

MEMORANDUM

TO: NCCUSL Commissioners

FROM: Connie Ring, Chair
Ray Nimmer, Reporter

DATE: July 1, 1998

RE: UCC Article 2B -- Significant Issues for Committee of the Whole

The draft of Article 2B you will receive from the Conference for the Annual Meeting reflects the deliberations of the Drafting Committee at five meetings this year with record attendance and participation (Minneapolis, 9/26-28/97 -- 93 attending; Memphis 11/22-24/97 -- 80 attending; Dallas, 2/20-22/98 -- 97 attending; San Diego, 3/27-29/98 -- 98 attending; and St. Louis, 5/1-3/98 -- 84 attending; see Attachment A hereto).

The draft also reflects the editing and styling of the Style Committee and a special Article 1 subgroup of Boris Auerbach, Neil Cohen and Kathleen Patchel. Since some of this editing could not be completed for the draft sent to you there will be an errata sheet provided at the Annual Meeting.

You are in receipt of a memorandum dated May 6, 1998 from President Gene Lebrun advising that Article 2B will be considered by the Committee of the Whole on final reading that will provide a stable draft for review and comment, but without a vote by the states. Concerns and suggested amendments by interested groups will be considered by the Drafting Committee at a meeting in November 1998. The final draft (from the Committee of the Whole) will be considered by the ALI Council in December. Any amendments or sections affected by amendments or concerns resulting from the ALI and Drafting Committee deliberations on the concerns and suggestions of interested groups will come before the Conference in July 1999 and the Act (with amendments) presented for a vote by the states at that time.

IMPORTANCE OF ACT

Among all of the participants, there is an universal recognition that "uniformity" of rules are essential; and most favor a uniform state law over congressional enactment.

The traditional methods of conveying information are rapidly converging to employ digital technology (and evolving new technologies). The information industry already is a larger component of our Gross National Product than manufacturing and is the largest U.S. export. The various states by analogy and common law of that state has sought to resolve issues relating to information transfers by contract. Article 2B would bring these transactions for the first time under the Uniform Commercial Code.

Among the modes of transfer is the Internet that in 1997 had 62 million subscribers, of which 25% (16 million) were new in 1997. Exponential growth will occur in 1998 and thereafter, yet there are no comprehensive universal rules governing these transactions -- just a hodge podge of court decisions among the various states.

The White House issued a paper on July 1, 1997 stating:

“Commerce on the Internet could total tens of billions of dollars by the turn of the Century.”

“For this potential to be realized fully, governments must adopt non-regulatory, market oriented approach to electronic commerce, one that facilitates the emergence of a transparent and predictable legal environment to support global business and commerce.”

Among the principles urged by the White House are:

“Parties should be free to order the contractual relationship between themselves as they see fit;”

“Rules should be technology neutral;” and

“Rules should be adopted . . . to support the use of electronic technologies.”

The White House specifically identifies the need for both a domestic and international “Uniform Commercial Code for electronic commerce.”

At the ALI Annual Meeting in May 1998, Hal Burman of the Office of Legal Adviser to the Department of State and an Advisory Member to NCCUSL stated:

Our ability to extend and protect United States interests in a globalized economy -- and electronic commerce is the epitome of that globalized economy -- depends entirely on our ability to proceed from a basis of some commonality in state law. If there is any substantial delay in the completion of UCC 2B that will not only impair our effort to accomplish that; other countries, other international bodies are going to take the lead. We would find that a really unfortunate development, both for our states and for our national interests, so I would really urge all members, both of this

body and the National Conference, to work seriously hard at bringing closure in a fairly rapid period of time on this new article of the UCC.

MAJOR ISSUES

Following the general guidelines of the discussion at the 1997 Annual Meeting, the draft follows existing Article 2 as much as possible. Out of a total of 91 sections, 23 sections follow closely Article 2 and 29 sections have their genesis in existing Article 2.

Ten sections and certain definitions (Part 1C and 2B-111 and 2B-112) are being coordinated with the Electronic Transaction Act (ETA). Seven sections (Part 5) have been coordinated with the Article 9 as they relate to secured transactions.

As previously mentioned, the participants generally express positively the hope that Article 2B will succeed but also expressing the need to study a stable final draft which can be analyzed and commented on by their respective constituencies. If the Drafting Committee and the Committee of the Whole do their work well, we will meet part of that request. The second part, will be the challenge of the Drafting Committee at its November meeting to consider concerns and suggested specific amendments. The principal issues are:

1. Mandatory Rules. Some of the criticisms of Article 2B arise from the desire of some parties for a more regulatory approach.

The fundamental premise of the UCC has been freedom of contract and the provision of “default” rules as gap fillers when the parties have not covered the point. The Drafting Committee does not propose to modify UCC policy.

Article 2B includes certain important protections for licensees (consumers) that expand or continue protections over the common law rules currently extant (see Table beginning on page 12 of draft):

- An “Unconscionable” contract or clause is unenforceable under Article 2B-110.
- “Bad Faith” in the performance or enforcement of a contract or duty under Article 2B is proscribed (1-203; 2B-102(21)).
- State Consumer Protection law trumps Article 2B (both present and future statutes, regulations or judicial decisions) (2B-104).
- Federal law trumps Article 2B to the extent of the preemption (2B-105).

- Supplemental general principles of law (*e.g.* estoppel, fraud, misrepresentation, duress, coercion, etc.) remain fully applicable except as is specifically “displaced” by the provision of Article 2B (1-103). There are no displacement provisions. See 2B-105(b) at page 43 of draft.
- The obligations for good faith, diligence, reasonableness and care prescribed by Article 2B may not be varied by agreement (1-102(3)). See 2B-106(a) at page 48 of draft.
- Special protections for consumers in Article 2B may not be varied by agreement (see 2B-106(b)), for example:

Choice of Law 2B-107
 Choice of Forum 2B-108
 Opportunity for Review 2B-111
 Consumer Right to Correct Errors 2B-118
 Expanded Refund Right 2B-208

The Drafting Committee recommends that the Committee of the Whole adhere to the fundamental policy of the UCC in Article 2B.

2. Scope.

The Scope provisions have received much comment as being too broad and not definitive enough. The approach to the Scope is similar to that of Article 9 and Article 2 in that the Scope is broad with specific exclusions (see Article 9-102 and 9-103 and particularly Official Comment 5 to 9-102).

A special Task Force was appointed after the May meeting to examine alternative formulations of Scope, (the report is included as Attachment B hereto). The draft before you incorporates the recommendations of the Task Force. The Report has been reviewed and considered by the ALI Ad Hoc Subcommittee on June 23-24. The Ad Hoc Committee had comments on the Task Force approach which will be considered by the Drafting Committee on July 23 and reported to the floor.

“Scope” never is an easy topic for any Code article and we hope the Committee of the Whole will be helpful in evaluating the Report of the Task Force.

3. Adhesion Contracts. White and Summers in their Treatise on the UCC state:

“In most fundamental terms Article 2 expands our concept of contract. It makes contracts easier to form . . . Parties may form a

contract through conduct rather than merely through the exchange of communications constituting ‘offer and acceptance’” (at page 5).

“Article 2 contracts are also more expansive in content than before . . . 1-201(3) defines “agreement” to mean “the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance. . . . The Code therefore adds to sales agreements much that is not made express by the parties.” (at page 6).

The Article 2B provisions not only draw from Article 2 but the Restatement of Contracts, Second as follows:

§ 19. Conduct as Manifestation of Assent

(1) The manifestation of assent may be made wholly or partly by written or spoken words or by other acts or by failure to act.

(2) The conduct of a party is not effective as a manifestation of his assent unless he intends to engage in the conduct and knows or has reason to know that the other party may infer from his conduct that he assents.

(3) The conduct of a party may manifest assent even though he does not in fact assent. In such cases a resulting contract may be voidable because of fraud, duress, mistake, or other invalidating cause.

Article 2B, however, specifically requires that there be an opportunity for review (“.: call it to the attention of a reasonable person. . .”) before a contract is formed. (2B-112). Assent by conduct requires “affirmative conduct . . . that the record conspicuously provides or the circumstances . . . clearly indicate, will constitute acceptance. . .” (2B-111; emphasis added). The words emphasized are intended to go beyond existing Article 2 and the Restatement, to require more empirical tests of intent to assent.

As we are all aware, many paper contracts with standard terms (airline tickets, car rentals, hotel accommodations, etc.) are not read but are enforced under Article 2 or common law. Electronic contracts with standard terms likewise may not be read but are enforceable under current law and would be enforceable under Article 2B if there is opportunity for review and assent by authentication or conduct (as explained above). Electronic commerce will have positive attributes; among them standard terms will be displayable on the Internet, and as a result many of those who wish to compare terms offered by competitors or act cooperatively to purchase may do so.

As the Restatement comments “Standardization of agreements serves many of the same functions as standardization of goods and services; both are essential to a system of mass production and distribution. . . . Operations are simplified and costs reduced, to the advantage of all concerned.” (at page 120; emphasis added).

Historically, there have been much professional comment on contracts of adhesion.

At the ALI meeting, a motion of the sense of the house by Professors Braucher and Linzer carried on a close vote: “The current draft of proposed UCC Article 2B has not reached an acceptable balance in its provisions concerning assent to standard form records and should be returned to the Drafting Committee for fundamental revision of several related sections governing assent” (including Sections 2B-203, 207, 208, 111 and 304).

The ALI Ad Hoc Subcommittee has suggested that the Drafting Committee consider (i) developing in the official comments the empirical and procedural factors appropriate to meet the standards of “conspicuous” and conduct that “clearly indicates” assent, and/or (ii) including some more specific standards in the black letter.

The Drafting Committee will review these suggestions on July 23 and may propose changes responsive to the concerns by errata sheets at the Annual Meeting.

4. Battle of Forms. 2B-203 and 2B-209. The battle of forms has had, and continues to have, no adequate answer. White and Summers state with respect to existing Article 2:

“More often, one or both parties will perform and a dispute will break out. In all these cases the parties will haul out their forms and read them -- perhaps for the first time -- and they will find that their forms diverge. Is there a contract? If so, what are the terms?” (at page 7).

“Not only does 2-207 suffer from being designed for the swamps yet called upon to fight in the desert, it also suffers because the desert terrain has proved to be so varied. (at page 9).”

The Drafting Committee (after efforts to design knock-out rules for both swamps and desert) concluded that it could not successfully draft definitive rules for all cases and therefore 2B-209 states general rules to guide courts when disputes arise. The case-by-case resolution appears to be the only approach for which a consensus can be forged.

5. Choice of Law (2B-107) and Forum (2B-108). At the ALI, two motions were presented by Professor Woodward. One was debated on deferring to Article 1 for choice of law, which motion on a split vote was not carried; and the other to delete choice of forum was not discussed for lack of time.

Article 4A, 5 and 8 all permit choice of law overriding Article 1. Under common law, Parties in commercial transactions do regularly choose the governing law even though the law chosen may

not bear a “reasonable relationship” to the transaction. In electronic commerce, where the licensee location may often be unknown and the network may involve many jurisdictions, commerce is best promoted by allowing the parties to select the substantive law (see White House Paper at page 6).

Article 2B-107 specifically provides that with respect to consumer transactions the law chosen cannot vary a rule that is for consumer protection.

2B-108 provides the exclusive choice of a forum cannot be “unreasonable and unjust.” This standard is the one followed by recent decisions by both state and federal courts, and parallels that of the Restatement of Conflicts of Law.

The ALI Ad Hoc Subcommittee suggests the Drafting Committee consider the formulation of Choice of Law in the current preliminary work of the Article 1 committee. It also suggests that the Drafting Committee consider leaving Choice of Forum to developing decisional law.

The Drafting Committee on July 23 will review the ALI suggestions from the floor and provide further thoughts to the Committee of the Whole.

6. Interface with IP Law. Concern has been expressed on whether Article 2B affects intellectual property law.

In 1997, the ALI passed the McManis motion by a narrow margin to require Article 2B to prohibit contractual provisions inconsistent with federal policies. The Conference received many communications from federal agencies and others opposing the McManis motion, and by voice vote in 1997 the Committee of the Whole overwhelmingly rejected the McManis proposal.

The Drafting Committee, however, spent much time in three of its five meetings considering the McManis concerns and inserted into the draft 2B-105 which clearly states that provisions preempted by federal law are preempted. The comments will state that Article 2B is neutral on the policy issues that are being fought out in Congress.

McManis, however, presented a revised motion to the ALI that the draft has not reached an acceptable balance of neutrality. The motion before the ALI did not pass.

Concern also has been expressed that Article 2B might be applied to displace existing state law. The Drafting Committee at its May meeting inserted a new provision, 2B-105(b), to clearly state that unfair competition and trade secrets law are not displaced by Article 2B.

The Drafting Committee also has modified the definitions of “Information” and “Information Rights” along with other related changes in other substantive sections, to clarify and adhere to the neutrality of the draft on substantive intellectual property rights. Also, the official comments will state affirmatively the policy of neutrality in the application of Article 2B.

7. Warranties

Article 2B generally follows Article 2 for express and implied warranties and for informational content common law.

The ALI Ad Hoc Committee has suggested that the Drafting Committee review again 2B-402(c) with respect to express warranties and 2B-404 for implied warranties with respect to published informational content which the Drafting Committee will do at its July 23 meeting.

8. Official Comments

The ALI Ad Hoc Committee has suggested that the Official Comments include references to the fact that the topics of viruses and electronic self-help are not covered but left to other law. Also, it was suggested that the European Directives be discussed and referenced in the Official Comments. This will be done.