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CONTRACTS AND ELECTRONIC COMMERCE: THE UNIFORM COMPUTER INFORMATION TRANSACTIONS ACT (UCITA)

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The Uniform Computer Information Transactions Act (UCITA)[1] is a model state law designed to apply to contracts for "digital" goods and services, such as software, databases and Internet access service. It has been adopted by two states, Maryland and Virginia,[2] and is under consideration in seven additional states and the District of Columbia. The analysis below describes how adopting UCITA will fill gaps and increase uniformity in the law applying to transactions involving digital goods, and therefore will enhance the development of e-commerce in those states that adopt it.

Currently, contracts involving digital goods may leave important issues – such as which state's law is applicable in the event of disputes – unresolved. UCITA addresses such gaps by providing a default set of contract rules that become effective unless the parties to the contract agree to alternative rules. Thus, UCITA provides the parties flexibility as to how these issues are resolved, but provides default rules that apply if the parties fail to address them directly. This provides greater certainty and reduces the transaction costs associated with electronic commerce.

UCITA has been criticized for not clearly defining new consumer protections in the marketplace for digital goods and services, for enabling a controversial practice called self-help, and other asserted shortcomings.[3] As discussed below, such concerns are of limited significance and are far outweighed by the advantages of a uniform commercial law tailored to the transactions that involve digital products and services.

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[1] The text of UCITA and all NCCUSL model laws can be found at *www.nccusl.org*.

[2] Maryland and Virginia enacted UCITA in 2000. A discussion of early state action as well as likely paths of adoption can also be found in Brian D. McDonald, "The Uniform Computer Information Transactions Act," *Berkeley Technology Law Journal*, 16 (2001): 467.

[3] As a result of these concerns, Iowa, North Carolina and West Virginia have enacted so called "bomb shelter" laws to preclude application of part or all of UCITA's provisions.

Background

UCITA was developed by the National Conference of Commissioners on Uniform State Laws (NCCUSL), the same organization that developed the Uniform Commercial Code (UCC) during the middle of the twentieth century.[4] UCITA is intended to be the basis for contract law (commercial law) for digital goods and services in the same way that the UCC is the basis for contract law in the realm of traditional goods and services. The UCC was drafted because of the widespread concern that the contract rules applicable to a largely agricultural economy were inadequate for a new industrial age.[5] Similarly, UCITA is designed to modernize contract law in response to the demands of commerce in a digital age.

The model UCITA law was developed and drafted by the NCCUSL through an open process that included input from a variety of affected parties and advocates. NCCUSL is an organization of hundreds of legal professionals appointed by their respective states. The principal objective of the organization is to draft proposals for uniform and model laws on subjects where uniformity is desirable. In the past, NCCUSL has addressed areas as diverse as commercial, family, probate and health law.

The UCITA model law was drafted over the course of ten years with significant input from all available points of view. UCITA was the subject of 16 public meetings over the course of four years (1996-1999) in several cities. The drafting committee also considered written comments. Throughout the drafting process, the American Bar Association (ABA) was integrally involved and consulted. For example, ABA advisors took part in each meeting of the UCITA Drafting Committee. UCITA was adopted by NCCUSL in July 1999 and a standby committee of the organization has recommended and accepted clarifications and changes to the existing proposed law as recently as July 2002.

Why are Digital Goods Different?

Intangible products dominate the marketplace for computer and informational products, where the information is many times more valuable than the tangible device – such as a chip, disk or tape – that holds the information.[6] Consumers are interested in obtaining the ability to use the information contained in the tangible device. The right to use this information is generally conferred by licenses, the standard contractual device for conveying limited rights to use information products.

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[4] The UCC was initially proposed in 1940 and drafting began in 1942. More than a decade later, the code was approved by NCCUSL in 1951. The first adopter – Pennsylvania in 1953 – was followed by other states and over the course of fifteen years 49 states adopted the law.

[5] Robert W. Hahn and Anne Layne-Farrar, "An Economic Assessment of UCITA," The AEI-Brookings Joint Center for Regulatory Studies, page 1, December 2001.

[6] Online sales of computer information may altogether eliminate the need for a physical medium to convey the product from seller to buyer. Producers of software have turned to licensing to determine the terms of use for downloadable software as well as software products bought at a store or through the mail.

A license is a type of contract that defines the rights and obligations of the licensee (buyer) and the licensor (seller). It defines the rights to use the information product that the consumer receives, the fees, royalties and prices he pays, and any limitations on his use such as copying or redistribution. It is commonly viewed as the product at issue in the exchange, since it conveys the rights valued by the consumer.

Contracts must answer essential questions such as when will the transaction take place, when will delivery be completed and what laws will apply to enforce it. Generally, they also allocate risks and address liability for defects: in the case of digital goods this would include responsibility for bugs and glitches. The rights conveyed by a license to a particular information product can vary dramatically. For example, a license may permit the licensee to install the product on a single computer, on a limited number of machines, or on every machine at a single workplace.

A principal difference between a license and a sales contract is that licenses generally restrict the use and transfer of the information product while the contract is in force and sales do not restrict use and transfer of a product. Thus, a copyright holder may license the use of a product without relinquishing control over the reproduction and dissemination of digital copies of the product. Consumer products in a digital environment are uniquely suited to this type of contractual arrangement, since, by their nature, such products can be copied, stored and distributed with ease.

Each digital copy can itself be copied perfectly at a marginal cost that approaches zero. As a result, producers will not introduce a digital product to the marketplace without some restrictions on use – particularly copying and redistribution. The alternative would be to allow each new product offering to quickly become a commodity with a price of zero. Contracts, and clear legal rules like those offered under UCITA help provide a stable digital marketplace for buyers and sellers.[7]

Software is often sold with the license appearing through clear shrink-wrapped packaging or inside a box (with the software in a separate shrink-wrap or enclosed in an envelope). The license typically takes effect if the shrink-wrap or seal enclosing the CDs is broken, or if the consumer affirmatively assents to a license by clicking on an "I Accept" button in the course of installing the product. Acceptance is also commonly indicated with a mouse click when media is distributed over the Internet.

Shrink-wrap and click-wrap licenses are typically "form contracts" that offer the same terms to every consumer. Form contracts are common in situations where it would be prohibitively expensive to negotiate a contract with each individual consumer. Consumers are free to choose among competing information product offerings, so that the absence of negotiation does not imply a lack of consumer choice or competition.

[7] Of course, if the costs of detecting violations of restrictions, or of obtaining remedies for breach are high, it may be more difficult to for an effective marketplace to emerge. For a discussion of these issues in the context of online delivery of digital content, see William F. Adkinson, Jr. and Jeffrey A. Eisenach, "The debate Over Digital Online Content: Understanding the Issues," *Progress on Point*, Release 9.14, The Progress & Freedom Foundation, April 2002.

Moreover, neither shrink-wrap nor click-wrap licenses prevent consumers from inspecting the license prior to final assent to the contract and many producers voluntarily place their product licenses on their website for inspection by consumers.

The licensing models that have emerged for the software marketplace provide benefits to both producers and consumers. The producers of copyright-intensive software retain property rights in their product,[8] incur limited liability and realize lower transaction costs associated with uniform contract practices. The consumers of the same products gain lower prices for otherwise prohibitively expensive software.

The existing UCC does not provide an adequate foundation for the efficient exchange of rights for the digital goods increasingly seen in the marketplace. As a result, UCITA was drafted to accommodate the special contracting problems associated with licensing computer information. UCITA does not require licensing for computer information products, although it does provide a comprehensive framework within which licenses can be drafted, analyzed and enforced. This framework is based on the widely understood contracting principles used by the UCC to guide transactions of more traditional commerce.

What Does UCITA Do?

UCITA applies to computer information products like software, databases and online access, and the computer information product components of traditional goods. If a transaction entails a combination of computer information goods and traditional goods, UCITA applies only to the computer information goods unless the "primary subject

A Word on Warranties

Warranties for manufactured goods – from home appliances to jewelry to jet engines – have developed as a key feature of many products and industries. Warranties help convey important information and assurances to consumers about trustworthiness of the product and the seller. This is especially true in markets where the producer has better access to information about the quality of a product prior to the commercial transaction such as in markets for software or computer information.

As an example, consider the difference in the marketplace for clothing and clothes washers. A consumer can easily inspect an article of clothing and spot defects in materials or workmanship prior to purchase. However, it is much more difficult to examine the quality of a clothes washer that has hundreds, if not thousands, of mechanical and electronic parts. As a result, warranties on the quality of home appliances are common and rare in the marketplace for clothing. Clearly, consumers who purchase digital goods confront similar difficulties.

The software industry commonly offers warranties that define an ongoing relationship between consumer and producer. For example, a software warranty may provide a guarantee for free upgrades or patches to a program licensed to consumers. Under UCITA, a seller warrants that a product (and all of its information-based components like software code or database lists) is free of rightful claims by a third party (such as copyright infringement). Similarly, if a contract requires a consumer to select components of a system, there is an implied warranty that all of the components (software applications) will work together.

Another aspect of the UCITA default rules for warranty assure that distributors of computer information products receive the correct number of copies or formats of a product to correspond to the packaging and labeling of the product. Still another affirms that any information, promise or description provided to a licensee by the licensor – including through advertisements to the general public – are a part of the warranted agreement. In this way, a consumer can have confidence about the advertised speed of a computer processor with a given software application or the thoroughness of a search and archive system advertised with reference to other products but sold independently.

[8] When a standard commercial good is exchanged, the consumer typically owns the product; however, with computer information the consumer rarely controls all of the rights associated with the information exchanged. See, for example, *DSC Communications Corp. v. Pulse Communications, Inc.*, 170 F.3d 1354 (Fed. Cir. 1999), for a discussion of the distinction between owning a copy of copyrighted software and owning the rights to the copyright itself.

matter" of the transaction is computer information. If, for example, a farmer buys a new combine with a navigation system that features a global positioning device utilizing proprietary software, only the computer information goods (the software and potentially the services associated with ongoing GPS updates) are covered by UCITA, while the combine and other farm equipment are covered by the UCC. If, however, a farmer buys a software package and specialized computer to allow him to refurbish and build antique tractors, the automatic computer-aided design program and the customized computer are both covered by UCITA. The latter transaction – purchase of the software and hardware – is primarily of computer information.

With limited exceptions, UCITA does not impinge on the ability of parties to a contract to define their own terms.[9] UCITA essentially consists of default rules and definitions designed to fill gaps in a contract in the event contracting parties do not address the relevant issues. For example, contracts typically include provisions that specify the state law and forum applicable in the event of a dispute. Under UCITA, if these issues are not addressed in the contract, then UCITA's defaults apply.

Depending on the type of contract, the default under UCITA selects laws and forums associated with the home of the buyer or the seller. When an Internet Service Provider (ISP) writes a contract for *access*, for example, the law of the ISP's jurisdiction governs the contract. On the other hand, a contract for delivery of the product on a physical medium – for example, a disk that contains a software program – is governed by the law of the customer's jurisdiction. UCITA incorporates default rules on a range of other issues, such as change in terms, First Amendment considerations for informational content, and various forms of breach.

The rules established by UCITA also cover warranties and the liability for the loss of information during a transaction. The latter provision is especially relevant for computer information that is delivered over the Internet or other electronic networks. UCITA expressly defers to state and federal consumer protection laws where they apply.[10] Thus concerns that it would undermine such safeguards are misplaced.

Under UCITA, consumers have an opportunity to review all contracts – including mass-market licenses – before their assent is given.[11] UCITA provides a licensee the opportunity to reject the contract for any reason and to obtain a refund as well as

[9] The following are exceptions to the standard "freedom to contract" architecture of UCITA, provisions that cannot be modified by the parties to the contract: Obligations of good faith, diligence, reasonableness and care as well as limitations on choice of law or forum (Sections 109 and 110); the right to relief from unconscionable contracts or clauses, the procedures for manifest assent and opportunity to review the product (Section 112); protections for consumers in the case of electronic error (Section 216); protections for mass market licensees (Section 210); requirements for an enforceable term (Sections 303(b), 307(g) and 406(b)(c) and 804(a)); restrictions on a state's statute of limitations (Section 805(a)); and the protections that limit the use of electronic self-help (Sections 815(b) and 816). In addition, other limitations are provided in Section 201 of UCITA.

[10] As Section 105(c) of UCITA makes clear, if consumer protection laws conflict with UCITA, then the consumer laws expressly take precedence over UCITA.

[11] See Section 112 of UCITA.

incidental costs associated with return or destruction of the product and reasonable costs associated with returning her home computer system to its pre-purchase configuration.[12] This means that if a consumer buys new software from a retailer, and must open the package and install the software on her home computer system to review the license, she still may remove the product from her system and obtain a refund.[13]

One of the more controversial issues that has swirled around the process of implementing a uniform computer information contract law is "self-help," particularly the right of a seller to take repossession under certain circumstances. In the case of computer information, one method of "repossessing" a product when a licensee does not hold up his end of the bargain (e.g., by failing to pay or violating restrictions on use) is through a process of electronically disabling the product, using methods that range from access through a backdoor in the software to requiring the licensee to periodically input licensor-provided codes. Such self-help measures can render the product useless to consumers, imposing considerable expense and inconvenience.

Amendments to UCITA were adopted earlier this year to ban self-help. The policy decision at issue was to determine how to allocate the costs of enforcement for contracts. The pre-amendment UCITA which allowed self-help under very specific and controlled circumstances, relied more on private enforcement mechanisms.[14] Today, UCITA is drafted to rely more on public – through the judicial process – enforcement mechanisms.

Benefits of UCITA's Adoption

If UCITA were widely adopted, it would provide a consistent and predictable statutory foundation for contracts involving the sale or licensing of digital products. Currently, these contracts are routinely entered into, although the legal environment – with respect to liability, jurisdiction and precedent – remains murky. A uniform law would provide universal rules, definitions and clarity to the adjudication of licensing disputes.[15]

Uniform contract law would provide clarity and consistency to producers with a national or multi-state reach for all of their computer information contracts. In addition,

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[12] See Section 112(e) of UCITA and especially Official Comment 8 thereto.

[13] Alternatively, a hard copy of the license could be made available in the box, so that the consumer can review its terms directly (i.e., without opening the package containing the media with the computer information). If so, her acceptance could be manifested by opening the envelope containing the CD.

[14] Before the 2002 amendments, UCITA banned self-help devices unless the licensee specifically agreed to the relevant self-help provisions of the contract. As a result of the new amendments, consumers now have additional protections. First, the name and address of the contact person for the licensee are specifically required in the consent. Second, after obtaining consent to the self-help provisions, the licensor is required to provide a 15-day notice prior to using a self-help device. Importantly, self-help is forbidden if there was a risk of serious harm to personal or public interests. Should a licensor act improperly with respect to self-help, it is responsible for all damages

[15] Hahn and Layne-Farrar cite four principal efficiency-enhancing attributes of a uniform contract law for computer information: reducing inconsistency in state statutes, reducing information costs, reducing other transactions costs and reducing litigation costs. See in particular pages 3-11.

there is a benefit from UCITA to vendors with a smaller or a more localized marketplace. It is obvious, but often overlooked, that only those vendors in states that adopt UCITA or a similar set of rules for contracts would have greater clarity in the development and performance of computer information contracts. A firm that does business in every state of the union would likely achieve economies in drafting, negotiating, and litigating contracts as a result of a consistent legal environment. Likewise, a firm that only does business in the state in which it is located would find efficiency gains if its state has adopted clear and predictable rules for contracts. In both cases, competition would ensure that consumers share in the gains.

UCITA would streamline the potentially costly and time-consuming process that otherwise would be needed to settle on a more standardized legal framework for the digital era. Efficient rules often arise from the common law process. However, the experience of the UCC suggests that efficient rules for a dramatically changed commercial environment may be best determined through widespread adoption of a model code, like UCITA. The costs of waiting – in higher transactions costs, and forgone contracts and commerce – for common law convergence grow with the expanded importance of information products and services in the economy.

Of the advantages to a uniform contract law – the same law across most or all of the states – the most important is the reduction of transaction costs associated with the negotiation and enforcement of contracts. The ability of consumers and sellers to reach accurate expectations regarding contractual rights and responsibilities is greatly enhanced through the adoption of an overall framework to govern those rights and responsibilities.

Consumer comparison-shopping and product evaluation would be much easier. Similarly, contract negotiation and enforcement would be streamlined and businesses would be able to write and enforce form contracts on a national basis. For example, the term "computer information" is defined in the proposed law.[16] As a result, there would be no need for a court to create its own definition of the term, which could potentially create a confusing patchwork of judicial definitions based on the state or circuit in which a case is brought. Similarly, courts will be less tempted to stretch and analogize the tangible goods provisions of article 2 of the Commercial Code to cover intangible goods such as software or other computer information.[17]

Widespread adoption of UCITA would also enhance economic efficiency by reducing the costs that firms incur to comply with numerous state standards – costs that ultimately are borne by consumers.[18] Likewise, a uniform contract law would reduce the

[16] The definition used is "Information in electronic form that is obtained from or through the use of a computer, or that is in [a] form capable of being processed by a computer. The term includes a copy of information in that form and any documentation or packaging associated with the copy."

[17] See, for example, Erika E. Schinler, "Trouble at the Sausage Factory: Has the Uniform Computer Information Transactions Act Been Unjustly Stigmatized?" Vol. 75:507, page 512, *Tulane Law Review*. Note also, this year the UCITA drafting-body, NCCUSL, amended Article 2 of the UCC to limit its effect with respect to intangible goods.

[18] Hahn and Layne-Farrar, particularly at pages 3-11.

costs of complying with a variety of legal obligations. The products covered by UCITA – principally software and other information-intensive intangible goods – are readily distributed via digital, or electronic means through multiple jurisdictions simultaneously. As Hahn and Layne-Farrar observe:

> Uniformity in state law can alleviate the problems that national vendors face when statutes are inconsistent across jurisdictions. While some discrepancies may remain in law enforcement standards across states, business can at least be sure that the written rules are the same. National companies can then set national standards for product design, testing, marketing or contract formation.[19]

Another key benefit of UCITA is that it requires contracts for information goods to be more specific and better defined that they otherwise might be. If a contract does not address the issues covered by UCITA's default rules, then the default rules would apply. This feature would reduce the incentive for courts to fill gaps with common law or UCC principles that may be inappropriate to digital goods and services.

UCITA offers important benefits to small businesses and consumers. The costs of non-uniformity fall disproportionately on smaller firms – of which there are many in the information technology industries – including potential entrants. Thus, an important positive effect of a uniform contracts law would be to lower barriers to entry and increase the competitiveness of information technology markets.

The difficulty of dealing with nonuniform contracts also places special burdens on consumers, who face direct costs from having to deal with nonuniform contracts.[20] Specifically, in the absence of uniform contracts, consumers either must incur the costs associated with learning about the differences in the contracts for the goods they purchase or purchase those products with greater uncertainty about the contract terms. A uniform contract law for digital goods and services would allow consumers to develop more accurate expectations about the terms under which most digital products are sold.

Costs Associated With UCITA

Along with the benefits of UCITA, there are potential costs. In general, uniform laws impose a single legal structure and thereby either preclude, or raise the costs of, positive innovations in the legal code. This concern is particularly noteworthy when the affected area of commerce is marked so thoroughly by dramatic rates of change.

Related to the loss of potential innovations to the legal code is a dominant feature of uniform laws: Once widespread adoption is achieved, uniform laws are relatively inflexible. However, the process by which UCITA was developed remains in

[19] Hahn and Layne-Farrar, page 4. Citation in the original omitted.

[20] For the seminal article on the problem of imperfect and decentralized knowledge in society, see F. A. Hayek, "*The Use of Knowledge in Society*," *The American Economic Review*, Volume 35, Issue 4, pages 519-530, September 1945.

place to modify it, if necessary. For example, the NCCUSL organization remains receptive to innovations and ongoing changes to the UCITA model legislation.[21] And the adoption process itself – model legislation debated, amended and adopted – by individual states suggests that minor modifications to suit local issues or market conditions are possible.[22] Indeed, this mechanism may be an efficient means to introduce improvements, by enabling states to coordinate changes in law that otherwise could not be synchronized across the states.[23]

However, this concern is substantially ameliorated by the flexibility incorporated into UCITA. UCITA applies primarily to transactions involving mass-market contracts. In this context, it permits the drafter of the contract (generally the seller) to modify most defaults to suit its needs, and the consumer to evaluate terms through choice among competing firms and products. Where contract is formed via negotiations by the parties, they are generally free to set the key terms, and can expect to tailor the license to their specific preferences. For example, the market for highly customized software typically involves contracts that are extensively negotiated prior to the exchange of the computer information, with terms reflecting the parties' specific needs.

A less tangible cost of UCITA goes to the heart of what is typically called the "federalism" argument. Many state lawmakers deride uniformity and consider it an assault on their sovereignty. Strictly speaking, UCITA does not raise a "federalism" problem in that the proposed legislation is not federal – nor does it spring from another sovereign state. Nonetheless, there is a spectrum of policy choices that spans between total uniformity across states on one end and unique rules and laws for each state at the other end. In commercial law, the benefits of uniformity for national markets outweigh the costs associated with reduced diversity among states' laws.

Conclusion

A small number of simple institutions give rise to an uncountable variety of complex and fruitful market processes. Among these vital institutions are contracts – legally recognized cooperation between market participants to achieve mutual benefit.[24]

Historically, enforceable contracts for computer information and other digital products have developed from principles culled from legal disciplines as diverse as

[21] As noted above, changes to UCITA have been adopted as recently as late 2002.

[22] It must be considered that with each modification to the model law, a measure of uniformity – and its consequent advantages – is lost.

[23] States that adopt UCITA after a substantial number of others have already experimented with its effects retain power as laboratories of innovation and democracy. Thus, early adopters pave the way for improvements to the law. A state that has already adopted UCITA would likely find it easier to make a conforming technical amendment to an existing UCITA statute compared to a state debating and passing UCITA for the first time. Thus, uniformity can be achieved even as room for improvement to UCITA is available.

[24] For an excellent treatment of the role of property rights in context of digital content, products and distribution of goods and services, see also William F. Adkinson, Jr. and Jeffrey A. Eisenach, "The Debate Over Digital Online Content: Understanding the Issues," *Progress on Point,* Release 9.14, pages 2-3 and 14, The Progress & Freedom Foundation, April 2002.

common law, statutory law (for example, sections 1 and 2 of the Uniform Commercial Code) and copyright law. A uniform contract law such as UCITA offers particular advantages over the multiplicity of contract laws currently governing the digital product transactions, by providing uniform default rules tailored to the unique challenges of the digital environment.

The standardization and uniformity achieved by UCITA, while not without costs, is likely to bring far greater benefits to the digital marketplace, increasing certainty and clarity. Most significantly, if broadly adopted, UCITA will likely reduce information costs for buyers and sellers as well as reduce transaction costs associated with negotiation and litigation of computer information or electronic commerce contracts. Nor does UCITA foreclose improvements to contracting in the digital marketplace. It provides the parties with flexibility in structuring their arrangements, and can be amended to ensure that innovations are available to the entire market.

On balance, widespread adoption of UCITA would benefit consumers, producers, and the digital economy generally. It would enhance overall welfare by reducing information and transactions costs in the exchange of informational goods and services, as compared with the current legal regime.

Publications on Related Topics

William F. Adkinson, Jr. and Jeffrey A. Eisenach, "The Debate Over Digital Online Content: Understanding the Issues," *Progress on Point 9.14* (April 2002)

James W. Harper and Thomas M. Lenard, "Online Tax Preparation: Beyond the Bounds of E-Government," *Progress on Point 9.13* (April 2002)

Dale W. Jorgenson, "American Economic Growth in the Information Age," *Progress on Point 9.12* (April 2002)

Jeffrey A. Eisenach, "The Need for a Practical Theory of Modern Governance," *Progress on Point* 7.7 (May 2000)

Paul H. Rubin and Thomas M. Lenard, *Privacy and the Commercial Use of Personal Information*, (Washington, DC: Kluwer Academic Publishes and The Progress & Freedom Foundation: November 2001)

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