Uniform Commercial Code Law Journal

A WARREN GORHAM LAMONT PUBLICATION FALL 1992

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Freedom of Contract Under the UCC: The Ability of Software Vendors to Exclude Recovery of Consequential Damages

*Paul E. Paray**

In this first of two articles, Mr. Paray discusses UCC and judicial treatment of damages exclusions in commercial software licenses.

With a focus on Article 2-719 of the UCC, which permits the contractual variation of both remedies and the measure of damages, the author argues that the inconsistency in interpreting Section 2-719 contravenes its very purpose.

The author discusses the repair and replace warranty, the alternate refund remedy, the "best efforts" standard, and other issues as they relate to the failure of essential purpose test. Further, he discusses how a failure of essential purpose should affect damages exclusions found in commercial software licenses. A brief look at Article 2A (Leases) of the UCC and its liquidation of damages provision is also included in Mr. Paray's examination of the topic.

Ever expanding computer usage requires that practitioners continually reexamine sources of law that have been altered by the computer age.[1] For example, Article 2 of the UCC has been put through several computer-inspired interpretive changes. First, although some courts have decided against placing computer software within Article 2's definition of "goods,"[2] a more reasonable

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[1] Indeed, "computer law" is nothing more than a grouping of legal doctrines that have all been altered by the birth of computer technology. For a compilation of decisions concerning computer system disputes, see Weikers, Comment, " 'Computer Malpractice' and Other Legal Problems Posed by 'Computer Vaporware,' " 33 Vill. L. Rev. 835, 836, n.4 (1988).

[2] The UCC's Article on Sales (Article 2) applies to "transactions in goods." U.C.C. § 2-102 (1990). And "goods" are "[a]ll things (including specially manufactured goods) which are movable at the time of indentification to the contract." U.C.C. § 2-105(1) (1990). 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

majority of courts has found that software transactions[3] involve "goods" and not services.[4] Second, although software transactions usually come in the form of leases or licensing agreements that allow the licensee to use and possess the software without acquiring any title interest, and under UCC Section 2-106(1) a "sale" consists in the "passing of title from the seller to the buyer for a price,"[5] a software license should still be governed by Article 2. This should follow because Article 2 applies to "transactions in goods"[6] and not only to "sales," and because each provision of Article 2 "with regards to the rights, obligations and remedies of the seller, the buyer, purchasers or other third parties applies irrespective of title to the goods except where the provision refers to such title."[7]

From a software vendor's perspective, whether a custom soft-

F.2d 906 (4th Cir. 1970); Micro-Managers, Inc. v. Gregory, 147 Wis. 2d 500, 434 N.W.2d 97, 100 (Wis. Ct. App. 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 (Ill. Ct. App. 1977).

[3] Software can be developed in three ways. "Custom software" is software that is specifically developed by a software vendor for a particular user according to predetermined specifications. "Canned software" is an already existing program that a user licenses or buys from a software vendor, usually a large manufacturer. Although canned software might not satisfy all the needs of an end-user, it is usually much less expensive than contracting for custom software. "Customized software" incorporates custom modifications onto an already existing software package. Since vendors rarely create a program from scratch, i.e., without borrowing from prior programming routines, it would be fair to guess that all "custom software" is actually a form of "customized software."

[4] 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."). See also RRX Indus., Inc. v. Lab-Con, Inc., 772 F.2d 543 (9th Cir. 1985); Chatlos Sys., Inc. v. National Cash Register Co., 479 F. Supp. 738 (D.N.J. 1979), *aff'd in relevant part*, 635 F.2d 1081 (3d Cir. 1980); Carl Beasley Ford, Inc. v. Burroughs Corp., 361 F. Supp. 325 (E.D. Pa. 1973), *aff'd*, 493 F.2d 1400 (3d Cir. 1974); Triangle Underwriters, Inc. v. Honeywell, Inc., 457 F. Supp. 765 (E.D.N.Y. 1978), *modified on other grounds*, 604 F.2d 737 (2d Cir. 1979); Systems Design v. Kansas City Post Office, 14 Kan. App. 2d 266, 788 P.2d 878 (Kan. Ct. App. 1990); Communications Group v. Warner Communications, Inc., 138 Misc. 2d 80, 527 N.Y.S.2d 341 (N.Y. Sup. Ct. 1988). Although courts have not made the distinction, it should be noted that custom software, to the extent it is not developed yet, is actually a "future" good. U.C.C. § 2-105(2) (1990) ("Goods must be both existing and identified before any interest in them can pass. Goods which are not both existing and identified are 'future' goods. A purported present sale of future goods or of any interest therein operates as a contract to sell.").

[5] Custom software vendors would rather license their programs than sell them outright because under the terms of most licenses vendors are then able to relicense modified versions of the same program to other users.

[6] See note 2 supra and accompanying text.

[7] U.C.C. § 2-401 (1990).

ware license agreement is actually governed by Article 2 is largely an academic issue. Since software licenses have been equated with leases,[8] software licenses can now be governed by Article 2A on leases in those states that have adopted Article 2A.[9] Also, several courts have already applied Article 2 to software licensing agreements,[10] and future courts can always apply the UCC by analogy even if the UCC were expressly held not to apply.[11] Simply put, there is just no way to guarantee the UCC will not be relied on by a court, and a vendor should negotiate a contract assuming it will. Indeed, a recent amendment to the Copyright Act indicates that software manufacturers need no longer set up "canned software" transactions as licenses and can now expressly set up such transactions as sales.[12]

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[8] See Communications Group v. Warner Communications, Inc., note 4 *supra*, 138 Misc. 2d 80, 527 N.Y.S.2d at 344–345, where the court held:

> The court finds that the Agreement clearly constituted a lease for the use of CGI's goods despite the terms expressed therein of a "license to use" CGI "proprietary" software for the payment of a one-time perpetual license fee in accordance with attached pricing schedules. The Agreement, although labelled a license agreement, is clearly analogous to a lease for chattels or goods. The movant has not addressed nor presented a distinction, factually or legally, between a license to use goods from an ordinary lease to use goods.

Id.

[9] Article 2A was made part of the UCC in 1987 and was revised in 1990. As of this writing, nine states have already adopted Article 2A: California, Florida, Kentucky, Minnesota, Nevada, Oklahoma, Oregon, South Dakota, and Utah. Uniform Commercial Code, 1B U.L.A. (Cum. Supp. 1991).

[10] See, e.g., *In re* Mesa Business Equip., Inc., No. 89-55825, slip op. at 4–5 (9th Cir. Apr. 30, 1991); RRX Indus., Inc. v. Lab-Con, Inc., note 4 supra, Earman Oil Co. v. Burroughs Corp., 625 F.2d 1291 (5th Cir. 1980); Office Supply Co. v. Basic Four Corp., 538 F. Supp. 776 (E.D. Wis. 1982); Harper Tax Servs., Inc. v. Quick-Tax Ltd., 686 F. Supp. 109 (D. Md. 1988).

[11] See, e.g., Chatlos Sys., Inc. v. National Cash Register Corp., note 4 supra, 479 F. Supp. at 740. See also Telesaver, Inc. v. U.S. Transmission Sys., Inc., 687 F. Supp. 997, 999, n.1 (D. Md. 1988), *aff'd*, 923 F.2d 849 (4th Cir.), *cert. denied*, 112 S. Ct. 60 (1991) (applying New Jersey law); Murray, "Under the Spreading Analogy of the Uniform Commercial Code," 39 Ford. L. Rev. 447 (1971).

[12] Under the "first sale doctrine" of federal copyright law, a purchaser of a copyrighted work can "sell or otherwise dispose" of his purchased work. 17 U.S.C. § 109(a) (West 1977). The U.S. Court of Appeals for the Third Circuit recently observed:

> Because of the ease of copying software, software producers were justifiably concerned that companies would spring up that would purchase copies of various programs and then lease those to consumers. Typically, the companies, like a videotape rental store, would purchase a number of copies of each program, and then make them available for over-night rental to consumers. Consumers, instead of purchasing their own copy of the program, would simply rent a copy of the program, and duplicate it.

Step-Saver Data Sys., Inc. v. WYSE Technology, 939 F.2d 91, 96, n.7 (3d Cir. 1991). Software manufacturers characterized the original transaction as a nontransferable personal license in order to evade this first sale doctrine. Under recent amendments to the copyright

Judicial treatment of damages exclusions negotiated in custom software licenses should be of major concern to vendors. Although courts upholding exclusions have recognized that excluding consequential damages "where the two parties are sophisticated business entities, and where consequential damages in the event of a problem could be extensive, is a reasonable business practice,"[13] courts judging exclusions under Article 2 have been less than laissez-faire to the allocation of risk negotiated by commercial parties.[14]

Consequential Damages and Custom Software

Under UCC Section 2-715, consequential damages "resulting from the seller's breach include (a) 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 and (b) injury to person or property proximately resulting from any breach of warranty."[15] Although Section 2-715 follows the "older rule at common law which made the seller liable for all consequential damages of which he had 'reason to know' in advance . . . that rule is modified by refusing to permit recovery unless the buyer could not reasonably have prevented the loss by cover or otherwise."[16]

Prior to contracting, a custom software vendor typically has intimate knowledge concerning what the program will be used for and what potential risks may arise from its use. A typical custom software contract begins with the drafting of a request for proposal

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law, the first sale doctrine only permits nonprofit libraries and educational institutions to lend or lease copies of software. 17 U.S.C. § 109(b)(1)(A) (West Supp. 1991). And, this amendment "renders the need to characterize the original transaction as a license largely anachronistic." *Step-Saver*, 939 F.2d at 96, n.7.

[13] Deerskin Trading Post, Inc. v. Spencer Press, Inc., 398 Mass. 118, 495 N.E.2d 303, 307 (1986). See also, Electro-Matic Prods., Inc. v. Prime Computers, Inc., No. 88-1790, slip op. at 12, (6th Cir. Aug. 28, 1989) ("[C]onsequential damages resulting from breach of the hardware service agreement could likely be extensive; the court's disregard of the exclusion provision would therefore effect a significant shift in the contractual risk allocation freely reached by the parties.") (rejecting plaintiff's argument that an express exclusion of consequential damages should be stricken as unconscionable).

[14] Although Article 2A should govern license agreements, because Article 2A has not yet been put through the litigation mill in those few states that have adopted it, Article 2 must be applied to any analysis of the issue.

[15] U.C.C. § 2-715(2) (1990).

[16] U.C.C. § 2-715, Official Comment 2 (1990). See cf. U.C.C. § 1-106, Official Comment 3 (1990) (Consequential damages "are not defined in terms in the Code, but are used in the sense given them by the leading cases on the subject.").

(RFP) by a computer user. This RFP describes the user's business functions (e.g., a diagnostic medical laboratory) and identifies the scope of the desired programming system (e.g., a system that allows for efficient medical billings).[17] Next, the user distributes its RFP to vendors interested in bidding on the programming project. After a particular vendor's bid is accepted, the chosen vendor studies the user's operations and comes up with a contract proposal based on the RFP and his study of the user's operations.[18] A vendor's study will usually entail numerous visits to the user's place of business and many discussions with key employees concerning business operations. The vendor's proposal will usually include a description of how the software will function and also provide for a delivery schedule.[19]

Contracting for custom software involves unique business risks for a vendor because foreseeability of damages frames the measure of consequential damages and a vendor has intimate knowledge of a user's business at the time of contracting. Also, the risks are great because programming techniques can create uncertain results.[20] So, although a vendor is not able to know the actual extent of its potential liability until all of the user's specifications are tested, and this cannot be completely determined until after the software system is given a live trial period, a vendor is subject to an enormous contingent liability because the vendor "at the time of contracting [has] reason to know"[21] of the user's potential lost profits were the system to fail.[22]

[17] See generally, RRX Indus., Inc. v. Lab-Con, Inc., note 4 supra.

[18] See, e.g., *In re* Mesa Business Equip., Inc., BAP No. SC 88-1919 RPA, slip. op. at 2 (Bankr. 9th Cir. June 28, 1989), *aff'd*, No. 89-55825, slip op. (9th Cir. Apr. 30, 1991); 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); Chatlos Sys., Inc. v. National Cash Register Corp., note 4 supra, 479 F. Supp. at 741; Badger Bearing Co. v. Burroughs Corp., 444 F. Supp. 919, 920 (E.D. Wis. 1977), *aff'd*, 588 F.2d 838 (7th Cir. 1978).

[19] See generally, *In re* Mesa Business Equip., Inc., note 18 *supra*. This overly simplistic account of how a typical custom software transaction is negotiated ignores many elements, e.g., the use of acceptance tests,and is given only to illustrate the fact that vendors have great familiarity with a user's operations before contract signing. For an excellent discussion on the use of acceptance tests in software procurements, see Harris, "Complex Contract Issues in the Acquisition of Hardware and Software," 4 Computer/L.J. 77, 92–100 (1983).

[20] "User's Rising Expectations Seen Spurring Software Crisis," Computerworld, Sept. 24, 1984, at 25 ("Many software designers experience two major problems. First, as the complexity of the program increases, each error is more difficult to extract. Second, corrections made to the program at the end of the development process are likely to create new errors somewhere in the program.").

[21] See note 15 *supra* and accompanying text.

[22] See, e.g., In re Merritt Logan, Inc., 901 F.2d 349, 364 (3d Cir. 1990) (discussing lost profits as a measure of damages).

Although risk allocation between user and vendor was once undermined by the advantage shown by vendors in the negotiating process vis-à-vis their superior computer expertise,[23] because users are today far more computer literate, and can usually choose from a larger number of vendors, the bargaining tables have been leveled.[24] The reality of high potential consequential damages, however, has not changed and vendors continue to limit remedies and exclude recovery of consequential damages.[25] Such exclusions and limitations on remedies are allowed under Article 2.

Specifically, Subsection 2-316(4) states:

> (4) Remedies for breach of warranty can be limited in accordance with the provisions of this Article on liquidation or limitation of damages and on contractual modification of remedy (Sections 2-718 and 2-719).[26]

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[23] See Accusystems, Inc. v. Honeywell Information Sys., Inc., 580 F. Supp. 474, 482 (S.D.N.Y. 1984); Scott, "Commercial User-Vendor Litigation: The User's Point of View," 5 Computer/L.J. 287, 288–289 (1985) ("In most instances the user has virtually no computer expertise, has no knowledge of the vendor's products, and has no means of evaluating the sales literature, the salesperson's representations or even the technical documentation the vendor may or may not provide.").

[24] See, e.g., Feldman, "Warranties and Disclaimers in Computer Contracts," 8 Computer Law. 1, 3 (1991) ("Past truisms concerning the inflexibility of large vendors can no longer be regarded as entirely accurate. The heat of competition has burned through some old barriers. The increasing sophistication of the user community constantly challenges set contractual patterns.").

[25] See generally, D. Brandon & S. Segelstein, *Data Processing Contracts: Structure, Contents, and Negotiation* (2d ed. 1984). A limited remedy clause might read:

> Customer's exclusive remedy and Honeywell's entire liability in contract, tort or otherwise for equipment is the repair or exchange of any parts which Honeywell determines during the applicable warranty period are defective in workmanship or material. All exchanged parts are the property of Honeywell. If, however, after repeated efforts, Honeywell is unable to repair or exchange such a defective part, then Customer's exclusive remedy and Honeywell's entire liability in contract, tort or otherwise is the payment by Honeywell of actual damages in an amount not to exceed the amount paid for the irreparable device.

Ritchie Enters. v. Honeywell Bull, Inc., 730 F.Supp. 1041, 1045 (D. Kan. 1990). A typical damages exclusion might read:

> IN NO EVENT SHALL BURROUGHS BE LIABLE FOR LOSS OF PROFITS OR OTHER ECONOMIC LOSS, INDIRECT, SPECIAL, CONSEQUENTIAL, OR OTHER SIMILAR DAMAGES ARISING OUT OF ANY BREACH OF THE AGREEMENTS OR OBLIGATIONS UNDER THIS AGREEMENT.
>
> BURROUGHS SHALL NOT BE LIABLE FOR ANY DAMAGES CAUSED BY DELAY IN DELIVERY, INSTALLATION OR FURNISHING OF THE EQUIPMENT OR SERVICE UNDER THIS AGREEMENT.

Earman Oil Co. v. Burroughs Corp., note 10 supra, 625 F.2d at 1294, n.6. See also Jaskey Fin. & Leasing v. Display Data Corp., 564 F. Supp. 160, 162 (E.D. Pa. 1983); Office Supply Co. v. Basic/Four Corp., note 10 *supra*, 538 F. Supp. at 782; Badger Bearing Co. v. Burroughs Corp., note 18 *supra*, 444 F. Supp. at 921; Investors Premium Corp. v. Burroughs Corp., 389 F. Supp. 39, 45 (D.S.C. 1974).

[26] U.C.C. § 2-316 (1990).

Section 2-718 allows parties to liquidate contract breach damages:

> Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.[27]

And Section 2-719 allows parties to limit the remedies after a breach of warranty occurs. It reads:

> (1) Subject to the provisions of subsections (2) and (3) of this section and of the preceding section on liquidation of damages,
>
> (a) the agreement may provide for remedies in addition to or in substitution for those provided in this Article and 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 nonconforming goods or parts; and (b) resort to a remedy as provided is optional unless the remedy is expressly agreed to be exclusive, in which case it is the sole remedy.
>
> (2) Where circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided in this Act.
>
> (3) Consequential damages may be limited or excluded unless the limitation or exclusion is unconscionable. Limitation of consequential damages for injury to the person in the case of consumer goods is *prima facie* unconscionable but limitation of consequential damages where the loss is commercial is not.[28]

The U.S. Court of Appeals for the Ninth Circuit has held that under Subsection 2-719(2), a limited remedy's "total and fundamental" failure of essential purpose is sufficient to expunge a vendor's conscionable exclusion on the recovery of consequential damages.[29] This article examines the Ninth Circuit rule and proposes an alternative that is in harmony with the UCC's respect for freedom of contract. Specifically, this article recognizes that under the UCC, a nonfraudulent vendor's conscionable exclusion of consequential damages should *never* be expunged. A vendor's repudiation of a limited remedy may sometimes warrant an award of damages, but

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[27] U.C.C. § 2-718(1) (1990).

[28] U.C.C. § 2-719 (1990).

[29] See *In re* Mesa Business Equip., Inc., No. 89-55825, slip op. (9th Cir. Apr. 30, 1991); RRX Indus., Inc. v. Lab-Con, Inc., note 4 supra.

such an award should be limited to compensating for the vendor's breach of the covenant of good faith and *not* as a form of compensation for the limited remedy's failure of essential purpose. Although the measure of damages may coincide in certain instances, a breach of the covenant of good faith may not always warrant a windfall award in the form of consequential damages.

UCC Section 2-719: Failure of Essential Purpose and the Ability to Exclude Recovery of Consequential Damages

Courts have been less than uniform in interpreting Section 2-719,[30] and commentators have criticized the manner in which courts have applied the failure of essential purpose test.[31] Section 2-719(1)(a) allows contracting parties to "limit or alter the measure of damages recoverable under [the] Article" subject to Subsections 2-719(2) and 2-719(3).[32] According to the Official comments to Section 2-719, the purpose of this provision is to allow for freedom of contract while still ensuring that "there be at least a fair quantum of remedy for breach of the obligations or duties outlined in the contract." Under Section 2-719(1)(b), an exclusive remedy must be clearly expressed as such or it will be presumed to be cumulative, thereby allowing for other remedies.[33] Likewise, if an exclusive remedy fails of its essential purpose under Section 2-719(2), all of the remedies found in the UCC are available.[34] The question left unanswered in the UCC is whether "all of the remedies found in this Act" includes consequential damages even when such damages are expressly excluded pursuant to Subsection 2-719(3).

A perceived relationship between Section 2-719(2) and Section 2-719(3) has led courts to expunge a consequential damages exclu-

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[30] Compare Avenell v. Westinghouse Elec. Corp., 41 Ohio App. 2d 150, 324 N.E.2d 583 (1974) (limitation of remedy clause must be conspicuous) with Argo Welded Prods., Inc. v. J.T. Ryerson & Sons Steel, 528 F. Supp. 583 (E.D. Pa. 1981) (limitation of remedy clause need not be conspicuous).

[31] See, e.g., Eddy, "On the Essential Purposes of Limited Remedies: The Metaphysics of UCC Section 2-719(2)," 65 Cal. L. Rev. 28 (1977); Anderson, "Failure of Essential Purpose and Essential Failure on Purpose: A Look at Section 2-719 of the Uniform Commercial Code," 31 SW. L.J. 759 (1977).

[32] U.C.C. § 2-719(1)(a) (1990).

[33] U.C.C. § 2-719, Official Comment 2 (1990). This does not mean, however, that alternative exclusive remedies are prohibited. See notes 92–98 *infra* and accompanying text.

[34] U.C.C. § 2-719, Official Comment 1 (1990).

sion when an exclusive remedy fails of its essential purpose.[35] Other courts have recognized that the plain language of Section 2-719 indicates that exclusions are not to be tested by the failure of essential purpose test. For example, in *Schurtz v. BMW of North America, Inc.*,[36] the court reasoned:

> If we were to read subparts (2) and (3) as dependent, we would effectively read out the unconscionability test of subpart (3) for determining the validity of a provision limiting incidental and consequential damages and substitute "failure of essential purpose" from subpart (2) as the operative test. Such a reading seems to fly in the face of the plain language of the statute.[37]

The U.S. Court of Appeals for the Sixth Circuit relied on a basic rule of statutory construction when it stressed the independent nature of Subsections (2) and (3):

> [A]bsent the specific language of subsection (3), the general language of subsection (2) would seem to cover the issue of consequential damages. Since it is a basic principle of statutory construction that the particular governs over

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[35] See, e.g., Ragen Corp. v. Kearney & Trecker Corp., 912 F.2d 619, 625 (3d Cir. 1990) ("[W]e conclude that the Wisconsin Supreme Court would hold that because Ragen's exclusive limited remedy failed in its essential purpose, it can recover consequential damages under the UCC, notwithstanding that consequential damages may be excluded under its contract with K & T."); RRX Indus., Inc. v. Lab-Con, Inc., note 4 *supra* (interpreting California law); Fidelity & Deposit Co. of Md. v. Krebs Eng'rs, 859 F.2d 501, 504–505 (7th Cir. 1988) (interpreting Wisconsin law); R.W. Murray Co. v. Shatterproof Glass Corp., 758 F.2d 266, 272–273 (8th Cir. 1985) (interpreting Missouri law); Fiorito Bros., Inc. v. Fruehauf Corp., 747 F.2d 1309, 1315 (9th Cir. 1984) (" 'It cannot be maintained that it was the parties' intention that Defendant be enabled to avoid all consequential liability for breach by first agreeing to an alternative remedy provision designed to avoid consequential harms, and then scuttling that alternative remedy through its recalcitrance in honoring the agreement.' ") (quoting trial court); Soo Line R.R. Co. v. Fruehauf Corp., 547 F.2d 1365, 1373 (8th Cir. 1977) (interpreting Minnesota law); Riley v. Ford Motor Co., 442 F.2d 670, 673–674 (5th Cir. 1971) (interpreting Alabama law); KKO, Inc. v. Honeywell, Inc., 517 F. Supp. 892 (N.D. Ill. 1981); Fargo Mach. & Tool Co. v. Kearney & Trecker Corp., 428 F. Supp. 364, 381–382 (E.D. Mich. 1977) (interpreting Michigan law); Kalil Bottling Co. v. Burroughs Corp., 127 Ariz. 278, 619 P.2d 1055, 1059 (Ct. App. 1980); Great Dane Trailer v. Malvern Pulpwood, 301 Ark. 436, 785 S.W.2d 13, 18 (1990) ("Arkansas case law indicates consequential damages are recoverable upon the failure of a limited remedy's essential purpose."); Cooley v. Big Horn Harvestore Sys., 813 P.2d 736, 745 (Colo. 1991); Directors of Harriman School Dist. v. Southwestern Petroleum Corp., 757 S.W.2d 669 (Tenn. Ct. App. 1988). The Court in Clark v. International Harvester Co., 99 Idaho 326, 581 P.2d 784, 800 (1978) found:

> The majority of the courts in cases involving the failure of an exclusive remedy contained in a warranty provision which also excludes liability for consequential damages have ruled that the provisions limiting liability fail also and that the plaintiffs are entitled to the full array of remedies provided by the UCC, including the recovery of consequential and incidental damages.

[36] 814 P.2d 1108 (Utah 1991).

[37] *Id.* at 1111.

the general, we believe that the section 2-719 drafters intended subsection (3) to deal with the issue of consequential damages.[38]

The fact that "[n]othing in § 2-719 or other provisions of the Code explains whether consequential damages may be recovered following the failure of a limited remedy if they are expressly excluded by a contract,"[39] has provided for an uneven path of Code interpretation.[40] A "strict constructionist" view[41] has much appeal and the current trend is to enforce conscionable exclusions even when a limited remedy fails of its essential purpose.[42]

Failure of Essential Purpose and Exclusive Remedies

UCC Section 2-719(1)(a) states that a seller can provide a "repair and replacement" warranty or limit the buyer's remedy "to return of the goods and repayment of the price."[43] Courts have recognized two situations where these two exclusive remedies can fail of their essential purpose. The usual refund remedy failure

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[38] Lewis Refrigeration Co. v. Sawyer Fruit, Vegetable & Cold Storage Co., 709 F.2d 427, 435 (6th Cir. 1983) (footnote omitted).

[39] Canal Elec. Co. v. Westinghouse Elec. Corp., 406 Mass. 369, 548 N.E.2d 182, 185 (1990).

[40] Schurtz v. BMW of N. Am., Inc., 814 P.2d 1108, 1113–1114 (Utah 1991) (recognizing that "there is a split among the courts across the country, with some courts reading (2) and (3) independently and others reading them dependently."); American Nursery Prod. v. Indian Wells Orchards, 115 Wash. 2d 217, 797 P.2d 477, 484 (1990) ("There is disagreement over whether the failure of a limited remedy vitiates the validity of a conscionable exclusionary clause.").

[41] Although commentators have split the line of cases analyzing the Section 2-719 failure of essential purpose/exclusion of the consequential damages issue into an "independent school," which reads subsections (2) and (3) independently and an "interdependent school" which reads subsections (2) and (3) interdependently, more useful labels would focus on the methodology used by the courts and not the end results of the methodology. For example, the interdependent school could be thought of as the "judicial activist" school and the independent school could be renamed the "strict constructionist" school.

[42] Riegel Power Corp. v. Voith Hydro, 888 F.2d 1043, 1047 (4th Cir. 1989); McKernan v. United Technologies Corp., 717 F. Supp. 60, 70 (D. Conn. 1989). For cases adhering to a strict construction of Section 2-719 see, e.g., Employers Ins. of Wausau v. Suwannee River Spa Lines, Inc., 866 F.2d 752 (5th Cir.), *cert. denied*, 493 U.S. 820 (1989); Smith v. Navistar Int'l Transp. Corp., 714 F. Supp. 303 (N.D. Ill. 1989); Harper Tax Servs., Inc. v. Quick-Tax Ltd., note 10 *supra*; Flow Indus., Inc. v. Fields Constr. Co., 683 F. Supp. 527 (D. Md. 1988); Cole Energy Dev. Co. v. Ingersoll-Rand Co., 678 F. Supp. 208 (C.D. Ill. 1988); Office Supply Co. v. Basic/Four Corp., note 10 *supra*; Canal Elec. Co. v. Westinghouse Elec. Corp., note 39 *supra*; Kearney & Trecker Corp. v. Master Engraving Co., 107 N.J. 584, 527 A.2d 429 (1987); Cayuga Harvester, Inc. v. Allis-Chalmers Corp., 95 A.D.2d 5, 465 N.Y.S.2d 606 (N.Y. App. Div. 1983); Schurtz v. BMW of N. Am., Inc., note 36 *supra*; Envirotech Corp. v. Halco Eng'g, Inc., 234 Va. 583, 364 S.E.2d 215 (1988).

[43] U.C.C. § 2-719(1)(a) (1990).

involves the sale of a product requiring processing in the hands of the buyer. The seller limits the buyer's remedy to the return of the purchase price so long as notice of the defect is given soon after delivery. After processing the goods, a defect is found and the buyer asserts that because the defect was undiscoverable while the goods were in an unprocessed state, the limitation of remedy failed in its essential purpose.[44] In the second situation, the seller negotiates a limited "repair and replacement" warranty and either refuses to repair or is not able to do so within a reasonable period of time. This failure to repair causes the limited remedy to fail in its essential purpose.[45]

Since the "repair-or-replace" warranty is probably the most commercially used exclusive remedy,[46] most Section 2-719 decisions deal with the failure of essential purpose of a "repair-or-replace" warranty. The early case of *Beal v. General Motors Corp.*[47] involved the purchase of a defective heavy tonnage tractor. The buyer sued, claiming that because the tractor was not repaired within a reasonable period of time, the exclusive remedy of repair or replacement failed of its essential purpose, thereby allowing for damages.[48] In holding that the plaintiff stated a cause of action notwithstanding any good faith efforts to repair, the court emphasized the nature of the agreement and the purpose of the exclusive remedy:

> From the point of view of the buyer the purpose of the exclusive remedy is to give him goods that conform to the contract within a reasonable time after a defective part is discovered. When the warrantor fails to correct the defect as promised within a reasonable time he is liable for a breach of that warranty.

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[44] Frequently cited decisions concerning the latent defect situation include: Wilson Trading Corp. v. David Ferguson, Ltd., 23 N.Y.2d 398, 244 N.E.2d 685, 297 N.Y.S.2d 108 (1968); Earl M. Jorgensen Co. v. Mark Constr., Inc., 56 Haw. 466, 540 P.2d 978 (1975); Marr Enters., Inc. v. Lewis Refrigeration Co., 556 F.2d 951 (9th Cir. 1977); and Coastal Modular Corp. v. Laminators, Inc., 635 F.2d 1102 (4th Cir. 1980).

[45] See Eddy, note 31 *supra*, at 29; Anderson, note 31 *supra*, at 764.

[46] See generally, A. Schwartz & R. Scott, *Commercial Transactions Principles and Policy* 189–196 (1982); Eddy, note 31 *supra*, at 61.

[47] 354 F. Supp. 423 (D. Del. 1973).

[48] *Id.* at 425. The contract contained the following limited warranty:

> GMC Truck & Coach Division's obligation under this warranty being limited to repairing or replacing at its option any part or parts thereof which shall, within twenty-four (24) months after delivery of such vehicle or chassis to the original retail purchaser or before such vehicle or chassis has been driven twenty-four thousand (24,000) miles, whichever event shall first occur.

Id. Plaintiff averred as consequential damages lost profits incurred while the tractor was being repaired. *Id.* at 427.

> [citations omitted] The limited, exclusive remedy fails of its purpose and is thus avoided under § 2-719(2), whenever the warrantor fails to correct the defect within a reasonable period.[49]

The court in *S.M. Wilson & Co. v. Smith International, Inc.*[50] quoted the following passage to show the assumptions underlying the "repair-or-replace" limited remedy:

> This rosy picture of the limited repair warranty, however, rests upon at least three assumptions: that the warrantor will diligently make repairs, that such repairs will indeed "cure" the defects, and that consequential loss in the interim will be negligible. So long as these assumptions hold true, the limited remedy appears to operate fairly and, as noted above, will usually withstand contentions of "unconscionability." But when one of these assumptions proves false in a particular case, the purchaser may find that the substantial benefit of the bargain has been lost.[51]

"Standard Goods" Model

The view that a "repair-or-replace" exclusive remedy fails of its essential purpose whenever the defect is not corrected within a reasonable time[52] has been applied vigorously where the goods in question, like the tractor in *Beal*, are "standard."[53]

Standard goods are made under a manufacturing standard that allows for uniformly well-functioning products.[54] A buyer of standard goods expects a product that will substantially conform to the industrial standard regardless of the seller's good faith efforts to

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[49] *Id.* at 426. Several commentators consider this the most accurate expression of what is encompassed in the essential purpose of a Section 2-719(1)(a) "repair-or-replacement" warranty limitation. See, e.g., Eddy, note 31 *supra*, at 72; Anderson, note 31 *supra*, at 769. See also Milgard Tempering, Inc. v. Selas Corp. of Am., 902 F.2d 703, 707 (9th Cir. 1990) ("A limited repair remedy serves two main purposes. First, it serves to shield the seller from liability during her attempt to make the goods conform. Second, it ensures that the buyer will receive goods conforming to the contract specifications within a reasonable period of time.").

[50] 587 F.2d 1363, 1375 (9th Cir. 1978).

[51] *Id.* (quoting Eddy, note 31 *supra*, at 63).

[52] What is a "reasonable time" is governed by U.C.C. § 1-204: "(1) Whenever this Act requires any action to be taken within a reasonable time, any time which is not manifestly unreasonable may be fixed by agreement. (2) What is a reasonable time for taking any action depends on the nature, purpose and circumstances of such action." U.C.C. § 1-204 (1990).

[53] See generally Eddy, note 31 *supra*, at 76. Automobiles are regularly sold with a repair-or-replace warranty. See Herbrand, Annotation, "Construction and Effect of New Motor Vehicle Warranty Limiting Manufacturer's Liability to Repair or Replacement of Defective Parts," 2 A.L.R.4th 576 (1980) (collecting cases).

[54] See Eddy, note 31 *supra*, at 76.

repair.[55] Sellers benefit from such a warranty because a "repair-or-replace" limited warranty serves to avoid the economic loss associated with re-selling repaired goods.[56]

"Experimental Goods" Model

In contrast to the "standard goods" line of cases, there are courts that use a "best efforts" standard when applying the failure of essential purpose test on "repair-or-replace" warranties.[57] These rulings involve the sale of experimental goods.[58] Courts are less willing to disturb the allocation of unknown risks[59] made by parties who deal in experimental goods, and thus, they are more willing to apply a lesser standard when determining failure of essential purpose. The "experimental goods" model recognizes that when goods are experimental in nature, the parties are aware that defects might occur and the seller "has implicitly promised on these unique facts

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[55] Professor Eddy points out that, "either a consumer or a commercial purchaser would regard as ridiculous a construction of the contract that called only for 'best efforts' by the car manufacturer to make the car substantially conform to an average performance standard for the model." *Id.* at 76–77.

[56] For example, if a defect is found in a sold product, the buyer will ordinarily be entitled to revoke acceptance and tender back the item. The seller now has an item he has to repair. Once repaired, this item will sell at a substantially discounted price because it is now deemed a used good. If the seller has the option of repairing the defective goods, he avoids losses incurred in selling "used" goods, i.e., having to substantially discount the price of the goods. See generally Eddy, note 31 *supra*, at 62.

[57] Frequently cited experimental goods cases include: U.S. Fibres, Inc. v. Proctor & Schwartz, Inc., 358 F. Supp. 449 (E.D. Mich. 1972), *aff'd*, 509 F.2d 1043 (6th Cir. 1975); Neville Chem. Co. v. Union Carbide Corp., 422 F.2d 1205 (3d Cir.), *cert. denied*, 400 U.S. 826 (1970); American Elec. Power Co., Inc. v. Westinghouse Elec. Corp., 418 F. Supp. 435 (S.D.N.Y. 1976); Kearney & Trecker Corp. v. Master Engraving Co., note 42 *supra*; J.A. Jones Constr. Co. v. City of Dover, 372 A.2d 540 (Del. Super. Ct. 1977). See also Logan Equip. Corp. v. Simon Aerials, Inc., 736 F. Supp. 1188, 1196 (D. Mass. 1990) (enforcing an exclusionary clause because the clause "appears to be a valid and reasonable allocation of commercial risk, especially in light of the somewhat 'experimental' nature of the boomlift ordered."); Canal Elec. Co. v. Westinghouse Elec. Corp., note 39 *supra*; Eddy, note 31 *supra*, at 78–84; Anderson, note 31 *supra*, at 777.

[58] Examples of goods adjudicated to be "experimental" include: steam turbine generators (American Elec. Power Co. v. Westinghouse Elec. Corp., note 57 *supra*), machinery to produce resinate padding (U.S. Fibres, Inc. v. Proctor & Schwartz, Inc., note 57 *supra*), equipment to expand the capacity of an electricity generating plant (J.A. Jones Constr. Co. v. City of Dover, note 57 *supra*), and computer-controlled machining tools (Kearney & Trecker Corp. v. Master Engraving Co., note 57 *supra*).

[59] The Official Comments to Section 2-719 recognize that an exclusion of consequential damages is "merely an allocation of unknown or undeterminable risks." U.C.C. § 2-719, Official Comment 3 (1990).

only to use his best efforts to correct defects.''[60] As goods become more complex and custom-designed a best-efforts standard for repair and replacement becomes more plausible.[61]

The U.S. Court of Appeals for the Fourth Circuit quoted with approval the following from Professor Hawkland's treatise:

> A more difficult case arises where the seller makes good faith but unsuccessful efforts to repair the defective goods. Where the buyer is a consumer, this state of affairs should usually be sufficient to invalidate the prescribed remedy term on the basis of failure of esential purpose, and the same result ought to obtain as between merchants where standard goods are sold because the assumption in each case is that the seller can cure the defects that may crop up with regard to such goods. The situation and result may be different where the goods are experimental items, of complicated design, or built especially for the buyer. In those cases, the repair or replacement clause 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.[62]

In *American Electric Power Co. v. Westinghouse Electric Corp.*, the Court reasoned that a contract for the sale of a turbine-generator required a more laissez-faire judicial attitude towards the parties' allocation of commercial risk:

> [T]he 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. Moreover, compliance with a warranty to repair or replace must depend on the type of machinery in issue. In the case of a multi-million dollar turbine-generator, we are not dealing with a piece of equipment that either works or does not, or is fully repaired or not at all. On the contrary, the normal operation of a turbine-generator spans too large a spectrum for such simple characterizations.[63]

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[60] Anderson, note 31 *supra*, at 777. See also Anderson, "Contractual Limitations on Remedies," 67 Neb. L. Rev. 548, 591 (1988) ("Often, particularly with respect to goods manufactured to the buyer's specifications, the seller may be unwilling to make any warranty at all other than to provide goods of the contract description. In other cases the seller may be willing to go a bit further and promise to use good faith and diligent efforts to correct defects as they arise, but not that the repair attempts will be successful. In such cases, of course, this very limited remedy should not be found to fail under subsection (2) if the seller has acted with good faith and diligence.").

[61] Eddy, note 31 *supra*, at 77; Anderson, note 31 *supra*, at 777.

[62] Riegel Power Corp. v. Voith Hydro, note 42 *supra*, 888 F.2d at 1045–1046 (quoting Hawkland UCC Series Sec. 2-719:03 at 447 (1984)).

[63] American Elec. Power Co. v. Westinghouse Elec. Corp., note 57 *supra*, 418 F. Supp. at 458. Interestingly, the U.S. District Court for the Southern Distict of New York, in *American Electric Power*, was also one of the first courts to rule that a failure of essential purpose does not automatically cause an exclusion to fall. See *id.* at 457–458.

Professors White and Summers have recognized that the experimental goods model, as set out in *American Electric Power*, represents an accurate vision of the Code's intent:

> In general we favor the American Electric Power line of cases. Those cases seem most true to the Code's general notion that the parties should be free to contract as they please. When the state intervenes to allocate the risk of consequential loss, we think it more likely that the loss will fall on the party who cannot avoid it at the lowest cost. This is particularly true when a knowledgeable buyer is using an expensive machine in a business setting. It is the buyer who operates the machine, adjusts it, and understands the consequences of its failure. Sometimes flaws in such machines are inherent and attributable to the seller's faulty design or manufacture. *But the fault may also lie in buyer neglect, in inadequate training and supervision of the operators or even in intentional use in ways forbidden by the seller.* Believing the parties to know their own interests best, we would leave the risk allocation to the parties.[64]

Custom software fits under the "experimental goods" model because all custom programs are experimental by definition and they almost always contain "bugs" that have to be worked out.[65] As stated by the court in *American Electric Power*, an experimental good is not the type of good "that either works or does not or is fully repaired or not at all."[66] And, as recognized by Professors White and Summers, breakdowns in experimental goods may be caused after delivery by buyer neglect. Similarly, vendors cannot control all problems occurring after delivery. For example, because the average computer system consists of hardware and an operating system in addition to the software, errors or power surges in any part of this electronic chain causes problems with the software program.[67]

Surprisingly, the "experimental goods" model has not been

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[64] J. White & R. Summers, I *Uniform Commercial Code* at 605 (3d ed. 1988).

[65] See notes 17–20 *supra* and accompanying text.

[66] American Elec. Power Co., Inc. v. Westinghouse Elec. Corp., note 57 *supra*, 418 F. Supp. at 435, 458.

[67] See Item Leasing Co. v. Burroughs Corp., 684 F.2d 573 (8th Cir. 1982) (user entered data improperly); Bruffey Contracting Co. v. Burroughs Corp., 522 F. Supp. 769, 774 (D. Md. 1981), *aff'd*, 681 F.2d 812 (4th Cir. 1982) ("The nature of the system is that no one could say with certainty in every case exactly what caused a malfunction.") (defendant alleged excess heat in plaintiff's office caused computer system failure); Byrd Tractor, Inc. v. Burroughs Corp., 7 Computer L. Serv. Rep. (Callaghan) 969 (E.D. Va. 1977) (dust collecting on circuit caused breakdown); Honeywell, Inc. v. Lithonia Lighting, Inc., 317 F. Supp. 406 (N.D. Ga. 1970) (user improperly combined programs).

used in software license disputes. In *Ritchie Enterprises v. Honeywell Bull, Inc.*,[68] the U.S. District Court for the District of Kansas did, however, emphasize the inherent economic risks of computer usage when it enforced an exclusionary clause:

> *The possibilities that a computer system will not meet the buyer's needs and business opportunities consequently will be lost are inherent risks* that the parties as experienced commercial entities must be presumed to have known and allocated by their agreement, in the absence of conflicting evidence. Public interest is better served when the courts look to the agreements between commercial entities in determining the allocation of risks.[69]

One commentator has argued that because of the aggressive sales tactics of some vendors, that is, vendors market computer systems as if they are proven goods, the "experimental goods" model has no place in computer-related disputes.[70] No justification, however, is given for allowing the aggressive sales tactics of *some* vendors to supplant substantive contract law by estopping *all* other vendors from using the model. Notwithstanding the fact that unfair marketing strategy can *sometimes* cause an exclusion to fall on unconscionability or fraud grounds, and notwithstanding the use of aggressive sales tactics by *some* vendors, excluding custom software from the "experimental goods" model ignores that this model already exists and courts should remain consistent and apply the rule to goods that are by definition experimental—custom software.[71] Courts can always look at marketing strategy when deciding the

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[68] 730 F. Supp. 1041 (D. Kan. 1990).

[69] *Id.* at 1050 (emphasis added).

[70] See Plunkett, Comment, "U.C.C. § 2-719 as Applied to Computer Contracts—Unconscionable Exclusions of Remedy?: *Chatlos Systems, Inc. v. National Cash Register Corp.*," 14 Conn. L. Rev. 71, 110 (1981):

> All data processing systems are to some degree experimental. Except for the smallest of models (mini- and microcomputers), computers do not simply plug in and run. Each computer must be tailored to the particular needs of the customer. Courts have deemed the exclusion of consequential damage clause to be commercially reasonable where equipment was experimental, or where it was tailored to the customer's particular needs. But this is *not* how computers are customarily sold. The marketing approach of most vendors is to sell the computer as an integrated, proven machine—an appliance. Unfortunately for the customer, the contract treats the equipment differently, and vendors should not be able to justify exclusion clauses on the grounds that computers are experimental while their marketing strategy is to convince the customer of just the opposite.

Id. (emphasis in original) (footnotes omitted).

[71] Even the commentator who objects to applying the experimental goods model recognizes that "[a]ll data processing systems are to some degree experimental." Plunkett, Comment, note 70 *supra*, at 110.

enforceability of an exclusionary clause. And, if a vendor's marketing strategy is fraudulent or unconscionable, his exclusion on the recovery of consequential damages should be stricken. Marketing strategy that is less than unconscionable or less than fraudulent should not, however, be enough to expunge an exclusion.

Problems can arise when courts allow the Subsection 2-719(2) failure of essential purpose analysis to be influenced by evidence of unfair marketing strategy. For example, although the court in *Milgard Tempering, Inc. v. Selas Corp. of America*[72] was faced with a seller's unfair marketing strategy, it used a failure of essential purpose argument to strike down an exclusion that may properly have fallen on fraud or unconscionability grounds.[73] The U.S. Court of Appeals for the Ninth Circuit, in affirming a lower court's decision to expunge an exclusion, stated:

> We agree with the district court's decision to lift the cap on consequential damages. Milgard did not agree to pay $1.45 million in order to participate in a science experiment. It agreed to purchase what Selas represented as a cutting-edge glass furnace that would accommodate its needs after two months of debugging. Selas' inability to effect repair despite 2.5 years of intense, albeit injudicious, effort caused Milgard losses not part of the bargained-for allocation of risk. Therefore, the cap on consequential damages is unenforceable.[74]

Because the Court in *Milgard* failed to rule on the conscionability of the contract and failed to determine whether the seller misrepresented facts, the decision sets a dangerous precedent whereby a judge can now potentially expunge an exclusion on the basis of sales "puffing" and huge damages.[75]

Unconscionability as a Factor

A court is obviously not precluded from applying an unconscionability test when deciding the enforceability of a limited remedy.[76]

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[72] 902 F.2d 703 (9th Cir. 1990).

[73] *Id.* at 703, 705 ("Under the contract, Selas agreed to design and manufacture the furnace for $1.45 million. Its design was complex, and in Selas' eyes, experimental. However, Selas marketed it as a working piece of equipment.") (striking a consequential damages exclusion because the seller's failure to repair "caused a loss which was not part of the bargained-for allocation of risk").

[74] *Id.* at 709.

[75] See notes 135–137 *infra* and accompanying text.

[76] Article Two's general unconscionability provision applies to "any clause" of the contract. U.C.C. § 2-302 (1990).

For example, in *Phillips Petroleum Co. v. Bucyrus-Erie Co.*,[77] the Supreme Court of Wisconsin reversed an intermediate court[78] and rejected a "repair-or-replace" limited warranty on unconscionability grounds.[79]

The plaintiff, in *Phillips Petroleum* purchased marine cranes for use on drilling platforms in the North Sea.[80] The contract between the parties contained a repair-or-replace warranty and a refund remedy.[81] After one of the cranes broke off at its base it was discovered that the pedestal adapters securing the cranes to the platform were manufactured with inadequate steel.[82] Finding that the remedy of repair and replacement did not fail in its essential purpose, the Wisconsin Court of Appeals held that the defendant had satisfied its obligations because "[w]ithin a reasonable time after the crane accident (eighteen to twenty-four months) Bucyrus replaced all twelve of the North Sea crane pedestals, bringing them up to contract specifications."[83]

Using what it termed the "common sense approach to commercial transactions utilized in the Uniform Commercial Code," the Wisconsin Supreme Court reversed.[84] The court held that the inability to use expensive and complex equipment for an extended period of time rendered the limited remedy unable to make the plaintiff whole.[85] Wisconsin's highest court found that the contract's limited remedy of replacement was "an unrealistic remedy" because the buyer had to replace at the seller's place of business, "a site thousands of miles from where the replacement was needed."[86]

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[77] 131 Wis. 2d 21, 388 N.W.2d 584 (1986).

[78] 125 Wis. 2d 418, 373 N.W.2d 65 (Wis. Ct. App. 1985), *rev'd*, 131 Wis. 2d 21, 388 N.W.2d 584 (1986).

[79] See Ragen Corp. v. Kearney & Trecker Corp., note 35 *supra*, 912 F.2d at 625 ("The holding of the Wisconsin Supreme Court [in *Phillips Petroleum*] was not that the exclusive remedy failed in its essential purpose; but rather that the exclusive remedy was unrealistic and unconscionably low.") (footnote omitted) (applying Wisconsin law). Other courts have ignored the unconscionability doctrine when testing a limited remedy's enforceability. See, e.g., Oregon Bank v. Nautilus Crane & Equip. Corp., 68 Or. App. 131, 683 P.2d 95 (1984) ("Unconscionability and failure of essential purpose are distinct legal theories that need to be examined separately"); and Hartzell v. Justus Co., 693 F.2d 770, 774 (8th Cir. 1982) ("A finding of unconscionability is, as a matter of logic, simply unnecessary in cases where § 2-719(2) applies.").

[80] 373 N.W.2d at 66.

[81] Note 77 *supra*, 388 N.W.2d at 587–588

[82] Note 78 *supra*, 373 N.W.2d at 67.

[83] Note 78 *supra*, 373 N.W.2d at 71.

[84] Note 77 *supra*, 388 N.W.2d at 590.

[85] *Id.*, 388 N.W.2d at 592.

[86] *Id.*, 388 N.W.2d at 591.

And, even though the court in *Phillips Petroleum* considered the parties "giants in their areas of enterprise," and saw "no willfulness or any evidence of subjective sharp practices in the performance of the contract," it nevertheless held that the replacement remedy, which was "concealed or masked in the warranty Section," was an "unconscionably low" remedy and the clause limiting damages to a refund was "unreasonable."[87] The court concluded that the "repair-or-replace" warranty did not allow for a "fair quantum of remedy for breach of obligations."[88]

Wisconsin's high court correctly viewed the unconscionability test relevant in determining the enforceability of an exclusive remedy. Under UCC Section 2A-503(2), if "provision for an exclusive remedy is unconscionable, remedy may be had as provided in this Article."[89] The drafters explained: "Subsection (2) makes explicit with respect to this Article what is implicit in Section 2-719 with respect to the Article on Sales (Article 2): if an exclusive remedy is held to be unconscionable, remedies under this Article are available."[90]

Assuming a vendor's repair-or-replace remedy is in some way unconscionable,[91] or that it has failed of its essential purpose because the vendor has failed to exert his best efforts to debug the program, can a vendor still avoid consequential damages without having an exclusion? The answer should be yes, so long as an alternate refund remedy is provided in the agreement and this remedy provides an adequate remedy under the Code.

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[87] *Id.*, 388 N.W.2d at 592. Because sharp practices and inequality of bargaining tend to demonstrate procedural unconscionability, the court was apparently holding that the remedy was substantively unconscionable. See notes 152–154 *infra* and accompanying text. Did the court hold that a remedy that does not provide a "fair quantum of remedy," is substantively unconscionable under the Code?

[88] *Id.*, 388 N.W.2d at 592 (citing U.C.C. § 2-719, Official Comment 1).

[89] U.C.C. § 2A-503(2)(1990).

[90] U.C.C. § 2A-503, Official Comment (1990). Since the UCC's general unconscionability provision, Section 2-302, applies to bar enforcement of all unconscionable contract terms, this result is hardly surprising. See note 145 *infra* and accompanying text. See also U.C.C. § 2-303, Official Comment 1 (1990) (certain risks and burdens imposed by Article 2 may be modified or allocated as parties desire "always subject, of course, to the provisions on unconscionability.").

[91] See, e.g., Latham & Assocs., Inc. v. William Raveis Real Estate, Inc., No. 22-90-46, 1990 WL 271683 at *10 (Conn. Sup. Ct. 1990) ("Plaintiff did not hesitate to charge defendant a total of $44,000.00 for 'licensing' the complete Mortgage system with its addenda, but it seeks to limit its [repair or replace] warranty to thirty days. Such a provision is clearly unconscionable.").

Alternate Refund Remedy

The Official Comments to Section 2-719 recognize that: "Under this section parties are left free to shape their remedies to their particular requirements and reasonable agreements limiting or modifying remedies are to be given effect. *However, it is of the very essence of a sales contract that at least minimum adequate remedies be available.*"[92] Although courts have reasoned that, "where a repair-or-replace remedy deprives the buyer of minimum adequate remedies, the warranty will be said to have failed of its essential purpose,"[93] the use of alternate exclusive remedies, i.e., repair-or-replace *and* return and refund, has been sufficient to provide minimum adequate remedies and avoid a finding of failed essential purpose even though the repair-or-replace remedy fails.

One court that found a refund remedy negotiated in a bundled computer package, i.e., a combined software and hardware purchase, effective to compensate for a failed repair-or-replace remedy, stated:

> Although an occasional decision holds that return of the purchase price is a remedy that fails of its essential purpose if the consequential damages far exceed that amount, these cases misread Section 2-719(2) and confuse the concepts of unconscionability with failure of essential purpose. The better reasoned decisions hold that refund of the purchase price prevents a limited remedy from failing of its essential purpose. . . .
>
> A backup remedy providing the aggrieved buyer with a replacement unit free from defects should blunt the argument that the repair-or-replace remedy has failed of its essential purpose. Or to put the matter another way, the backup remedy does not fail of its essential purpose even though the front-line remedy does. . . .
>
> Of course the backup remedy may also fail of its essential purpose. For example, the seller may refuse to refund the purchase price after failure of the front-line repair-or-replacement remedy. Or the seller might conceal facts regarding the breach of warranty until such time that rescission by the buyer could not be pursued as a backup remedy because it would cause severe financial strain.[94]

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[92] U.C.C. § 2-719, Official Comment 1 (1990) (emphasis added).

[93] Boston Helicopter Charter, Inc. v. Augusta Aviation Corp., 767 F. Supp. 363, 374 (D. Mass. 1991) (citations omitted).

[94] Ritchie Enters. v. Honeywell Bull, Inc., note 25 *supra*, 730 F. Supp. 1049 (quoting B. Clark, The Law of Product Warranties ¶ 8.04[2][d] at 8-60–8-61 (1984) (footnotes omited)).

The Court in *Computerized Radiological Services, Inc. v. Syntex Corp.*[95] was faced with a sales agreement for a computer aided topography (CAT) scanner containing a repair-or-replace limited remedy and a money damage remedy limiting damages to the amount paid to the seller. In rejecting the plaintiff's request for an award of consequential damages greater than the contract price, the court reasoned:

> Assuming plaintiff is correct that the first limitation-of-remedy clause does fail of its essential purpose, plaintiff still gets the benefit of the money damage remedy provided in the second clause. Even though an exclusive remedy is stricken because it fails of its essential purpose, that does not mean that all limitations must be stricken. [citations omitted] The second clause, limiting plaintiff's recovery to the price paid for the System 60, affords plaintiff the adequate remedy required by the Code.[96]

The view that an alternate refund remedy caps the recovery of consequential damages has been adopted in other jurisdictions.[97] And, the fact that a user refuses to accept a refund does not necessarily mean that the refund remedy is inadequate.[98] The question remains: What happens when a vendor has also contracted for an exclusion on consequential damages?

What Effect Should a Custom Software Agreement's Limited Remedy's Failure of Essential Purpose Have on an Exclusion on Consequential Damages?

Because determining whether a remedy has failed in its essential purpose is a fact sensitive inquiry,[99] "courts have usually assumed

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[95] 595 F. Supp. 1495 (E.D.N.Y. 1984), *aff'd in relevant part*, 786 F.2d 72 (2d Cir. 1986).

[96] *Id.* at 1510–1511.

[97] See Kaplan v. RCA Corp., 783 F.2d 463, 467 (4th Cir. 1986); Marr Enters., Inc. v. Lewis Refrigeration Co., note 44 *supra*, 556 F.2d at 955; Cole Energy Dev. Co. v. Ingersoll-Rand Co., 678 F. Supp. 208, 212 (C.D. Ill. 1988); Garden State Food Distribs., Inc. v. Sperry Rand Corp., 512 F.Supp. 975, 978 (D.N.J. 1981); U.S. Fibres, Inc. v. Proctor & Schwartz, Inc., note 57 *supra*, 358 F. Supp. at 456; Canal Elec. Co. v. Westinghouse Elec. Corp., note 39 *supra*, 406 Mass. at 369, 548 N.E.2d at 186.

[98] See, e.g., Kearney v. Trecker Corp. v. Master Engraving Co., Inc., note 42 *supra*, 527 A.2d at 435–438 (enforcing an exclusion on consequential damages even though buyer did not invoke return and refund remedy because the mere existence of such a remedy, when combined with the availability of direct damages, supplied at least minimum adequate remedies).

[99] See Boston Helicopter Charter, Inc. v. Augusta Aviation Corp., note 93 *supra*, 767 F. Supp. 373 ("Whether a remedy has failed of its essential purpose is a question of fact."); Chemtrol Adhesives, Inc. v. American Manufacturers Mut. Ins. Co., 42 Ohio St. 3d 40, 537 N.E.2d 624, 639–640 (Ohio 1989) ("[W]hether a warranty has failed to fulfill its essential purpose is ordinarily a question of fact for the jury.") (citations omitted).

at the summary judgment level that the remedy of repair or replacement has failed and then have gone on to consider whether a consequential damages exclusion remains independently enforceable.''[100]

Although Subsection 2-719(2) provides that when a limited remedy fails of its essential purpose, ''remedy may be had as provided in this Act,'' the UCC does not state whether a consequential damages exclusion is enforceable after a remedy failure.[101] Thus, courts are divided as to the effect a failure of essential purposes has on a Section 2-719(3) exclusion of consequential damages.[102] Even though the doctrine of ''unconscionability'' acts as the only specific check on the enforceability of consequential damages exclusions,[103] courts have held that a limited remedy's failure of essential purpose can also expunge an exclusion.[104]

In *Jones & McKnight Corp. v. Birdsboro Corp.*,[105] the court reasoned that it would be in ''an untenable position if it allowed the defendant to shelter itself behind one segment of the warranty when it has allegedly repudiated and ignored its very limited obligations under another segment of the same warranty.''[106] As pointed out by the U.S. District Court for the District of Connecticut:

> The rationale behind the interdependence of subsections (2) and (3) is that where a limited or exclusive remedy has failed under (2), it would be unfair to allow a disclaimer under (3) because the buyer when agreeing to the disclaimer was under the impression that the contractual remedy would be effective.[107]

Other courts, however, have correctly recognized that exclusionary clauses and limitations of remedies are two separate contracting devices that allocate risks under different circumstances and must be judged by different criteria. An analysis focusing on the exclusionary clause's conscionability, as well as the circumstances of the transaction, has been pursued in *Kearney & Trecker Corp. v. Master Engraving Co.*[108]

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[100] Ritchie Enters. v. Honeywell Bull, Inc., note 25 *supra*, 730 F. Supp. at 1041, 1049.
[101] See note 39 *supra* and accompanying text.
[102] See note 40 *supra* and accompanying text.
[103] See note 28 *supra* and accompanying text.
[104] See note 35 *supra* and accompanying text.
[105] 320 F. Supp. 39 (N.D. Ill. 1970).
[106] *Id.* at 43–44.
[107] McKernon v. United Technologies Corp., 717 F. Supp. 60, 70 (D. Conn. 1989).
[108] 107 N.J. 584, 527 A.2d 429 (1987).

Kearney & Trecker Corporation (K&T) sold Master Engraving Company (Master) a computer-controlled machine tool that performed various machining operations on metal parts.[109] K&T's written contract contained a clause excluding liability for consequential damages and an exclusive one-year remedy limiting recovery to the repair or replacement of the defective product part or a refund of the purchase price.[110] Master claimed that frequent downtime during the machine's first year of usage caused the product to inadequately meet the buyer's needs.[111] In its attempt to correct these malfunctions, K&T made numerous service calls.[112]

K&T filed suit to recover the expenses of two service calls made after the expiration date of the warranty.[113] Master counterclaimed, seeking both incidental and consequential damages arising from the failure of the product to perform as warranted.[114] The trial court instructed the jury that consequential damages could be awarded if the jury determined that K&T failed "to make the machine as warranted."[115]

A jury found in favor of Master and awarded consequential damages in the amount of $57,000. In affirming, the New Jersey Appellate Division held that the jury's verdict should be interpreted as a finding that the repair and replacement remedy failed of its essential purpose.[116] The Appellate Division concluded that under the circumstances of the case, K&T's failure to adequately repair the

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[109] *Id.*, 107 N.J. at 587, 527 A.2d 429, 430.

[110] *Id.*, 107 N.J. at 588, 527 A.2d 429, 431.

[111] Although according to Master's Witnesses, "[n]o specific defect was predominant" during the first year of operation, and the machine was inoperable from 25 percent to 50 percent of its available time. *Id.* The industry had a "downtime" average of five percent. *Id.*

[112] K&T's manager of technical services testified that by the second year of operation the machine "was operable approximately 98% of the time available for its use." *Id.*, 107 N.J. at 589, 527 A.2d 429, 431.

[113] *Id.*

[114] *Id.* Master's alleged consequential damages were in the form of lost profits stemming from unfilled customer orders caused by the machine's inoperability. *Id.*, 107 N.J. at 588, 527 A.2d 429, 431.

[115] The critical portion of the charge reads as follows:

> However, if you find that the plaintiff's actions in repairing and replacing the defective parts did not make the machine as warranted, that is, free from the defects in material and workmanship, then you may find that the defendant is entitled to all of its consequential economic losses and damages despite the language of the contract.

Id., 107 N.J. at 589–590, 527 A.2d 429, 432 (quoting jury instructions) (emphasis added by court).

[116] *Id.*

machine rendered the separate exclusion of consequential damages ineffective.[117] In reversing, the New Jersey Supreme Court disagreed with the intermediate court's conclusion that the allocation of risk created by the exclusion of consequential damages was inextricably tied to the remedy limitation.[118]

The court first reasoned that Section 2-719 did not mandate the invalidation of a consequential damages exclusion whenever a limited remedy fails of its essential purpose.[119] Reviewing UCC policy, the court noted that the UCC's Official Comments emphasize that the UCC must be interpreted in a commercially reasonable manner; and that parties are "free to vary its terms through custom, usage or express agreement."[120] The court next reasoned that because "the potential significance of liability for consequential damages in commercial transactions . . . could drastically affect the conduct of [sellers], causing them to increase their prices or limit their markets,"[121] the exclusion of consequential damages is a "beneficial risk-allocation device."[122]

New Jersey's Supreme Court also observed that although Subsection 2-719(3) expressly allows for the exclusion of liability for consequential damages, the Official Comment 1 to Section 2-719 states that in the event of a breach of a sales contract, at the very least some minimum adequate remedies should be made available.[123] The conflict between the right of parties "to exclude liability for consequential damages, and the insistence upon minimum adequate remedies to redress a breach of contract" is what ultimately framed the issue for the court.[124] In holding that the various remedies

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[117] *Id.* (quoting Kearney & Trecker Corp. v. Master Engraving Co., Inc., 211 N.J. Super. 376, 511 A.2d 1227 (App. Div. 1986), *rev'd*, 107 N.J. 584, 527 A.2d 429 (1987)).

[118] *Id.*, 107 N.J. at 602, 527 A.2d 429, 439.

[119] *Id.*, 107 N.J. at 592–593, 527 A.2d 429, 434.

[120] *Id.*, 107 N.J. at 591, 527 A.2d 429, 433. See also, Spring Motors Distribs., Inc. v. Ford Motor Co., 98 N.J. 555, 571, 489 A.2d 660, 668 (1985) ("Underlying the U.C.C. policy is the principle that parties should be free to make contracts of their choice, including contracts disclaiming liability for breach of warranty.").

[121] Kearney & Trecker Corp. v. Master Engraving Co., note 108 *supra*, 107 N.J. at 591–592, 527 A.2d 429, 433.

[122] *Id.* Indeed, the UCC expressly recognizes that "[a]ny seller who does not wish to take the risk of consequential damages has available the section on contractual limitation of liability." U.C.C. § 2-715, Official Comment 3 (1990). See also Eddy, note 31 *supra*, at 74; Anderson, note 31 *supra*, at 765 (discussing Section 2-719 as a risk-shifting device).

[123] Kearney & Trecker Corp. v. Master Engraving Co., note 108 *supra*, 107 N.J. at 593, 527 A.2d 429, 434 (quoting from N.J.S.A. 12A:2-719, comment 1).

[124] *Id.*, 107 N.J. at 593, 527 A.2d 429, 434.

available to Master offered "a fair quantum of remedy" sufficient to satisfy the Code's requirements, the court stated:

> We are fully satisfied that the availability of damages for breach of the repair and replacement warranty under N.J.S.A. 12A:2-714(2), combined with the return and refund provision in the contract of sale not invoked by Master, adequately fulfills the U.C.C.'s mandate that "at least minimum adequate remedies be available" when a limited remedy fails to achieve its purpose.[125]

In rejecting the view that "there is an integral relationship between the exclusion of consequential damages and the limited remedy of repair or replacement, so that the failure of the limited remedy necessarily causes the invalidation of the exclusion of consequential damages," the court relied heavily on an opinion from the U.S. Court of Appeals for the Third Circuit.[126] The court adopted the following Third Circuit rationale:

> The limited remedy of repair and a consequential damages exclusion are two discrete ways of attempting to limit recovery for breach of warranty. [citations omitted] The Code, moreover, tests each by a different standard. The former survives unless it fails of its essential purpose, while the latter is valid unless it is unconscionable. We therefore see no reason to hold, as a general proposition, that the failure of the limited remedy provided in the contract without more, invalidates a wholly distinct term in the agreement excluding consequential damages. The two are not mutually exclusive.[127]

Although *Chatlos* only relied on an unconscionability test to determine whether a consequential damages clause was enforceable, the court in *Kearney & Trecker* emphasized the need to judge each breach sub judice.[128] Specifically, it found: "It is only when the circumstances of the transaction, including the seller's breach, cause the consequential damage exclusion to be inconsistent with the intent and reasonable commercial expectations of the parties that

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[125] *Id.*, 107 N.J. at 602, 527 A.2d 429, 439. The UCC's mention of "minimum adequate remedies" has led some courts to rule that the use of alternate limited remedies, e.g., repair *or* refund, is sufficient to prevent exclusive remedies from failing in their essential purpose. See notes 92–97 *supra* and accompanying text.

[126] *Id.*, 107 N.J. at 595, 527 A.2d 429, 435.

[127] *Id.*, 107 N.J. at 597, 527 A.2d 429, 436. (quoting Chatlos Sys., Inc. v. National Cash Register Corp., 635 F.2d 1081, 1087 (3d Cir. 1980)).

[128] *Chatlos* only utilized the unconscionability test in determining whether the exclusionary clause was to be enforced. *Id.*, 107 N.J. 598, 527 A.2d 429, 437. But cf. Chatlos Sys., Inc. v. National Cash Register Corp., note 127 *supra* at 1086 ("Whether the preclusion of consequential damages should be effective in this case depends upon the circumstances involved.").

invalidation of the exclusionary clause would be appropriate under the Code.''[129] The court continued:

> For example, although a buyer may agree to the exclusion of consequential damages, a seller's wrongful repudiation of a repair warranty may expose a buyer to consequential damages not contemplated by the contract, and other Code remedies may be inadequate. In such circumstances, a court might appropriately decline to enforce the exclusion.[130]

This view, i.e. one that defers to the allocation of risks entered into by the parties, was considered consistent with prior New Jersey law.[131]

Other courts adopting a strict constructionist view of Subsections 2-719(2) and 2-719(3) have also adopted a fact-specific ''case-by-case'' approach when determining whether exclusions should fall upon a failure of essential purpose.[132] In *AES Technology Systems, Inc. v. Coherent Radiation*,[133] the U.S. Court of Appeals for the Sixth Circuit stated:

> [W]e reject the contention that failure of the essential purpose of the limited remedy automatically means that a damage award will include consequential damages. An analysis to determine whether consequential damages are warranted must carefully examine the individual factual situation including the type of goods involved, the parties and the precise nature and purpose of the contract.[134]

Unfortunately, courts have allowed the case-by-case approach to focus on acts committed *after* contracting. It is the position of

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[129] Kearney & Trecker Corp. v. Master Engraving Co., Inc., note 108 *supra*, 107 N.J. at 600, 527 A.2d 429, 438.

[130] *Id.*

[131] *Id.*, 107 N.J. at 599, 527 A.2d 429, 437. The court quoted Spring Motors Distribs., Inc. v. Ford Motor Co., note 120 *supra*: ''As between commercial parties, then, the allocation of risks in accordance with their agreement better serves the public interest than an allocation achieved as a matter of policy without reference to that agreement.'' 98 N.J. at 577, 489 A.2d 660, 671. See cf. S.M. Wilson & Co. v. Smith Int'l, Inc., 587 F.2d 1363, 1375 (9th Cir. 1978) (''Risk shifting [by a court] is socially expensive and should not be undertaken in the absence of a good reason. An even better reason is required when to so shift is contrary to a contract freely negotiated.'').

[132] See, e.g., Ritchie Enters. v. Honeywell Bull, Inc., note 25 *supra*, 730 F. Supp. 1050 (''The case-by-case approach requires an evaluation of the relative bargaining strength of the parties and the allocation of risks reflected by the specific terms of the agreement.''); Smith v. Navistar Int'l. Transp. Corp., note 42 *supra*, 714 F. Supp. 307 (''The rationale underlying *AES Technology Systems* and the other decisions adopting this case-by-case approach is compelling.'').

[133] 583 F.2d 933 (7th Cir. 1978).

[134] *Id.* at 941 (footnote omitted).

this article that because the unconscionability standard is the only statutorily prescribed test for exclusions, it should be the only one used when judging the validity of exclusionary clauses. A case-by-case methodology taking into account events occurring post-contract signing should be rejected in favor of one that adheres to the unconscionability doctrine of UCC Section 2-302. Since acts post-contract signing are not relevant when applying the Section 2-302 unconscionability test, such acts should not be looked at by a court when determining the enforceability of an exclusion under Section 2-719.[135]

To the extent courts have created a nonunconscionability case-by-case approach that focuses on the circumstances at the time of contract signing, such a rule is both useless and harmful because *every* contract dispute requires that the court look at what the parties intended and such ad hoc rules allow courts to disrupt the uniform application of the UCC. This follows because the UCC only looks to an unconscionability standard to judge exclusions and a case-by-case standard may potentially use less of a standard.

For example, although the court in *Kearney & Trecker* states that an additional ground for expunging the clause may exist if after contracting the seller wrongfully repudiates a repair warranty,[136] it is "not clear whether [the court in *Kearney & Trecker*] would invalidate an exclusion provision that is less than unconscionable."[137]

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[135] For text of Section 2-302 see note 145 *infra* and accompanying text.

[136] Kearney & Trecker Corp. v. Master Engraving Co., note 108 *supra*, 107 N.J. at 600, 527 A.2d 429, 438. See also Canal Elec. Co. v. Westinghouse Elec. Corp., note 39 *supra*, 406 Mass. at 369, 548 N.E.2d 182, 186 ("We add that consequential damages are awarded in cases in which the facts show wilful dilatoriness or repudiation of warranty obligations by the seller."). See cf. S.M. Wilson & Co. v. Smith Int'l, Inc., note 131 *supra*, 587 F.2d at 1375 ("The seller . . . did not ignore his obligation to repair; he simply was unable to perform it"); Cole Energy Dev. Co. v. Ingersoll-Rand Co., note 97 *supra*, 678 F. Supp. at 212 (buyer failed to allege that seller was "willful or dilatory in failing to meet its warranty obligations"); Cayuga Harvester, Inc. v. Allis-Chalmers 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); Eddy, note 3 *supra*, at 85 ("Where the bulk of consequential damages flow directly from the failure to repair and accrue during the period of wrongful refusal, what 'incentive' exists to compel compliance with the remedy, unless consequential damages are awarded?"); 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).

[137] McKernan v. United Technologies Corp., note 107 *supra*, 717 F. Supp. at 73, n.8. But see, Telesaver, Inc. v. U.S. Transmission Sys., Inc., 687 F. Supp. 997, 998 (D. Md. 1988) (applying New Jersey law) ("Recently, the Supreme Court of New Jersey adopted

Unconscionability as Sole Standard

A methodology that focuses solely on unconscionability accommodates concerns of the case-by-case line of decisions. If the unconscionability test is itself done on a case-by-case fact-sensitive basis, a court is able to determine the enforceability of an exclusion by looking at the circumstances of each transaction much in the same way it is already being done in the case-by-case decisions.

In *Schurtz v. BMW of North America, Inc.*,[138] the Supreme Court of Utah recognized that the concerns of the "strict constructionist" and "judicial activist" schools can be accommodated by using a case-by-case unconscionability test:

> An analysis that takes a case-by-case approach to the question of unconscionability accommodates the results in virtually all the cases dealing with the relationship between subparts (2) and (3). It also provides the courts with a flexible tool for determining the validity of limitations on incidental and consequential damages that serves well the different policies appropriate to consumer and commercial settings.[139]

Utah's highest court reasoned that although courts reading Subsections 2-719(2) and 2-719(3) independently or dependently may seem irreconcilable,

> when the facts of the cases are taken into account, the policy considerations that seem to underlie the decisions holding the two subparts dependent appear reconcilable with the considerations underlying those holding them independent, and the split of authority on the question of a dependent or independent construction seems largely a result of the context in which the question was presented to the courts.[140]

The *Schurtz* court ultimately held that "the context" that determines the enforceability of an exclusion almost always turns on whether the transaction is consumer or commercial based.[141] Al-

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the reasoning of the United States Court of Appeals for the Third Circuit in Chatlos Systems, Inc. v. National Cash Register Corp., 635 F.2d 1081, 1086 (3d Cir. 1980) (enforcing a contractual provision barring consequential damages), and held that a consequential damages disclaimer is valid unless unconscionable.") (citing Kearney & Trecker Corp. v. Master Engraving Co., 107 N.J. 584, 596–597, 527 A.2d 429, 436 (1987)), *aff'd*, 923 F.2d 849 (4th Cir.), *cert. denied*, 112 S. Ct. 60 (1991).

[138] 814 P.2d 1108 (Utah 1991).

[139] *Id.* at 1114.

[140] *Id.* at 1113.

[141] *Id.* at 1113–1114. Specifically, the court held that,

> a trial court confronted with an issue of unconscionability takes into account any disparities in bargaining power between the parties, the negotiation process, if any, and the type of contract entered into by the parties, specifically addressing whether the contract was one of adhesion. As noted above, in practice after these factors

though not articulated in the *Schurtz* decision, a view that relies heavily on the nature of the transaction, i.e., whether it is commercial or consumer, apparently represents what the UCC drafters had in mind when Subsection 2-719(3) was given its prima facie unconscionability/conscionability test.

The unconscionability standard has been recognized as the only test relevant in determining whether a consequential damages exclusion in a services contract is enforceable.[142] The test is designed,

> not to erase the doctrine of freedom of contract, but to make realistic the assumption of the law that the agreement has resulted from real bargaining between parties who had freedom of choice and understanding and ability to negotiate in a meaningful fashion.[143]

Unconscionability analysis represents a method for evaluating contract terms older in age than any U.S. statute.[144] Although Section 2-719 does not detail what is meant by the term "unconscionable," it does cross-reference the UCC's general unconscionability provision, Section 2-302. Section 2-302 provides:

> (1) *If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made* the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.
>
> (2) When it is claimed or appears to the court that the contract or any clause thereof may be unconscionable the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose and effect to aid the court in making the determination.[145]

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are examined and weighed, a trial court will generally find that provisions limiting incidental and consequential damages are unconscionable in consumer settings and conscionable in commercial settings.

Id. at 1114. See also Canal Elec. Co. v. Westinghouse Elec. Co., note 39 *supra*, 406 Mass. at 369, 548 N.E.2d 182, 186 ("Cases awarding consequential damages generally arise from consumer transactions and involve 'relatively uncomplicated products' like cars and tractors.").

[142] Telesaver, Inc. v. U.S. Transmission Sys., Inc., note 137 *supra*, 687 F. Supp. at 999 ("[T]his Court will only invalidate the Agreement's consequential damages disclaimer if it is unconscionable.").

[143] *Id.* at 999 (quoting Kugler v. Romain, 58 N.J. 522, 544, 279 A.2d 640, 651–652 (1971)).

[144] See, e.g., Earl of Chesterfield v. Janssen, 28 Eng. Rep. 82, 100 (Ch. 1740) (refusing to enforce a contract provision that was so unfair "no man in his senses and not under delusion would make on one hand, and as no honest and fair man would accept on the other").

[145] U.C.C. § 2-302 (1990) (emphasis added).

Elaborating on how courts are to apply Section 2-302, the Official Comments to it state:

> The basic test is whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be *unconscionable under the circumstances existing at the time of the making of the contract*. Subsection (2) makes it clear that it is proper for the court to hear evidence upon these questions. The principle is one of the prevention of oppression and unfair surprise [citation omitted] and not of disturbance of allocation of risks because of superior bargaining power. . . .
>
> The commercial evidence referred to in subsection (2) is for the court's consideration, not the jury's.[146]

Unconscionability questions are therefore submitted to the judge and are evaluated "under the circumstances existing at the time of the making of the contract."[147] Such a methodology is crucial from a vendor's viewpoint for two important reasons. First, any unfortunate consequences of contracting, e.g., huge consequential damages due to a system failure, cannot be used to reallocate risks and strike an exclusion since only the circumstances existing at the time of contracting are relevant. Second, in most cases costly and unpredictable trials can be replaced with summary judgment motions because the unconscionability test is decided as a matter of law. Section 2-302 provides, when it combines with the burden of proof rule found in Subsection 2-719(3), i.e., that the unconscionability doctrine is prima facie inapplicable in commercial transactions,[148] near absolute statutory protection for commercial exclusionary clauses.[149]

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[146] U.C.C. § 2-302, Official Comments 1, 3 (1990) (emphasis added).

[147] U.C.C. § 2-302, Official Comment 1 (1990). See Boston Helicopter Charter, Inc. v. Augusta Aviation Corp., note 93 *supra*, 767 F. Supp. at 375 ("The relevant consideration is the circumstances at the time the contract was made, and not the circumstances as they later developed.") (applying Section 2-302 to a Section 2-719 analysis); McKernan v. United Technologies Corp., note 107 *supra*, 717 F. Supp. at 73, n.8 (opining that Section 2-302 applies to any Section 2-719(3) unconscionability analysis); White & Summers, note 64 *supra* at 608, n.9 ("Section 2-302(1), which presumably applies to 2-719(3) by virtue of the cross-reference in the comments, requires that the court itself determine unconscionability.").

[148] U.C.C. § 2-719(3) (1990).

[149] See, e.g., Chemtrol Adhesives, Inc. v. American Manufacturers Mut. Ins. Co., note 99 *supra*, 42 Ohio St. 3d at 40, 537 N.E.2d 624, 639 ("Numerous cases have held that in a situation such as the instant case, where there is no great disparity of bargaining power between the parties, a contractual provision which excludes liability for consequential damages and limits the buyer's remedy to repair or replacement of the defective product is not unconscionable.").

The unconscionability inquiry is often broken down into procedural and substantive components. Substantive unconscionability refers to unfair terms in an agreement, whereas procedural unconscionability refers to unfair bargaining. A substantively unconscionable term in a software license agreement may be, for example, a warranty that lasts only thirty days.[150] And, as stated by a court deciding the conscionabiliy of a contract involving a computer system procurement: "The procedural sort of unconscionability requires a showing of overreaching or sharp practices by the seller and ignorance or inexperience on the buyer's part, resulting in a lack of meaningful bargaining by the parties."[151]

One frequently cited case involving a computer system dispute listed the following factors as being relevant to the procedural unconscionability inquiry:

> Among the factors relevant to determining unconscionability are the length of the negotiation process, the length of time the buyer has to deliberate before signing the contract, the experience or astuteness of the parties, whether counsel reviewed the contract, and whether the buyer was a reluctant purchaser.[152]

An instructive case dealing with the unconscionability doctrine in a software license context is *Harper Tax Services, Inc. v. Quick-Tax Limited*,[153] decided by the U.S. District Court for the District of Maryland. In *Harper Tax*, a Maryland corporation that provided "computer-based accounting services" entered into a software license agreement with the defendant for "computer software designed for preparing Maryland and federal tax returns for the 1982 tax year."[154] After mistakenly delivering a software program for the 1981 tax year, the defendant forwarded a program for the correct tax year.[155] The plaintiffs filed suit, complaining that the updated software package still "contained defective programming which rendered the software useless for tax preparation purposes."[156]

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[150] See note 91 *supra* and accompanying text.

[151] Earman Oil Co., Inc. v. Burroughs Corp., note 10 *supra*, 625 F.2d at 1291, 1300 (affirming district court's grant of summary judgment to defendant on issue of unconscionability).

[152] Office Supply Co. v. Basic/Four Corp., note 10 *supra*, 538 F. Supp. at 788 (granting defendant summary judgment on issue of unconscionability) (applying California law).

[153] 686 F. Supp. 109 (D. Md. 1988).

[154] *Id.* at 110.

[155] *Id.* The original licensee transferred its use of the program to another accounting company and both companies joined in suing the defendant, Quick-Tax, Ltd. *Id.*

[156] *Id.* at 110.

although inequality of bargaining power does meet one of the popular definitions of unconscionability, the unconscionability doctrine of Section 2-302 is designed to prevent " 'oppression and unfair surprise,' " and is not meant to disturb " 'allocation of risks because of superior bargaining power.' "[164]

After observing that the plaintiffs did not allege "undue influence, force, or threats to sign the license agreement,"[165] the court concluded that the exclusion of consequential damages was conscionable:

> Plaintiffs' complaint that they were presented with "take-it-or-leave-it" restrictions comes too late—they were free to reject the terms or offer to pay more for greater financial security. The fact that plaintiffs were especially vulnerable to delayed delivery does not mean that it was unconscionable for defendant to offer no insurance for business losses. The fairness of business deals premised upon clear allocations of risk cannot be judged in hindsight.[166]

The seemingly harsh *Harper Tax* approach should be applicable to most commercial software license disputes and represents an astute evaluation of what the Code drafters probably intended by the unconscionability doctrine, that is, "unconscionability" is "fraud" without the scienter requirement.

Intervening Unconscionability

Several commentators have argued that the unconscionability standard under Subsection 2-719(3) differs from that found in the UCC's general unconscionability provision, Section 2-302, because under Subsection 2-719(3) a court is allowed to look to events that occur after the contract is executed.[167] Specifically, Professor Anderson has offered the following analysis:

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[164] *Id.* at 112–113 (quoting N.Y.U.C.C. § 2-302, Official Comment 1).

[165] *Id.* at 113.

[166] *Id.*

[167] See Anderson, "Contractual Limitations on Remedies," 67 Neb. L. Rev. 548, 587 (1988); Murtagh, Note, "U.C.C. Section 2-719: Limited Remedies and Consequential Damage Exclusions," 74 Cornell L. Rev. 359, 366 (1989) ("Subsequent events bear directly on the fairness of the Buyer's recovery, and courts should consider these events in evaluating a consequential damage exclusion. Even if a consequential damage exclusion clause is conscionable, the Buyer may not be fairly compensated without receiving consequential damages. The independent courts produce an inequitable result when they fail to consider the consequential damage clause in light of the events that required an evaluation of the exclusion.").

> Section 2-302 is concerned by its very terms with unconscionability in a contract "at the time it was made." Section 2-719(3), on the other hand is concerned with how a consequential damage disclaimer operates in light of circumstances as they occur *after* the contract is made. In the words of the Official Comment to the provision: "[S]ubsection (3) recognizes the validity of clauses limiting or excluding consequential damages but makes it clear that they may not operate in an unconscionable manner." This type of unconscionability can be labeled "intervening unconscionability."[168]

Although Professor Anderson considers the concept of "intervening unconscionability" to be the first "important tool" to emerge from Section 2-719 commentary in over one decade,[169] his tool rests on too slender a reed. The fact that the comments state exclusions "may not operate in an unconscionable manner" simply cannot mean that exclusions can somehow *become* unconscionable. Why would the UCC fail to use intervening language for unconscionability when it used such language for a failed purpose test? The UCC used very specific language to distinguish the failed purpose test with the unconscionability test. Unlike Subsection 2-719(2), which states that, "*where circumstances cause* an exclusive or limited remedy to fail of its essential purpose," Subsection 2-719(3) states that "consequential damages may be limited or excluded unless the limitation or exclusion *is* unconscionable."[170] Section 2A-503 makes the distinction even more apparent: "If *circumstances cause* an exclusive or limited remedy to fail of its essential purpose, *or provision for an exclusive remedy is* unconscionable."[171]

The reference in the Comments stating that an exclusion "may not operate in an unconscionable manner" merely reflects a more direct statement of Section 2-302's suggestion that a court may "limit the application of any unconscionable clause so as to avoid any unconscionable result." Further, even without the doctrine of "intervening unconscionability," Subsection 2-719(3) is not redundant with Section 2-302 because Subsection 2-719(3) contains a proviso not found in Section 2-302. Under Subsection 2-719(3), the court is given the burden of proof to be applied in any unconscionability inquiry—exclusions for personal injury in consumer transactions are prima facie unconscionable "but limitations of damages

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[168] Anderson, note 167 *supra*, at 587 (footnotes omitted) (emphasis in original).
[169] *Id.* at 616.
[170] U.C.C. §§ 2-719(2), 2-719(3) (1990) (emphasis added).
[171] U.C.C. § 2A-503(2) (1990) (emphasis added).

when the loss is commercial is not.''[172] Section 2-302 has no such instruction.

New UCC Article 2A

A brief look at Article 2A further demonstrates why a laissez-faire philosophy should guide interpretations of Section 2-719. Under the most recent revisions to Article 2A on leases, parties to a lease are given great freedom to allocate risks. Article 2A's version of Section 2-719, entitled ''Modification or Impairment of Rights and Remedies,'' reads in part:

> (1) Except as otherwise provided in this Article, the lease agreement may include rights and remedies for default in addition to or in substitution for those provided in this Article and may limit or alter the measure of damages recoverable under this Article.
>
> (2) Resort to a remedy provided under this Article or in the lease agreement is optional unless the remedy is expressly agreed to be exclusive. If circumstances cause an exclusive or limited remedy to fail of its essential purpose, or provision for an exclusive remedy is unconscionable, remedy may be had as provided in this Article.
>
> (3) Consequential damages may be liquidated under Section 2A-504, or may otherwise be limited, altered, or excluded unless the limitation, alteration, or exclusion is unconscionable. Limitation, alteration, or exclusion of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable but limitation, alteration, or exclusion of damages where the loss is commercial is not prima facie unconscionable.[173]

Section 2A-503, unlike its Article 2 counterpart, states that parties can also *alter* the measure of consequential damages. And, unlike in Subsection 2-719(3), Subsection 2A-503(3) ''makes clear that consequential damages may also be liquidated.''[174] The Comments to Section 2A-503 emphasize that the only statutorily authorized bar to exclusions is found in the subsection:

> A significant purpose of this Part is to provide rights and remedies for those parties to a lease who fail to provide them by agreement or whose rights and remedies fail of their essential purpose or are unenforceable. However, it is important to note that this implies no restriction on freedom to contract. . . . [T]his part shall be construed neither to restrict the parties' ability to provide

[172] U.C.C. § 2-719(3) (1990).
[173] U.C.C. § 2A-503 (1990).
[174] U.C.C. § 2A-503, Official Comment 1 (1990) (emphasis added).

> for rights and remedies or to limit or alter the measure of damages by agreement, nor to imply disapproval of rights and remedy schemes *other than those set forth in this Part*.[175]

Professors White and Summers have opined that,

> in the language of section 2A-503, and particularly the comments to it, we see an interesting invitation to the courts to allow the parties to agree to almost any limitation or alternative remedy they wish. If the courts accept that invitation, section 2A-503 may lead to a new jurisprudence not only in leasing, but also in sales.[176]

Under Article 2A's liquidation of damages provision, parties are also given greater freedom to shape their contracts:

> (1) Damages payable by either party for default, or any other act or omission, including indemnity for loss or diminution of anticipated tax benefits or loss or damage to lessor's residual interest, may be liquidated in the lease agreement but only at an amount or by a formula that is reasonable in light of the then anticipated harm caused by default or other act or omission.
>
> (2) If the lease agreement provides for liquidation of damages, and such provision does not comply with subsection (1), or such provision is an exclusive or limited remedy that circumstances cause to fail of its essential purpose, remedy may be had as provided in this Article.[177]

And, unlike in Subsection 2-718, which requires that liquidated damages be "reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy,"[178] Section 2A-504(1) only requires that the liquidated amount be "reasonable in light of the then anticipated harm caused by the default or other act or omission."[179] This reduction in the breadth of the liquidated damages test is further evidence that the UCC seeks to leave commercial parties to the bargains struck.

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[175] *Id.*
[176] J. White & R. Summers, 1A Uniform Commercial Code 52 (3d ed. 1991).
[177] U.C.C. § 2A-504 (1990).
[178] U.C.C. § 2-718(1) (1990).
[179] U.C.C. § 2A-504(1) (1990).