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Judicial Treatment of Damages Exclusions Negotiated in Custom Software Licenses

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In this second of two articles, the author examines judicial decisions where courts have circumvented contractual clauses precluding recovery of consequential damages in software agreements. He pays special attention to the Ninth Circuit's "total and fundamental" breach standard used for determining whether to award such damages and argues that those courts that have allowed consequential damages in spite of provisions in the contract to the contrary have violated the freedom to contract rule of UCC Section 2-719.

The case law during the past two decades demonstrates that some courts hearing computer-related warranty litigations have ignored the text of the UCC and have become result-oriented instead. Although there is ample precedent for allowing contract provisions that limit the availability of consequential damages, the courts have recently looked for ways of interpreting the UCC to negate such provisions. Such negation seems to curtail the ability of parties to freely allocate risk. Earilier courts were less willing to disturb allocated risk.

For example, to decide the enforceability of a damages exclusion in a computer sales agreement, the court in *Bakal v. Burroughs Corp.*[1] strictly construed a contract and rejected a plaintiff's claim for damages.[2] Asking for damages totaling the purchase price and incidental and consequential damages, the user alleged breaches of the warranty of merchantability and warranty of fitness for a particular purpose.[3] Plaintiff alleged that he entered into a written contract with defendant for an accounting computer and automatic reader and that before contracting he

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[1] 74 Misc. 2d 202, 343 N.Y.S.2d 541 (Sup. Ct. 1972).

[2] *Id.*, 343 N.Y.S.2d at 542.

[3] *Id.*, at 543. Plaintiff also sought to rescind the contract. *Id.*

> outlined his business operations and requirements to defendant's representatives, who produced literature, brochures and catalogs, which were studied by plaintiff, and who selected and recommended to plaintiff the computer and reader mentioned above and who allegedly orally warranted that these machines would perform all of plaintiff's business operations and requirements in an expeditious, reliable and efficient manner.[4]

Plaintiff further alleged that, "in reliance upon these representations in the literature and by defendant's representatives, plaintiff entered into the contract; but that these warranties and promises were not true and were false in that the machines were not expeditious, reliable or efficient, were of inferior quality and design, and were continuously broken down and in need of repair."[5]

After opining that the contract entered into by the parties expressly excluded warranties and consequential damages,[6] the court granted defendant's motion for dismissal of the complaint.[7] Relying on Sections 2-316 and 2-719, the court reasoned that the defendant was permitted to so limit its potential liability and found "nothing unusual" in these limitations.[8]

The *Bakal* decision is significant because it has been cited with approval in computer-related litigations heard in higher forums[9] and it demonstrates a methodology for analyzing consequential damages issues used in the early days of computer-related litigation, a methodology that respects contractual allocation of risk by enforcing a contract as written.[10] Unlike other courts faced with similar contractual language, the *Bakal* court did not search for a way to defeat a vendor's consequential damages exclusion.[11] Thus, although

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[4] *Id.* at 542.

[5] *Id.* at 543.

[6] *Id.* at 545.

[7] *Id.* at 543.

[8] *Id.* at 543–544.

[9] See, e.g., Earman Oil Co. v. Burroughs Corp., 625 F.2d 1291, 1298 (5th Cir. 1980); Harper Tax Servs., Inc. v. Quick Tax Ltd., 686 F. Supp. 109, 112 (D. Md. 1988); Jaskey Fin. & Leasing v. Display Data Corp., 564 F. Supp. 160, 163 (E.D. Pa. 1983); Applications, Inc. v. Hewlett-Packard Co., 501 F. Supp. 129, 134 (S.D.N.Y. 1980); Patriot Gen. Life Co. v. CFC Inv. Co., 11 Mass. App. 857, 420 N.E.2d 918, 921 (1981); W.R. Weaver Co. v. Burroughs Corp., 580 S.W.2d 76, 84 (Tex. Civ. App. 1979).

[10] See, e.g., Sperry Rand Corp. v. Industrial Supply Corp., 337 F.2d 363 (5th Cir. 1964); Three-Seventy Leasing Corp. v. Ampex Corp., 528 F.2d 993 (5th Cir. 1976); Investors Premium Corp. v. Burroughs Corp., 389 F. Supp. 39 (D.S.C. 1974); Farris Eng'g Corp. v. Service Bureau Corp., 276 F. Supp. 643 (D.N.J. 1967), *aff'd*, 406 F.2d 519 (3d Cir. 1969).

[11] See, e.g., RRX Indus. v. Lab-Con, Inc., 772 F.2d 543 (9th Cir. 1985); Chatlos Sys., Inc. v. National Cash Register Corp., 479 F. Supp. 738 (D.N.J. 1978), *aff'd in part, rev'd in part*, 635 F.2d 1081 (3d Cir. 1980); Convoy Co. v. Sperry Rand Corp., 672 F.2d 781

the agreement between the parties limited the user's remedy to the exchange of equipment, the court did not discuss this limited remedy's failure of essential purpose under Subsection 2-719(2) as a possible means of excluding the consequential damages exclusion.[12]

Failure of Essential Purpose Standard

In *Chatlos v. National Cash Register Corporation*,[13] the U.S. District Court for the District of New Jersey found a way to award a user consequential damages notwithstanding the existence of exclusionary language similar to that found in *Bakal*. The U.S. District Court for the District of New Jersey interpreted Section 2-719 in the context of a typical computer contract.[14]

On July 24, 1974, plaintiff Chatlos Systems Inc. (CSI), entered into an agreement with defendant National Cash Register Corporation (NCR), for the use of a computer system.[15] This system was to aid CSI, a manufacturer of cable pressurization machinery for the telecommunications industry, with its inventory problems as well as manage the payroll, create a state income tax program, and create an accounts receivable function.[16] NCR represented to CSI that the system would be "up and running" within six months. After the equipment was installed it became apparent that the system would not be able to function as represented.[17] In fact, only the payroll function was performing properly two years after the system was installed.[18]

After first determining that the transaction was a "sale of goods," even though it was a lease arrangement including servicing, the district court held that NCR had breached its express and implied

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(9th Cir. 1982); Huntington Beach Union High School Dist. v. Continental Info. Sys. Corp., 621 F.2d 353 (9th Cir. 1980); Applied Data Processing Inc. v. Burroughs Corp., 58 F.R.D. 149 (D. Conn. 1973); Burroughs Corp. v. Chesapeake Petroleum & Supply Co., 282 Md. 406, 384 A.2d 734 (1978).

[12] Bakal v. Burroughs Corp., note 1 *supra*, 343 N.Y.S.2d at 544.

[13] Chatlos Sys., Inc. v. National Cash Register Corp., note 11 *supra*, 479 F. Supp. at 745 (applying New Jersey law).

[14] See generally, Bernacchi, Davidson & Grogan, "Computer System Procurement," 30 Emory L.J. 395 (1981) (opining that the *Chatlos* contract was typical in the industry).

[15] Chatlos Sys., v. National Cash Register Corp., note 11 *supra*, 479 F. Supp. at 741.

[16] *Id.*

[17] *Id.* at 742. The system's most serious flaw was its inability to correctly keep track of inventory parts used in the manufacturing process. *Id.*

[18] *Id.*

warranties.[19] Furthermore, notwithstanding the existence of an incidental and consequential damages exclusion,[20] the district court awarded CSI both consequential and incidental damages because the limited repair or replace remedy failed in its essential purpose.[21] On appeal, the U.S. Court of Appeals for the Third Circuit reversed on the issue of damages.[22]

The Third Circuit adopted a strict constructionist view, treating the limited remedy provision independently from the consequential damages exclusion.[23] The court of appeals reasoned that the damages exclusion was valid unless unconscionable.[24] This strict construction of Subsections 2-719(2) and 2-719(3) did not, however, stop the court from allowing damages to be awarded.

Agreeing with the lower court's finding that the limited remedy failed of its essential purpose, the court of appeals remanded so that the "benefit of the bargain" formula could be applied.[25] Specifically, the court remanded so that the lower court could apply Subsection 2-714(2), which states:

> The measure of damages for breach of warranty is the difference at the time and place of acceptance between the value of the goods accepted and the value they would have had if they had been as warranted, unless special circumstances show proximate damages of a different amount.[26]

Indeed, the remand yielded a direct damages award over three times the district court's original award.[27]

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[19] *Id.* at 744–745.

[20] Defendant's obligation was " 'limited to correcting any error in any program as appears within 60 days after such has been furnished.' " *Id.* (quoting contract).

[21] *Id.* at 746–747. These damages compensated for lost profits and increased labor costs. *Id.* In awarding these damages, the district court relied on the failure of essential purpose provision found in UCC Subsection 2-719(2) (1990).

[22] Chatlos Sys., Inc. v. National Cash Register Corp., note 11 *supra*, 635 F.2d at 1081, 1084–1088.

[23] *Id.* at 1086.

[24] *Id.*

[25] *Id.* at 1088.

[26] *Id.* (quoting N.J.S.A. 12A:2-714(2)).

[27] The district court originally awarded $57,152.76 in direct damages, whereas on remand the district court determined these damages to be $201,826.50. Chatlos Sys., Inc. v. National Cash Register Corp., 670 F.2d 1304, 1305 (3d Cir.), *cert. dismissed*, 457 U.S. 1112 (1982). Interestingly, the consequential damages originally awarded only amounted to $63,558.16. *Id.*, 670 F.2d at 1305.

Consequential Damages Awarded

In *RRX Industries, Inc. v. Lab-Con, Inc.*,[28] the Court of Appeals for the Ninth Circuit rejected the view that a consequential damages exclusion and limited remedy provision are to be viewed as independent provisions having no effect on one another.[29] Furthermore, the court held that neither "bad faith nor procedural unconscionability" is needed for an exclusionary clause to be expunged from the contract.[30] This ruling has created an unfortunate precedent for vendors.[31]

On October 21, 1980, RRX Industries, Inc. (RRX), a California corporation doing business as Western Pacific Reference Laboratory, entered into a written contract with Thomas E. Kelly & Associates Inc. (TEKA), a New Jersey corporation, for the license of a medical laboratory software system.[32] RRX had bargained for a software system that would have permitted it to efficiently and reliably automate its medical billings.[33] Under the contract's terms, TEKA was required to provide RRX with an operational system by January 18, 1981.[34] TEKA's contractual obligations also included maintaining the system,[35] correcting any "bugs", i.e., errors during a program run that result in improper output, found in the system,[36]

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[28] 772 F.2d 543 (9th Cir. 1985).

[29] *Id.* at 547.

[30] *Id.* at 547.

[31] See Feldman, "Warranties and Disclaimers in Computer Contracts," 8 Computer Law. 1, 9 (1991) ("One of the 'hottest' topics pertaining to computer-related warranty litigation has been the ability to emasculate damage limitations when warranty remedies 'fail of their essential purpose.' ").

[32] RRX Indus., Inc. v. Lab-Con, Inc., No. CV 82 5375 ER, slip op. at 15 (C.D. Cal. Dec. 27, 1983), *aff'd*, 772 F.2d 543 (9th Cir. 1985) (applying California law).

[33] RRX Indus., Inc. v. Lab-Con, Inc., note 11 *supra*, at 547.

[34] RRX Indus., Inc. v. Lab-Con, Inc., note 32 *supra*, slip op. at 8.

[35] Although TEKA represented to RRX that a west coast Maintenance Diagnostic Center would provide for local maintenance, no such center was ever created. *Id.*, slip op. at 3.

[36] Specifically, footnote 2 of the contract provided:

Kelly warrants that during the use of Lab-Con system by User, Kelly shall respond to telephone calls from User in regard to programming errors according to the following schedule:

1. Within two hours of the initial telephone call Kelly shall respond by telephone to the User to assist in identifying the programming error, and if unsuccessful;
2. Within 4 hours following the initial telephone call, Kelly will cause its Maintenance Diagnostic Center to establish telecommunications connection with User's computer to identify the programming error, and if unsuccessful;
3. By 8:00 A.M. of the day following the initial telephone call from user, Kelly will cause to have a Kelly technical representative on-site at User's facility to correct

and providing RRX workers with adequate training on the system.[37]

The contract specifically limited the buyer's remedies to the fixing of any bugs found in the system and the return of payments made to TEKA.[38] Bugs began appearing soon after the June 1981 installation.[39] TEKA was unsuccessful in repairing the malfunctioning system; and after TEKA had upgraded the system, making it compatible with more sophisticated hardware, bugs continued to make the system unreliable.[40]

In September 1982, RRX instituted a diversity action against TEKA; Lab-Con, Inc., the successor corporation to TEKA; and TEKA's corporate president Thomas E. Kelly on an alter ego theory.[41] After a bench trial, the district court determined that TEKA materially breached its contract and awarded damages in the amount of the contract price as well as consequential damages—notwithstanding the existence of a clause excluding such damages.[42]

The Court of Appeals for the Ninth Circuit affirmed the award of damages.[43] Specifically, the court, with almost no analysis, affirmed the district court's ruling that the seller's breach of its contract for a custom software package was so "total and fundamental" that a standard contract provision limiting remedies to the cost of repairs was not to be enforced.[44] In a subsequent decision from

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the error.

Id. at 3.

[37] *Id.* at 7. Paragraph 15 of the contract provided:

> 15. Kelly agrees to provide on-site training of User's personnel in four sessions of one-half day per session, at mutually convenient times and places to Kelly and User. Kelly will make available to User additional training session at the rate of $400.00 per session, plus expenses, provided, however, Kelly shall have the right to terminate the availability of such additional training session upon written notice given at any time subsequent to one year from the date hereof.

Id. at 7.

[38] RRX Indus., Inc. v. Lab-Con, Inc., note 11 *supra*, 772 F.2d at 548. See also RRX Indus., Inc., v. Lab-Con, Inc., note 32 *supra*, slip op. at 15.

[39] RRX Indus., Inc. v. Lab-Con, Inc., note 11 *supra*, 772 F.2d at 545. The system's bugs affected the ability to produce medical billings and private client billings and prevented interfacing with the Gamma counter. RRX Indus., Inc. v. Lab-Con, Inc., note 32 *supra*, slip op. at 3.

[40] RRX Indus., Inc. v. Lab-Con, Inc., note 32 *supra*, slip op. at 3.

[41] *Id.*

[42] RRX Indus., Inc. v. Lab-Con, Inc., note 11 *supra*, 772 F.2d at 545.

[43] *Id.* The district court awarded $7,456.39 in consequential damages—$6,314 was for compensating for employee time spent dealing with the breach and $1,142.39 was for additional costs, including telephone calls. RRX Indus., Inc. v. Lab-Con, Inc., note 32 *supra*, slip op. at 9.

[44] RRX Indus., Inc. v. Lab-Con, Inc., note 11 *supra*, 772 F.2d at 547.

the same Circuit, the court in *Milgard Tempering, Inc. v. Selas Corp. of America*[45] explained that this "total and fundamental" breach standard requires a district court to examine the remedy provisions at issue and determine whether the seller's default "caused a loss which was not part of the bargained-for allocation of risk."[46] If such a loss occurred, consequential damages should be awarded notwithstanding the existence of an exclusion.[47]

A Well-Reasoned Dissent

Dissenting Judge Norris argued that the cap on damages was contractually limited to the amount paid by TEKA to Lab-Con and any effort to recover consequential damages in excess of that amount should have been rejected.[48] In rejecting the majority's "total and fundamental" sliding scale for judging the validity of exclusionary clauses, Judge Norris first emphasized that there "is no suggestion that Lab-Con acted in bad faith in failing to repair the 'bugs' . . . . There is no suggestion that the contract was unconscionable in any respect."[49]

Judge Norris recognized that the fundamental goal of Section 2-719 is ensuring that "at least minimum adequate remedies be available" to a non-breaching party.[50] And consequential damages go well beyond minimum adequate remedies because such damages can include loss of goodwill as well as lost profits.[51] To illustrate his point that a limitation "on consequential damages becomes a part of the value of the bargain" and "a buyer may be willing to impose a limitation on damages in exchange for a lower price," Judge Norris offered the following hypothetical:

> Assume, for example, that a Fortune 500 company offers a contract to a small

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[45] 902 F.2d 703 (9th Cir. 1990) (applying Washington law).

[46] *Id.* at 709.

[47] *Id.*

[48] RRX Indus., Inc. v. Lab-Con, Inc., note 11 *supra*, 772 F.2d at 548 (Norris, J., concurring and dissenting).

[49] *Id.*

[50] *Id.* at 549 (quoting from U.C.C. § 2-719, Official Comment 1).

[51] *Id.* at 550. See also Convoy Co. v. Sperry Rand Corp., note 11 *supra*, 672 F.2d at 783–787 (discussing recoverable damages for breach of computer system contract) (applying Oregon law). But see, Consolidated Data Terminals v. Applied Digital Data Sys., 708 F.2d 385, 392–393 (9th Cir. 1983) (holding that a clause excluding "consequential damages, loss or expense arising in connection with the use of or inability to use" computer terminals *does not* include monies spent trying to recapture lost goodwill) (applying New York law).

> company, such as Lab-Con. Although the contract could be profitable for the small company, the prospect of liability for the large company's lost profits or good will that might result from an interruption in operations caused by faulty software could be staggering. The stakes could be far too high for a small software company. Being much larger, and capable of diversifying its risk, the large company should be free to bargain for a lower price in exchange for its agreement to limit the seller's consequential damages. Thus, the contract price may vary according to which party assumes the risk of consequential damages in excess of the limit.[52]

The dissent's major objection with the majority's adoption of a slippery "total and fundamental" breach standard turned on the confusion that would be caused by such a standard. Judge Norris observed:

> More importantly, the majority opinion creates confusion rather than guidance for parties contemplating a contract provision limiting consequential damages. The opinion provides no basis for predicting with confidence when a bargained-for cap on consequential damages will be judicially enforced.
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> The Official Comment to subsection (3) suggests that a central purpose of the subsection is to facilitate "the allocation of unknown or undeterminable risks." U.C.C. section 2-719, Official Comment 3, Cal. Comm. Code section 2719 at 682 (West 1964). Parties should be free to bargain. And yet, the majority's sweeping interpretation of subsection (2) undermines this freedom and provides parties no moorings in negotiating an allocation of risk by imposing limits on recoverable consequential damages.[53]

Consequential Damages Not Awarded

Confusion is certainly manifest in an unpublished decision issued from Judge Norris' Circuit. In *In re Mesa Business Equipment, Inc.*,[54] the U.S. Court of Appeals for the Ninth Circuit affirmed a Ninth Circuit Bankruptcy Appellate Panel's affirmation of a summary judgment dismissal. The original action was brought because of the alleged breach of a custom software agreement. Mesa Business Equipment, Inc. (Mesa) had contracted with The Ultimate Corporation and Ultimate Southern California, Inc. (Ultimate) for the procurement of a "new computer system for use in its office supply business."[55] Prior to entering into the agreement, Mesa retained a

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[52] RRX Indus., Inc. v. Lab-Con, Inc., note 11 *supra*, 772 F.2d at 550 (Norris, J., dissenting and concurring).

[53] *Id.* at 552.

[54] No. 89-55825, slip op. (9th Cir. April 30, 1991) (applying California law).

[55] *Id.* slip op. at 2.

"computer programmer and analyst specializing in the evaluation of business computer systems, to assist in evaluating the various available software programs."[56] The chosen method for procuring Mesa's software was not uncommon:

> In August, 1983, Mesa sent a detailed "Request for Proposal/Quote and Specification for the Mesa Office Supply Business System" ("RFP") to a number of prospective suppliers that invited sales proposals. Twelve vendors, including [Ultimate], submitted written responses to Mesa's RFP. On September 2, 1983, at an all-day meeting that Mesa arranged after it received Ultimate's response to the RFP, Mesa's requirements were discussed in depth. Ultimate made proposals that varied in cost depending on their completeness. The basic agreement negotiated on September 2 was made final on September 28, when Mesa signed five contracts with Ultimate.[57]

The five written contracts comprising the system procurement dealt with maintenance, hardware, peripheral equipment, and software.[58] Mesa's software purchase was embodied in a two-page, seven-provision contract, the Application Software Agreement, which provided, inter alia, that,

> the amounts to be paid to the Seller under this Agreement do not include any assumption of risk, and the Seller disclaims any and all liability for incidental or consequential damages arising out of the use or operation of the programs provided herein.
>
> The warranties set forth herein are in lieu of all other warranties, express or implied, arising out of or in connection with any Program (or the use or performance thereof), including, but not limited to, the implied warranties of merchantability and fitness for a particular purpose.[59]

Mesa's software agreement is interesting because the software agreement is set out in a contract separate from the hardware contract, the disclaimers are not conspicuous, and the agreement expressly states that the amounts paid "do not include any assumption of risk." Perhaps fearful of the Ninth Circuit's "total and fundamental" breach rule, Ultimate apparently tried to create a situation where either the UCC would be judged not to apply or, if a court applied the UCC, the court would not apply the UCC to bar the exclusion.

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[56] In re Mesa Business Equip., Inc., BAP No. SC 88-1919 RPA, slip op. at 2 (9th Cir. Bankr. June 28, 1989), *aff'd*, No. 89-55825, slip op. at 2 (9th Cir. April 30, 1991).

[57] *Id.*

[58] *Id.*

[59] *Id.*, slip op. at 3 (quoting contract).

First, because software transactions not involving hardware have often been considered contracts for services and not transactions in goods, some courts would not apply the UCC to the Mesa software transaction.[60] Second, Ultimate's disclaimers would be ineffective under the UCC because they are not conspicuous.[61] Third, assuming that the UCC were applicable, a clause stating that the purchase price does not include an assumption of risk would seem to address the Ninth Circuit's concern with losses not part of the parties' allocation of risk.[62]

Mesa's complaint alleged that bugs in the program "destroyed" its business "by creating problems in inventory, shipping, credit, and billing."[63] In summarily rejecting Mesa's argument that the consequential damages exclusionary provision was unenforceable, the Bankruptcy Appellate Panel stated:

> No serious argument can be raised that this provision is an unconscionable provision. It was one of only seven provisions in a short, two-page contract. The contract was the subject of extensive negotiations at arms' length between two sophisticated business entities. Additionally, the contract was offered by one of twelve alternative vendors competing to do business with Mesa.
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> Since Mesa has failed to prove that the damage limitation provision is unconscionable, the provision must be upheld.[64]

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[60] Cases holding that computer software cannot be within the purview of the UCC's definition of "goods" because intangibles such as software are actually services; and therefore, can only be part of a "sale" when hardware is also included in the transaction, include: Computer Servicenters, Inc. v. Beacon Mfg. Co., 328 F. Supp. 653 (D.S.C.), *aff'd*, 443 F.2d 906 (4th Cir. 1970); Micro-Managers, Inc. v. Gregory, 147 Wis.2d 500, 434 N.W.2d 97, 100 (1988); Data Processing v. L.H. Smith Oil Corp., 492 N.E.2d 314 (Ind. Ct. App.), *reh'g denied*, 493 N.E. 2d 1272 (Ind. Ct. App. 1986); Walter E. Heller & Co. v. Convalescent Home of First Church of Deliverance, 49 Ill. App. 3d 213, 365 N.E.2d 1285 (1977). The better view is to treat software as a "good" rather than a service. See Advent Sys. Ltd. v. Unisys Corp., 925 F.2d 670, 676 (3d Cir. 1991) ("The importance of software to the commercial world and the advantages to be gained by the uniformity inherent in the U.C.C. are strong policy arguments favoring inclusion. The contrary arguments are not persuasive, and we hold that software is a "good" within the definition in the Code."); Systems Design v. Kansas City Post Office, 14 Kan. App. 2d 266, 788 P.2d 878 (1990); Communications Group v. Warner Communications Inc., 138 Misc. 2d 80, 527 N.Y.S.2d 341 (Sup. Ct. 1988); Neilson Business Equip. Center, Inc. v. Monteleone, 524 A.2d 1172 (Del. Sup. Ct. 1987).

[61] See U.C.C. § 2-316 (1990). Although it appears that the disclaimers were not conspicuous because the vendor did not want to give any impression that the UCC was applicable, it is equally plausible that the disclaimers were not conspicuous for other reasons, e.g., the contract's author was careless.

[62] RRX Indus., Inc. v. Lab-Con, Inc., note 11 *supra*, 772 F.2d at 547. See also Milgard Tempering, Inc. v. Sales Corp. of Am., note 45 *supra*, 902 F.2d at 709.

[63] In re Mesa Business Equip., Inc., note 56 *supra*, slip op. at 4.

[64] Id. at 6.

Although the court relied on UCC Section 2-719 when enforcing the exclusionary clause, no mention was made of the *RRX Industries, Inc.* "total and fundamental" breach doctrine. On appeal, however, the Ninth Circuit, citing to its prior ruling in *RRX Industries, Inc.*, stated that the conseqential damages exclusion was enforceable, "provided said limitation is not unconscionable *and does not fail of its essential purpose.*"[65]

The Ninth Circuit's Opinion

In upholding the exclusion, the Ninth Circuit attempted to distinguish the *RRX Industries, Inc.* decision with the following:

> In *RRX Indus., Inc.*, the contract obligated the seller to correct any malfunctions in the computer system, but limited liability to the contract price. [citation omitted] The Court held that neither bad faith nor procedural unconscionability need be demonstrated in order to invoke § 2719(2), as that section provides "an independent limit when circumstances render a damages limitation clause oppressive and invalid." [citation omitted]
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> Unlike *RRX Indus., Inc.*, this case does not involve the avaricious seller who, after limiting the buyer's remedies, is " 'unwilling or unable to provide a system that worked as represented, or to fix the "bugs" in the software . . . .' " *RRX Indus., Inc.*, 772 F.2d at 547 (quoting district court). Instead, the evidence clearly establishes that Ultimate made extensive repair efforts and was eventually successful in providing Mesa with a satisfactory system. Therefore, because Ultimate's alleged default was not total and fundamental, *RRX Indus., Inc.* is inapposite, and Mesa is limited to those damages not excluded by the Agreement.[66]

The Ninth Circuit's decision to apply the "total and fundamental" rule as a bar in *RRX Industries, Inc.* but not in *Mesa* demonstrates the rule's unpredictability. Given the fact that in *RRX Industries, Inc.* the "district court found that Lab-Con's failure to make repairs was not deliberate but resulted from the loss of two key TEKA employees,"[67] any suggestion that *RRX Industries, Inc.* involved an "avaricious seller," whether accurate or not, is not relevant unless one's level of "greed" is now part of the analysis. Although the installed *RRX Industries, Inc.* computer system was defective for

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[65] in re Mesa Business Equip., Inc., note 54 *supra*, slip op. at 12 (emphasis added).
[66] *Id.* (footnote omitted).
[67] RRX Indus., Inc. v. Lab-Con, Inc., note 11 *supra*, 772 F.2d at 548 (Norris, J., concurring and dissenting).

one year and three months before suit was filed,[68] in *Mesa*, the system allegedly "wreaked havoc" on Mesa's business for almost one year before the system operated satisfactorily.[69] And, approximately six months after the Mesa system was finally made operational, Mesa filed for bankruptcy and then *one week later* sued Ultimate for " 'the virtual ruination of plaintiff's once thriving business.' "[70]

A Confusing Result

The approach being utilized by the Ninth Circuit in deciding vendor disputes is confusing because it is not clear why the Ninth Circuit in *RRX Industries, Inc.* awarded consequential damages while refusing to do so in *Mesa*.[71] Further, the Ninth Circuit's eagerness to award consequential damages in *RRX Industries, Inc.* runs counter to U.C.C. Subsection 1-106(1), which provides: "The remedies provided by this Act shall be liberally administered to the end that the agreed party will be put in as good a position as if the other party had fully performed *but neither consequential or special nor penal damages may be had except as specifically provided in this Act or by other rule of law.*"[72] The UCC's drafters have explained that Subsection 1-106(1) "is intended to . . . make it clear that compensatory damages are limited to compensation. They do not include consequential or special damages. . . ."[73]

Obviously, the goal of a contractual relationship is actual performance since parties rarely bargain for mere promises.[74] Unfortunately, actual performance is not always possible. This uncertainty of performance leads a vendor to bargain for a risk-allocator known as a consequential damages exclusion. A nonfraudulent vendor does not enter into a custom software agreement thinking that a system will not perform as specified. Such a vendor, however, wants to

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[68] *Id.* at 545.

[69] In re Mesa Business Equip., Inc., note 54 *supra*, slip op. at 2–3.

[70] In re Mesa, Business Equip., Inc., note 56 *supra*, slip op. at 4 (quoting from Complaint ¶ 14).

[71] In addition, since the Ninth Circuit is located at a hub of the Pacific Rim, its approach has far-reaching consequences in the high technology community.

[72] U.C.C. § 1-106(1) (1990) (emphasis added).

[73] U.C.C § 1-106(1), Official Comment (1990).

[74] See U.C.C. § 2-609, Official Comment 1 (1990) ("[T]he essential purpose of a contract between commercial men is actual performance and they do not bargain merely for a promise, or for a promise plus the right to win a lawsuit.").

make certain at the time of contracting that liability arising from a failure to perform can be limited. So, in addition to disclaimer clauses, which control the seller's liability by reducing the number of situations a seller can be in breach, a vendor contracts for remedy limitations or exclusions that control what remedies are available once a breach is established.[75] A jurisprudence that would determine the enforceability of a consequential damages exclusion using case-by-case methodology not anchored by unconscionability standards "provides no basis for predicting with confidence when a bargained for cap on consequential damages will be judicially enforced."[76]

The ability to exclude consequential damages is absolutely essential from the perspective of a vendor. The fact that users, such as Mesa, can use competitive bids to procure a system and yet must still sign contracts containing exclusions demonstrates the necessity of these clauses in the computer industry. As stated by the court in *County Asphalt, Inc. v. Lewis Welding Engineering Corp.*,[77] when it enforced an exclusion in a sales agreement for complex factory equipment:

> Furthermore, the existence of competitors in defendant's industry, and plaintiff's utilization of that fact by procuring alternative contract proposals from defendant's competitors, precludes any argument of unequal bargaining power. There has been no showing that the clauses in question are part of an adhesion form agreed upon by every member of defendant's industry, and even if there had been such a showing, plaintiff would have retained the impressive negotiation power of one prepared to spend approximately one-half million dollars. The continued inclusion of the clauses in the contracts here in issue, in spite of plaintiff's powerful bargaining position, is further support for the inference *that they are necessary to the orderly functioning of defendant's industry.*[78]

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[75] See generally Ritchie Enters. v. Honeywell Bull, Inc., 730 F. Supp. 1041, 1047 (D. Kan. 1990) ("[D]isclaimers attempt to limit the circumstances of liability while remedy limitations restrict the buyer to certain forms of relief."); Apex Supply Co. v. Benbow Indus., 189 Ga. App. 613, 376 S.E.2d 694, 696 (1988) ("A disclaimer is more comprehensive in its legal effect. It leaves the buyer with no remedy for breach of implied warranties, there being no implied warranties for the seller to breach. A limitation of remedies is less comprehensive in its legal effect. The Seller's implied warranties remain in effect but, if breached, the buyer's recovery is circumscribed.").

[76] See generally RRX Indus., Inc. v. Lab-Con, Inc., note 11 *supra*, 772 F.2d at 552 (Norris, J., concurring and dissenting).

[77] 323 F. Supp 1300 (S.D.N.Y. 1970).

[78] *Id.* at 1308 (emphasis added).

Best Effort Standard

Although the Ninth Circuit has chosen to reallocate risks and strike down exclusions when confronted by a remedy limitation that fails of its essential purpose, a different approach was taken by the Supreme Court of New Jersey when it reviewed a contract for "a complex, computer-controlled machine tool."[79] In enforcing an exclusion on the recovery of consequential damages, the court in *Kearney & Trecker* reasoned that, " 'the rule that the agreed-upon allocation of commercial risk should not be disturbed is particularly appropriate where, as here, the warranted item is a highly complex, sophisticated, and in some ways experimental piece of equipment.' "[80]

The U.S. Court of Appeals for the Fourth Circuit has held that a repair or replacement clause found in a contract for experimental goods "may simply mean that the seller promises to use his best efforts to keep the goods in repair and in working condition and that the buyer must put up with the inconvenience and loss of down time."[81] Custom software fits within this "experimental goods" model and should be treated accordingly.

A court faced with the alleged failure of essential purpose of a software agreement's repair or replace remedy should apply a "best efforts" standard. If this standard is not satisfied, the court must next decide whether any other limited remedies exist. If a refund remedy is available, it should be enforced under a Subsection 2-719(2) failure of essential purpose standard or a Subsection 2-718(1) liquidated damages standard. In almost all cases, courts resolving custom software disputes that involve refund and repair or replace remedies should enforce exclusionary clauses and limit the right to recovery, as direct damages, the full purchase price of a program.

The allocations of risk found in contracts containing repair or replace remedies and consequential damages exclusions should be disrupted to allow for consequential damages only in two circumstances, and both circumstances involve factors at the time of contracting. The only express check on consequential damages

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[79] Kearney & Trecker Corp. v. Master Engraving Co., 107 N.J. 584, 600, 527 A.2d 429, 438 (1987).

[80] *Id.*, 527 A.2d at 438 (quoting American Elec. Power Co. v. Westinghouse Elec. Corp., 418 F. Supp. 438, 458 (S.D.N.Y. 1976).

[81] Riegel Power Corp. v. Voith Hydro, 888 F.2d 1043, 1046 (4th Cir. 1989).

exclusions is found in the Subsection 2-719(3) unconscionability test.[82] This is the only test relied on by the Third Circuit in *Chatlos*.[83] And this should be the only check derived from a commercial law perspective. The second method to invalidate a consequential damages exclusion is derived from tort law. A buyer, licensee, or lessee can always claim the software contract was fraudulently obtained and thereby seek invalidation of the exclusion on that basis.[84]

Although courts have stated that a seller's wrongful repudiation of the repair warranty might cause an exclusion to be invalidated,[85]

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[82] U.C.C. § 2-719(3) (1990) states: "Consequential damages may be limited or excluded unless the limitation or exclusion is unconscionable."

[83] Chatlos Sys., Inc. v. National Cash Register Corp., note 11 *supra*, 635 F.2d at 1086.

[84] See American Elec. Power v. Westinghouse Elec. Corp., note 80 *supra*, at 460:

> [T]he contractual limitation of liability precluding the recovery of consequential damages cannot be effective if plaintiffs' claims of fraudulent inducement are sustained at trial. The defendant cannot be heard to rely on the provisions of a contract which was entered into as a result of fraudulent actions on defendant's part.

Id. See also Furniture Consultants, Inc. v. Datatel Minicomputer Co., No. 85 CIV. 8518 (RLC), 1986 WL 7792 at *8 (S.D.N.Y. 1986) (When denying a motion to dismiss a claim for consequential damages arising from a computer system's failure to adequately perform, the court reasoned that, "possible remedies for fraud may include consequential damages, and until plaintiff's fraud claims are repled, the consequential damages issue . . . cannot be resolved."). Invacare Corp. v. Sperry Corp., 612 F. Supp. 448, 454 (N.D. Ohio 1984) ("Sperry cannot shield itself with the language of a contract [for a computer system] when Invacare's allegations are that the contract itself was induced through fraud."); Applications Inc. v. Hewlett Packard Co., 501 F. Supp. 129, 136 (S.D.N.Y. 1980), *aff'd*, 672 F.2d 1076 (2d Cir. 1982) ("However, if plaintiff's claims for fraudulent misrepresentation is [sic] heard at trial, the contractual limitation precluding recovery of consequential damages is ineffective."). But see Wayne Memorial Hosp., Inc. v. Electronic Data Sys. Corp., No. 87-905-CIV-5-H, slip op. at 2-6 (E.D.N.C. May 17, 1990) (approving Magistrate's recommendation that defendant's motion for summary judgment barring recovery of consequential damages *should be granted* even though "plaintiffs may still invalidate the merger clause by establishing fraud in the inducement of the contract, mistake, or negligent omission."). See cf. U.C.C. § 2-721 (1990) ("Remedies for material misrepresentation or fraud include all remedies available under this Article for non-fraudulent breach."); Glovatorium v. NCR Corp., 684 F.2d 658 (9th Cir. 1982) (buyer of computer system recovered compensatory and punitive damages by way of fraud action); Dreier Co. v. Unitronix Corp., 218 N.J. Super. 260, 274, 527 A.2d 875, 883 (App. Div. 1986) ("Plaintiff claims that defendants knowingly and fraudulently represented that the computer system would satisfy plaintiff's business needs when in fact it could not, and that could not, and that plaintiff relied upon the false representations by paying the contract purchase price.") (reversing dismissal of fraud claim).

[85] See, e.g., Cole Energy Dev. Co. v. Ingersoll-Rand Co., 678 F. Supp. 208, 212 (C.D. Ill. 1988) (buyer did not recover consequential damages because it failed to allege that seller was "willful or dilatory in failing to meet its warranty obligations"); Canal Elec. v. Westinghouse Elec. Corp., 406 Mass. 369, 548 N.E.2d 182, 186 (1990) ("We add that consequential damages are awarded in cases in which the facts show wilful dilatoriness or repudiation of warranty obligations by the seller."); Kearney & Trecker Corp. v. Master Engraving Co., note 79 *supra*, 527 A.2d at 438; Cayuga Harvester, Inc. v. Allis-Chalmers

vendors should be allowed to repudiate a repair or replace warranty so long as a refund remedy is an alternative exclusive remedy and the refund remedy provides a fair quantum of remedy. The UCC, however, imposes an obligation of good faith upon every contract and if a vendor's actions rise to the level of a breach of this covenant of good faith, damages should be awarded notwithstanding any exclusionary clause.[86] Indeed, a seller's "obligations of good faith, diligence, reasonableness and care" represent the only Code terms that may not be disclaimed by agreement.[87]

The Code's duty of good faith, however, does not require that the floodgates of consequential damages be opened whenever a vendor breaches a covenant of good faith: *Only* those damages specifically arising from the covenant's breach should be awarded. For example, a vendor who ignores a repair or replace remedy and refuses to correct errors found in a software program may cause system downtime and force the user to "cover"[88] and hire a consultant to correct the problem. The costs incurred by hiring the consultant should be considered damages recoverable for breach of the contract's repair remedy and convenant of good faith.

In *Werner & Pfleiderer Corp. v. Gary Chemical Corp.*,[89] the court recognized that a seller's failure to meet its repair obligations would render the seller liable for repair costs should the buyer complete the repairs successfully at the buyer's own costs.[90] In so holding, the U.S. District Court for the District of New Jersey

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Corp., 95 A.D.2d 5, 465 N.Y.S.2d 606 (App. Div. 1983) (holding that a consequential damages exclusion could be expunged if there existed a finding of willfully dilatory conduct in repairing or replacing the defective goods); Eissenstat, Note, "Commercial Transactions: UCC § 2-719: Remedy Limitations and Consequential Damage Exclusions," 36 Okla. L. Rev. 669, 681 (1983) ("Where a willful refusal to perform *causes* the consequential damages alleged, then the enforcement of such a provision would be unconscionable.") (emphasis in original).

[86] See U.C.C § 1-203 (1990); *Restatement (Second) of Contracts* § 205, Comment d (1979); Burton, "More on Good Faith Performance of a Contract: A Reply to Professor Summers," 69 Iowa L. Rev. 497, 498–501 (1984); Burton, "Good Faith Performance of a Contract Within Article 2 of the Uniform Commercial Code," 67 Iowa L. Rev. 1, 4–6 (1981); Farnsworth, "Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code," 30 U. Chi. L. Rev. 666, 666–679 (1963); Summers, "The General Duty of Good Faith—Its Recognition and Conceptualization," 67 Cornell L. Rev. 810, 830–831 (1982); Summers, "Good Faith in General Contract Law and Sales Provisions of the Uniform Commercial Code," 54 Va. L. Rev. 195, 207–208 (1968).

[87] U.C.C. § 1-102 (1990).

[88] See U.C.C. § 2-715(2)(a) (1990).

[89] 697 F. Supp. 808 (D.N.J. 1988).

[90] *Id.* at 813.

reasoned: "Such a recovery of repair costs would be characterized as damages directly attributable to the Seller's breach of a duty to repair rather than as consequential damages caused by an overall breach of contract."[91]

When a refund remedy is an alternate exclusive remedy, however, the amount paid to the vendor should usually act as a cap on damages because the vendor bargained for, under an alternate remedy situation, the option of repairing *or* refunding. The fact that a vendor "intentionally" chooses the later option should usually be of no legal significance so long as this choice complies with the Code's good faith requirement.

Conclusion

The invalidation of a custom software agreement's consequential damages exclusion should never be premised on a limited remedy's failure of essential purpose because the use of such a slippery test would severly curtail the ability of parties to freely allocate their commercial risks. A basic policy of the UCC is to preserve freedom of contract.[92] This policy is best served "when the commercial law permits parties to limit the redress of a purchaser who fails to receive the quality of product he expected."[93] Courts have ample ammunition by which to strike down exclusions and need not resort to judicial constructs not within the spirit of the Code. Although courts have properly shown flexibility[94] when placing software agreements within the confines of the Code, the Ninth Circuit's development of a "total and fundamental" breach test for judging exclusions can only impede growth in the software industry.

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[91] *Id.* at 813, n.2.

[92] U.C.C. § 1-102(1)(b) (1990) (an underlying purpose and policy of the UCC is "to permit the continued expansion of commercial practices through custom, usage and agreement of the parties."); U.C.C. § 1-102(3) (1990) ("The effect of provisions of this Act may be varied by agreement."); U.C.C. § 1-102, Official Comment (1990) ("Subsection (3) states affirmatively at the outset that freedom of contract is a principle of the Code: 'the effect' of its provisions may be varied by agreement.").

[93] Salt River Project Agricultural Improvement and Power Dist. v. Westinghouse Elec. Corp., 143 Ariz. 368, 694 P.2d 198, 206 (1989).

[94] The UCC is flexible and is to be "developed by courts in light of unforseen and new circumstances." U.C.C. § 1-102, Official Comment (1990).