small systems may be relatively inexpensive, and price pressures may limit the use of systems analysts and other data processing professionals. The problem is, however, that the impact of a small-business computer system on business operations may be enormous. Consider, for example, the effect failure of an inventory-control system might have on an inventory-intensive business like an auto parts store. Small businesses can fail and have failed because of computer system failure.

It may not be realistic to suggest that a business owner purchasing a $10,000 computer system hire an analyst at $40 to $60 per hour to manage the purchase, although such a decision should be guided more by risks and consequences of failure than by the price of the system. However, at least the business owner should be informed and guided in some way through the complex process of a system implementation. It is certainly in the interests of the computer system vendor to minimize the amount of necessary customer hand holding and the number of trouble calls from the customer—or the risk of a lawsuit.
Implementing Methodology via the Contract

The contract should describe and provide a management tool for implementing the methodology. It should be a project planning document as well as a legal document. No magic words are needed, and technical terms of art should be as prevalent as legal terms of art.

The following discussion is not intended to prescribe the form of the contract, nor does it address all of the legal considerations the contract should cover. The purpose of the ideas set forth is to demonstrate how the contract can contribute to the goal of achieving a successful installation.

System definition

The contract should incorporate specifications of system needs. This can be done by including these specifications in the contract or by referring to other documents, such as a functional specification, and incorporating these documents into the contract. Such a contract provision should, first of all, point up the requirement for a written specification. Often, prospective buyers never objectively and specifically determine their needs, much less write them down. Even in a small system acquisition, a buyer can describe, in writing, the way his or her business functions and its special problems and considerations.

If buyer needs are not specified, there will be a real risk that the vendor does not understand what must be done. Furthermore, there will be no objective way to determine whether or not the system does what it is supposed to do, and if a lawsuit occurs, it will be more difficult and expensive to prove whether or not the system was defective.

Warranties are also much more meaningful if they are set out in this manner. The effect of a functional specification is, in many cases, to warrant that the system will perform the specified functions. Such warranties help buyers by informing them of what the vendor is promising to do. They help the vendor by limiting performance promises to what is contained in the specification, assuming that oral sales representations and written performance specifications are substantially similar.

Furthermore, a court is less likely to throw out or ignore contract terms if they seem fair. Specifying in writing what a system will do seems much fairer than making oral sales promises and then repudiating them in the "fine print" of a contract.

System design

If the system software is to be developed especially for a particular buyer, design specifications are required to inform all parties involved what is to be done and how. Even in the case of off-the-shelf software, the functional specification will provide a way to match buyer needs with a package that will meet those needs. If no package will fit the needs in every respect, necessary changes (either to the software or to the business operations) can be identified more easily if the business operations and needs have been previously described, documented, and incorporated into the contract.

System test and acceptance

This may be one of the most critical phases of a computer system acquisition from both a legal and a technical point of view. If a properly designed, planned, and executed test and acceptance procedure is accomplished, all parties can gain a high degree of assurance that the computer system will do the job it was designed to do. If this phase is done haphazardly, system problems may not surface until the buyer is actually using the system. Problems that arise during the operational use of a computer system are the ones that hurt the most and lead to lawsuits.

My experience in the litigation of computer cases has been that the last step in the acquisition process where problems can be discovered and corrected without serious adverse effects on business operations is the system test phase. Despite the importance of this phase, it is often given little attention and concern. Standard form contracts currently in use are almost invariably designed to get the user to sign off as soon as possible rather than to ensure that a proper test and acceptance procedure is employed.

Consider what a good system test requires. First of all, good functional specifications are needed. Not only must these specifications describe the needs to be met, but also objective measures of satisfaction of those needs must be developed against which to test system performance, whether a separate test specification or simply a comprehensive functional specification. The contract can and should set out the test procedures, the method of objective measurement of performance, the location of the testing, the personnel to be used, the type of data to be used, the procedure for isolating and reporting problems, and other considerations relevant to performance testing. This can be done in the contract itself or in another document that is referred to and incorporated into the contract by such reference.

The contract should also specify the procedure for acceptance of the system by the user. There frequently exists a serious discrepancy between what is called acceptance in the contract (if it is mentioned at all) and the practical requirements of an intelligent acceptance procedure. Perhaps an automobile can be intelligently accepted after a short period of driving it, but computer systems, depending on their size and the nature of the operations they support, may take several weeks to several months before users can be said to have had a reasonable opportunity to determine if their system does what is supposed to do. The law will give them this opportunity.

Rarely, particularly in small systems, does the contract or any other document make adequate provision for a reasonable test and acceptance procedure. The result of this situation is a dispute waiting to happen. Without an adequate test and acceptance procedure, users may not find problems until they have used the system operationally for weeks or months. The disputes that arise in this situation are the kind that frequently lead to lawsuits.

If a dispute does arise, despite the use of a good test and acceptance procedure, it can be resolved with much greater ease if there are objective ways of determining system performance.
Conversion, training, and implementation

The inexperienced buyer of a computer system is frequently not aware of the potential magnitude of the tasks of data conversion, training, and implementation. Even in small systems it may take days or weeks to get through this phase successfully. The contract should address the requirements of data conversion, training of user personnel, and implementation of the system into the user’s operations. If these matters are addressed in the contract, and if the contract is used as a management tool to be read and understood, users can be educated and informed of the requirements of this important phase and vendors can gain some degree of assurance that, when they believe the project to be nearly finished, major problems in getting the system running will not arise.

If these matters are not discussed and resolved early, they may create another area of potential dispute. As noted earlier, these disputes may grow into expensive and disruptive lawsuits.

Maintenance and support

This area is sometimes covered by a maintenance contract, usually drafted by the vendor’s attorney to protect the vendor. Maintenance contracts that a court sees as unfair or unreasonable are just as likely to be struck down as sales contracts. Furthermore, lack of user knowledge and forethought in this area can be just as destructive to a potentially successful transaction as they can in any other area.

The contract should discuss maintenance and support requirements up front, before these requirements turn into emergencies. For example, a user requirement for one-hour maintenance response can be discussed reasonably when the contract is being negotiated. Such a discussion held 15 minutes after a retail point of sale and inventory system goes down in the middle of the Christmas rush is likely to lead quickly to heated words and disputes with lawsuit potential.

CONCLUSION

This paper has discussed certain court decisions, laws, and marketplace characteristics that affect computer contracts and has proposed an alternative to the standard contract currently in use. This alternative is designed to educate, provide a management tool, prevent problems, and maximize the chance of a successful computer system project.

Viewing the contract as a management device rather than as a legal document with no real bearing on practical considerations will benefit both computer vendors and their customers. Vendors will benefit from certainty in their obligations, education for their customers, and happy and satisfied customers. Buyers will benefit from effective methods to ensure that their needs are defined and met with minimum adverse impact on business operations.

In this age of proliferation of highly sophisticated computer systems into business, professional, industrial, and educational entities, it is high time the industry changed its approach to contracting from a protectionist one to a success-oriented one.