

MEMORANDUM

TO: Committee on the Uniform Commercial Code and Emerging Technologies

FROM: Steven Harris, Reporter

RE: Bundled Hardware, Software, and Service Transactions (to be discussed on May 3, 11 a.m. CT)

DATE: April 25, 2021

The May 22, 2020 Report and Recommendations of the Subcommittee on Bundled Hardware, Software, and Service Transactions (attached) discusses three issues relating to the UCC's treatment of these "bundled transactions" and recommends changes to the UCC or its comments with respect to each. Specifically, the Report addresses the definition of "chattel paper" in UCC § 9-102, and the concept of "finance lease" in UCC § 2A-103(g). It also recommends that the UCC address more generally the applicability of Articles 2 and 2A to bundled transactions.

The attached Report contains a full discussion of the issues and explains the subcommittee's recommendations. This Memorandum suggests how the Drafting Committee may wish to structure its discussion of these issues.

Definition of "Chattel Paper."

UCC § 9-102(b)(11) defines "chattel paper" as:

a record or records that evidence both a monetary obligation and a security interest in specific goods, a security interest in specific goods and software used in the goods, a security interest in specific goods and license of software used in the goods, a lease of specific goods, or a lease of specific goods and license of software used in the goods. In this paragraph, "monetary obligation" means a monetary obligation secured by the goods or owed under a lease of the goods and includes a monetary obligation with respect to software used in the goods. The term does not include (i) charters or other contracts involving the use or hire of a vessel, or (ii) records that evidence a right to payment arising out of the use of a credit or charge card or information contained on or for use with the card. If a transaction is evidenced by records that include an instrument or series of instruments, the group of records taken together constitutes chattel paper.

1. Bringing obligations for services into chattel paper.

Question: Should the "monetary obligation" evidenced by chattel paper be expanded to include an obligation of the lessee, evidenced by the same record or records, to pay for services that are related to the goods?

Question: Should “chattel paper” be expanded to include records that evidence not only a security interest in or lease of specific goods, and a license of software used in the goods, but also an obligation to pay for services related to the goods?

Questions: Assuming that the answer to the previous question is “yes,” and a bundled transaction is evidenced by two records, one of which is a lease and the other of which is a contract for services related to the goods, when should the records taken together constitute “chattel paper” and when should they be treated separately (*i.e.*, the lease would be chattel paper but the obligation to pay for services would be an account)? Would it make a difference, for example, if neither record refers to the other?

2. Application of the definition to bundled transactions.

Question: Should the relationship between the account debtor’s obligation under the lease and its obligation for related services affect whether the record(s) evidencing the transaction constitute “chattel paper”? If so, how?

The Drafting Committee may wish to consider the following options if the record or records evidencing a bundled transaction include an Article 2A “lease” of goods, *i.e.*, “a transfer of the right to possession and use of goods for a term in return for consideration.”¹

(1) The records would constitute “chattel paper.”

(2) The records would constitute “chattel paper,” unless the value of the lessee’s rights under the lease is a trivial/immaterial/unsubstantial part of the transaction.

(3) The records would constitute “chattel paper,” unless the value of the lessee’s rights under the lease is less/substantially less than the value of the related services.

(4) The records would constitute “chattel paper,” unless the amount of the monetary obligation for the lessee’s rights under the lease is less than/substantially less than the monetary obligation for the related services.

(5) The records would constitute “chattel paper” only if the goods portion of the transaction predominates.

(6) The records would constitute “chattel paper” only if Article 2A would determine the parties’ rights under the lease.

The Report recommends that Article 9 be amended to reflect a combination of the rules in paragraphs (5) and (6). With respect to paragraph (6), it also recommends that Article 2A adopt the predominant-purpose test.

Question: If records are “chattel paper” when the right to possession and use of the goods for a term is a trivial or insubstantial portion of the transaction evidenced by the records,

¹ UCC § 2A-103(1)(j). In Article 9, “lease” has the meaning ascribed to the term in Article 2A. UCC § 9-102(b).

should they be “chattel paper” only to the extent that the monetary obligation is owed for the right to possession and use of the goods?

Question: If application of one of the options above results in records of a bundled transaction that include an Article 2A “lease” but are not “chattel paper,” should parties to the transaction be permitted to opt in to chattel-paper treatment by including an express provision to that effect in the record evidencing the lease?

Applicability of Articles 2 and 2A.

Question: Should the UCC or its comments indicate when Article 2 or 2A, or other law such as the common law of contracts, applies to determine contract law issues arising from a bundled transaction?

Question: If so, what approach should the UCC adopt? The Report recommends that the predominant-purpose test, which determines the governing law based on whether the goods aspect or non-goods aspect of the transactions predominates, should answer the question in most cases. That approach is dominant in transactions in which the goods aspect of the transaction would constitute a “sale” governed by Article 2 if considered alone. There are far fewer cases addressing the applicability of Article 2A in transactions in which the goods aspect of the transaction would constitute a “lease” if considered alone; however, some cases in that context have adopted the same predominant-purpose test to determine the reach of Article 2A, and it does not appear that cases have adopted any other approach. The Report recommends one exception to application of the predominant-purpose approach: Article 2 or 2A should be applied to a matter that relates solely to the goods aspect of a bundled transaction, such as a claim that the goods supplied do not conform to the contract, even if that aspect of the transaction does not predominate. This approach is often referred to as the “gravamen test.”

Finance lease.

Question: Does a bundled transaction that involves a lease and a significant amount of services, and in which the lease would be a finance lease if only the goods were involved, constitute a “finance lease,” as the term is defined in UCC § 2A-103(1)(g)? A finance lease gives the lessor the benefit of the “hell or high water” protection of UCC § 2A-407, i.e., the lessee’s promises under the lease contract become irrevocable and independent upon the lessee’s acceptance of the goods. A finance lease also extends to the lessee the supplier’s promises to the lessor under the lease contract, and all warranties. See UCC § 2A-209.

The Report recommends that in a bundled transaction involving both goods and non-goods that would qualify as a finance lease if only the goods were involved, (i) the rules governing finance leases under UCC §§ 2A-209 and 2A-407 should be applied to the goods aspects of the transaction in all cases, and (ii) if the goods aspect of the transaction predominates, the rules governing finance leases under UCC §§ 2A-209 and 2A-407 should be applied to the entire transaction.

MEMORANDUM

To: Edwin Smith, Chair
Steven Harris, Reporter

From: Leianne Crittenden and Neil B. Cohen, Co-Chairs of Subcommittee on Bundled Hardware, Software, and Service Transactions

Re: Subcommittee Report and Recommendations

Date: May 22, 2020

This subcommittee engaged in one live group discussion and in further email discussions generated by questions posed to the subcommittee members. Taking account those discussions, the subcommittee issued its first report on January 27, 2020. (See Attachment A.) In light of the discussions preceding the issuance of that report and the discussion of the report at the Study Committee meeting on February 1, 2020, the co-chairs propose the following resolution of the issues raised in that report.

Chattel Paper

Background: A contract pursuant to which a vendor transfers the right to possession and use of goods for a term in return for consideration is a lease (see UCC § 2A-103(j)) and a record or records reflecting such a transaction evidence both a monetary obligation and lease of specific goods and, thus, constitute “chattel paper” (see UCC § 9-102(a)(11)). But consider a bundled transaction that would be a lease if only goods were involved, but which also involves a significant amount of non-goods (especially technological services, including support, consulting or cloud services). Is that transaction a lease, so that the record or records reflecting the transaction constitute chattel paper, with the result that important Article 9 rules relating to chattel paper apply? Does the answer (or should the answer) depend on whether the goods or non-goods aspect of the transaction predominates? Do the record or records constitute chattel paper only to the extent of the portion of the monetary obligation attributable to the goods? The view was expressed in discussions that uncertainty with respect to this issue is harmful to the marketplace.

Proposed resolution: In a bundled transaction involving both goods and non-goods (such as cloud services, etc.), a transaction that would qualify as a “lease” if only the goods were involved should qualify as a “lease” (and, thus, the record or records reflecting the monetary obligation and the “lease” should qualify as “chattel paper”) if the goods aspect of the bundled transaction predominates.

Illustrations:

1. Customer and Tesla enter into a transaction pursuant to which, in exchange for a payment of \$500 per month, (i) Customer is entitled to possession of a Tesla automobile for 36 months, and (ii) Tesla will, from time to time, remotely update the automobile's operating system and back up Customer's personalized settings in "the cloud." The value of the right to possess and use the automobile is significantly greater than the value of the updates and backups. The goods aspect of this transaction predominates, so the record or record reflecting Customer's monetary obligation and its rights with respect to possession of the automobile and the update and backup services constitute chattel paper.
2. Customer and Cableco enter into a transaction pursuant to which Cableco provides specified television programming, along with a cable box needed to access the programming, for 12 months for a "special bundled price" of \$150 per month, which is less than the price of the components of the transaction if contracted for separately. If the components of the transaction were priced separately, the price for the possession and use of the cable box would have been 1/10 the price of the programming. The goods aspect of this bundled transaction does not predominate. Accordingly, the record or records reflecting Customer's monetary obligation and rights with respect to the programming and cable box do not constitute chattel paper.

Finance Lease

Background: Consider a bundled transaction that would be a finance lease if only goods were involved, but which also involves a significant amount of non-goods (especially technological services, including support, consulting or cloud services). Does the transaction constitute a finance lease, giving the lessor the benefit of the "hell or high water" protection of UCC § 2A-407 and giving the lessee rights against the supplier under UCC § 2A-209? Does the answer (or should the answer) depend on whether the goods or non-goods predominate? Is the transaction a finance lease only to the extent of the portion of the monetary obligation attributable to the goods? The view was expressed that uncertainty with respect to this issue is harmful to the marketplace. (Note that it is common in such transactions for the lease contract to contain explicit "hell or high water" language. In such a case, UCC § 9-403 provides that if the vendor assigns its right to be paid under the transaction, the customer will be unable to assert most defenses against the assignee. Note further that UCC § 2A-407 does not address the enforceability, as between the vendor and customer, of such contractual "hell or high water" language, and the "issue will continue to be determined by the facts of each case and other law which this section does not affect.")

Proposed resolution: In a bundled transaction involving both goods and non-goods that would qualify as a finance lease if only the goods were involved, (i) the rules governing finance leases under UCC §§ 2A-209 and 2A-407 should be applied to the goods aspects of the transaction and (ii) if the goods aspect of the transaction predominates, the rules governing finance leases under UCC §§ 2A-209 and 2A-407 should be applied to the entire transaction. (This assumes that there is no contractual language addressing the issue that would be given effect under UCC § 1-302 notwithstanding UCC §§ 2A-209 and 2A-407.)

Illustrations:

1. Customer, seeking “real time” stock market information services, identifies a vendor who will provide lifetime access to the information services and a customized terminal from which the services can be accessed for a fixed upfront price. Customer cannot pay that upfront price. Instead, it enters into a contract with a financing entity that acquires the information services and terminal from the vendor and then leases them to Customer for a fixed term for \$10,000 per month. Assume that it is clear that the stock market information services are worth many times as much as the terminal. Six months later, the terminal fails because it was not merchantable at the time of delivery (and the warranty of merchantability was not disclaimed); repair of the terminal would cost \$1000 and replacement would cost \$2000. If a lease of the terminal, standing alone, would have qualified as a financing lease under UCC § 2A-103(1)(g), Customer’s obligation to pay the financing entity is irrevocable and independent of the non-conformity of the terminal (see UCC § 2A-407) and the benefit of the implied warranty of merchantability that was part of the contract between the vendor and the financing entity extends to Customer (see UCC § 2A-209).
2. Customer, needing a truck for its business, identifies a dealer that will sell a truck to Customer for \$60,000, including all routine maintenance services for the first year. Customer cannot pay the \$60,000 price. Instead, it enters into a contract with a financing entity that buys the truck from the dealer on the terms described above and then leases the truck (and the right to routine maintenance for the first year) to Customer for \$1000 per month for three years. While the truck satisfies all applicable warranties, the dealer does not provide routine maintenance service of sufficient quality to satisfy its obligations under the contract with the financing entity. If the lease of the truck, standing alone would have qualified as a financing lease under UCC § 2A-103(1)(g), Customer’s obligation to pay the financing entity is irrevocable and independent of the dealer’s failure to provide routine maintenance services properly and the benefit of the dealer’s maintenance obligation that was part of the contract between the dealer and the financing entity extends to Customer. This is because the goods aspect of this transaction clearly predominates.

Determination as to Whether Bundled Transactions Are Governed by Article 2 or Article 2A Generally

Background: In a dispute arising out of a contract (traditionally referred to as a “mixed” or “hybrid” transaction and more recently often referred to as a “bundled transaction”) in which the vendor provides both goods and non-goods (especially technological services, including support, consulting or cloud services), most states apply a “predominant purpose” test to determine whether (i) the contract is governed by the UCC Articles about goods (Article 2 or Article 2A, as applicable), or (ii) by non-goods law outside the UCC. But not all disputes are alike. In some cases, the dispute concerns the contract taken as a whole (such as whether an enforceable contract was formed), while in other cases the dispute may involve only one aspect of the transaction. Such a dispute may involve only the goods aspect of the transaction (such as when the claim is that the goods do not conform to contractual specifications) or only the non-goods aspect (such as a claim about support services). Many members of the subcommittee indicated

that it would be preferable, in the case of a dispute involving only one aspect of the transaction, for the law governing the disputed issue to be the UCC law of goods when a dispute about the goods is the gravamen of the dispute, and for the law governing the disputed issue be non-UCC law when a dispute about the non-goods aspect of the transaction is the gravamen of the dispute.

Proposed resolution: In a bundled transaction involving both goods and non-goods, in deciding whether the parties' rights are determined under Article 2/2A (as applicable) or other law (typically the common law of contracts), the predominant purpose test should be applied in most cases. However, if a matter arises that relates solely to the goods, Article 2/2A should be applied to that matter even if the goods aspect of the transaction does not predominate.

Illustrations:

1. Vendor entered into negotiations with Truck Mechanic to provide Truck Mechanic with computerized diagnostic services that can enable her to repair efficiently the newest generation of trucks that contain many "smart" components that continuously upload information as part of the Internet of Things (IoT). The transaction that is the subject of the negotiations would involve vendor supplying specialized diagnostic software to Truck Mechanic along with highly-trained personnel to utilize the software and also supplying a terminal on which the software will reside and which can be used to transmit diagnostic information to specialists at Vendor's headquarters. When major issues concerning the proposed transaction were resolved, Truck Mechanic sent Vendor a "purchase order" for the diagnostic services. Vendor replied with an "order acknowledgement" that seemed to express acceptance of the purchase order but which contained some terms additional to those in the purchase order and others that were different from those in the purchase order. Before Vendor started providing the diagnostic services a dispute arose. Vendor claims that there is no contract with Truck Mechanic for the computerized diagnostic services, while Truck Mechanic claims that a contract exists. In the applicable jurisdiction, UCC § 2-207 has been enacted but the jurisdiction's common law of contracts follows the "mirror image rule" under which a purported acceptance of an offer operates as a rejection and counter-offer if the purported acceptance contains terms additional to or different from those offered. Because the non-goods aspect of this transaction predominates, the determination of whether the exchange of purchase order and order acknowledgment created a contract should be made under the rules of the jurisdiction's common law of contracts.
2. Customer and Newspaper enter into a contract pursuant to which, for a one-year period, Newspaper is to provide Customer with full access to Newspaper's website and a physical copy of each day's newspaper. The contract provides that the ink used in printing the physical copy of the paper to be delivered to Customer will be non-allergenic, which is important to Customer because many members of his family have an uncommon allergy to certain frequently-used newspaper inks. The contract price is \$500 per year. One day, as a result of a mistake by Newspaper, the issue delivered to Customer is printed with ink that can trigger allergies. As a result, when Customer's grandson, who has the uncommon allergy, read that day's paper while visiting

Customer's house, he suffered dermatological injuries that were caused by the allergy. Whether the benefit of the Newspaper's promise that the ink would be non-allergenic extends to the grandson is determined by the jurisdiction's enactment of UCC § 2-318 whether or not the predominant purpose of the contract is the furnishing of the physical copy of the newspaper each day or the provision of the access to Newspaper's website. This is because the matter that arose relates solely to the goods and was unrelated to the website access.