MEMORANDUM

To: Leianne Crittenden and Neil B. Cohen,
Co-Chairs of Subcommittee on Bundled Hardware, Software, and Service Transactions
From: Stephen L. Sepinuck
Date: August 31, 2020
Re: Subcommittee's Report and Recommendations

INTRODUCTION

The Subcommittee's first report (January 27, 2020) observed that "an increasing number of transactions include both goods and technology services," and discussed the "implications of that trend for the transactional needs for predictability and certainty of rights." As I understand it, the Subcommittee was and is concerned that both of the tests that courts use to determine whether Articles 2 and 2A apply to a hybrid transaction (*e.g.*, goods/services, goods/software, etc.) – the predominant purpose test and the gravamen of the claim test – are difficult to apply. As a result, contracting parties often do not know in advance what law will govern their transaction, courts struggle to resolve disputes, and in doing so they reach inconsistent results. The concern is that uncertainty, difficulty, and inconsistency will be exacerbated as hybrid transactions become more prevalent (*i.e.*, as hybrid transactions both increase in number and become an increasing percentage of transactions involving goods).

In the Subcommittee's second report (May 22, 2020), the Subcommittee recommended the following resolution of this problem:

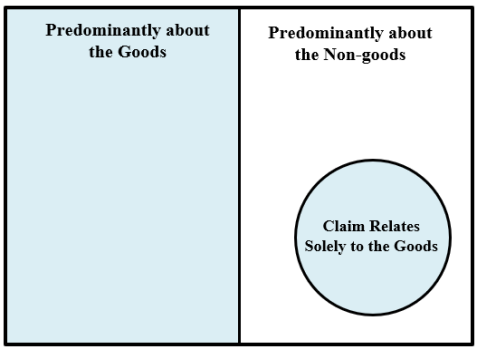
> In a bundled transaction involving both goods and non-goods, in deciding whether the parties' rights are determined under Article 2/2A (as applicable) or other law (typically the common law of contracts), the predominant purpose test should be applied in most cases. However, if a matter arises that 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.

I am writing to suggest that this recommendation is unlikely to address the problem, and in fact is likely to exacerbate the problem. I then suggest an alternative that might actually be what Subcommittee truly intends.

SUBCOMMITTEE'S RECOMMENDATION

Under current law, all or virtually all states use the predominant purpose test to determine what law applies to hybrid transactions.[1] Under that test the universe of hybrid transactions is bifurcated, and Article 2 (or 2A) applies to the those that are predominantly about the sale of goods (the shaded area in the diagram below):

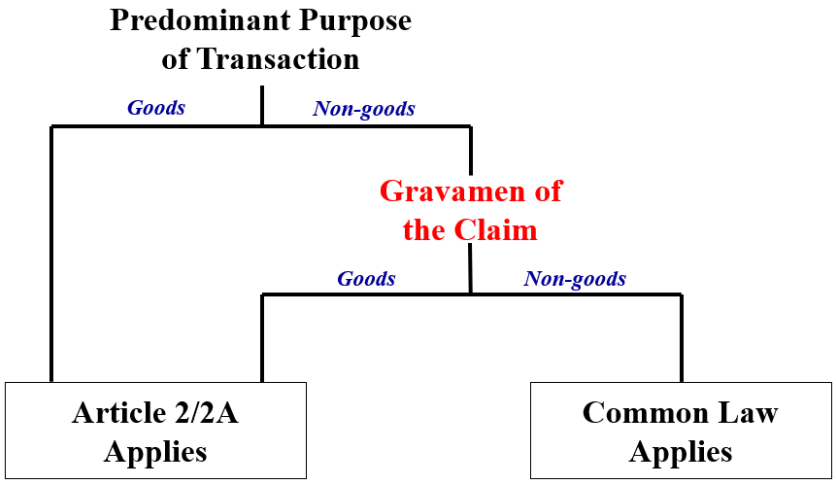
Under the Subcommittee's proposal, a portion of the claims arising in transactions that are predominantly about the non-goods aspect of the transaction – those claims that relate solely to the goods – will be governed by Article 2 (or 2A). As a result, the transactions and claims governed by Article 2 (or 2A) will increase (again the shaded are in the diagram below):



If the problem with current and projected law were that Article 2 (and 2A) is applied too narrowly, then the Subcommittee's proposal might be a proper and elegant solution. But the problem is not, as

[1] It is not clear that any state follows the gravamen of the claim test. The test appears to have originated in Maryland in Anthony Pools v. Sheehan, 455 A.2d 434, 441 (Md. 1983). *See also* J.O. Hooker & Sons, Inc. v. Roberts Cabinet Co., 683 So. 2d 396, 400 (Miss. 1996) (stating that the test in a mixed transaction – a construction contract – turned on the nature of the contract and "upon whether the dispute in question primarily concerns the goods furnished or the services rendered under the contract"). However, even courts in Maryland apparently now use the predominant purpose test. *See* Lohman v. Wagner, 862 A.2d 1042 (Md. Ct. Spec. App. 2004) (applying the predominant purpose test without even mentioning or citing to *Anthony Pools*); DeGroft v. Lancaster Silo Co., 527 A.2d 1316 (Md. Ct. Spec. App. 1987) (applying the predominant purpose test despite citing *Anthony Pools*). *See also* Jones v. Cecil Sand and Gravel, Inc., 627 A.2d 60, 63 n.1 (Md. Ct. Spec. App. 1993) ("Maryland has established two tests for determining whether a contract is for the sale of services or goods."); P/T Ltd. II v. Friendly Mobile Manor, Inc., 556 A.2d 694 (Md. Ct. Spec. App. 1989) (acknowledging the existence of both tests and concluding it was unnecessary to determine which applies).

I understand, that Article 2 (and 2A) applies too narrowly; it is that its application is too uncertain, too difficult to determine, and too inconsistent. Increasing the scope of Article 2 (and 2A) could potentially address this problem. If, for example, the two shaded portions of diagram above collectively comprised the vast majority of transactions involving goods (the diagram is not drawn to scale), that might provide a measure of certainty about what law applies. But we lack the information needed to conclude that the Subcommittee's proposal would produce this result. What we do know is that, as demonstrated by the chart below – a decision tree that courts would have to use to determine whether to apply Article 2 (or 2A) – the Subcommittee's recommendation would add a second layer of analysis (the question in red):



Thus, in many transactions – all those for which the predominant purpose is the sale of goods, the analysis would be the same as under current law. Accordingly, all the uncertainty, difficulty, and inconsistency that exists now would still exist. For all the remaining transactions, a second question would have to be answered: what is the gravamen of the claim?[2] Answering that question can be just as difficult as determining the predominant purpose of the transaction. In short, the uncertainty and difficulty of one issue would be compounded by an equally challenging second issue. That is not a recipe for increasing certainty or for making matters easier to determine. Indeed, it would seem likely to do the opposite: increase *un*certainty.

There is at least one other problem with the Subcommittee's proposal to engraft the gravamen of the claim test onto the predominant purpose test, a problem inherent in the gravamen of the claim test itself (at least to the extent that the test is viewed as relating to the scope of Article 2).

[2] A court might, however, choose to disregard the first question – whether the transaction is primarily about goods or non-goods – and address only the second question if it were to conclude that the claim relates solely to the goods. The Subcommittee's second illustration followed that approach.

Article 2 applies to "transactions" in goods. § 2-102. Article 2A similarly applies to any "transaction" that creates a lease of goods. § 2A-102. But the gravamen of the claim does not focus on the *transaction*, it focuses on the *claim*. This can lead to a situation in which the transaction is seemingly outside the scope of Article 2 (or 2A) but the claim is nevertheless somehow governed by it. It is unclear how this works, and it creates complexities if the dispute involves issues or claims in addition to one relating solely to the goods.

For example, if a hybrid transaction is predominantly about the non-goods aspect of the transaction, then presumably any contract formation question would be governed by the common law, not by the rules of Article 2 (or 2A), such as §§ 2-206 and 2-207. Is a court to apply the common law to determine if a contract exists – and if a contract does exist, what is terms are – with respect to any claim relating to the non-goods but apply the very different Article 2 rules with respect to a claim relating solely to the goods? That does not seem workable. Do different statutes of limitations apply?

These issues can be illustrated by varying the facts of the following illustration in the Subcommittee's report:

> 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.

What if we alter the facts slightly so that the dispute arises *after* Vendor started to perform? If Truck Mechanic asserts a claim that arguably relates solely to the goods aspect of the transaction, is the

contract formation issue governed by the common law or by the UCC? Is the formation issue governed by the UCC only with respect to the claim relating to the goods, so that there might be a contract only with respect to a portion of the transaction? Note, due to part performance, a contract might be formed under either Article 2 or the common law but the terms of the contract might differ significantly depending on which legal regime governs the formation process (the "last-shot" rule vs. § 2-207). Which law applies to determine whether an express warranty is part of the contract? Which law applies to determine whether a warranty disclaimer was part of the agreement and whether it is effective? In short, it is tempting to suggest that Article 2 would apply only to the "claim" relating solely to the goods, leaving all other issues such as formation and terms to the common law, but it is far from clear whether that structure would really work or lead to results that are consistent with other UCC rules and policies.

There might be other complications with the Subcommittee's proposal. For example, § 2-601's perfect-tender rule provides the buyer with remedies for breach "if the goods *or the tender of delivery* fail in any respect to conform to the contract" (emphasis added). If the claim relates solely to the goods, would this somehow nevertheless make the tender of delivery in a transaction that is primarily about non-goods subject to the perfect-tender rule? Would that be desirable?

Finally, absent other changes to the text of Article 2, simply applying the Article to claims relating to the goods might not achieve the Subcommittee's objective. That is because the Article 2 warranty of merchantability applies in a contract for sale. § 2 314(1). If the *transaction* is not governed by Article 2, then no such warranty would exist regardless of the nature of the *claim* asserted. In connection with this point, a brief review of the *Anthony Pools* decision, in which the gravamen of the claim test originated, might be helpful.

As you no doubt remember, the decision involved the installation of an in-ground swimming pool with a diving board. One of the claims was that the diving board was defective. The court concluded that the predominant purpose of the transaction was the furnishing of labor and services,[3] but chose to depart from the predominant purpose test in part due to the fact that the agreement described the plaintiff as "Buyer," expressly stated that Anthony Pools agreed not only to construct the pool but also to sell related goods, such as the diving board, and that the diving board remained detachable.[4] Moreover, as the court pointed out, had the board been purchased in a separate transaction, there would have been an implied warranty of merchantability.[5]

[3] 455 A.2d at 439.
[4] *Id.* The terms of the contract and the detachability of the goods might be different in other goods-services transactions.
[5] *Id.* Note, in a goods-software hybrid transaction, it might not be possible to purchase the goods separately.

The court's analysis was also influenced by the fact that Maryland has a non-uniform version of § 2-316, which provides that its provisions "do not apply to sales of consumer goods . . . services, or both."[6] This non-uniform reference to "services" was problematic. If the predominant purpose test applied, there would be no warranty of merchantability, and hence the reference to services in § 2-316 would be unnecessary. The non-uniform text, the court concluded, was "predicated on a legislative understanding that warranties under the U.C.C. are implied as to the goods" in transactions that are predominantly services transactions.[7]

Most important, the court did *not* then rule that Maryland's Article 2 applies in hybrid transaction if the claim is predominantly about the goods. Instead, it ruled that where:

> consumer goods are sold which retain their character as consumer goods after completion of the performance promised to the consumer, and where monetary loss or personal injury is claimed to have resulted from a defect in the consumer goods, the provisions of the Maryland U.C.C. dealing with implied warranties apply to the consumer goods, even if the transaction is predominately one for the rendering of consumer services.[8]

In short, the court's ruling can be viewed – and is better viewed – not as about the scope of Article 2 generally, but as about the scope of the warranty of merchantability.

SUGGESTION

Instead of engrafting the gravamen of the claim test onto the predominant purpose test – that is, instead of approaching the issue as one relating to the scope of Article 2 (or 2A), simply extend the warranty of merchantability to transactions that are not predominantly sales or leases of goods. This approach, which is essentially what the court in *Anthony Pools* did – avoids the thorny issues discussed above, such as those about contract formation and the perfect tender rule. Sections 2-207 and 2-601 would continue to apply only to transactions that are predominantly a sale of goods.[9] Nevertheless, this approach should reduce uncertainty. That is because the issue of scope arises most commonly in connection with claims for breach of the implied warranty of merchantability. If the warranty applied not merely to transactions in which the sale or lease of goods predominates, but also to transactions in which the non-goods aspect predominates, the issue of scope might well disappear. In other words, if the goods aspect of the transaction were covered by the implied

[6] Md. Code Ann., Com. Law § 2-316.1(1).
[7] 455 A.2d at 441.
[8] *Id.*
[9] Section 2-601 refers to both the "contract" and the "buyer," and hence is limited, as most of Article 2's provisions are, to contracts for the sale of goods. *See* § 2-106(1). Subsections (2) and (3) of § 2-207 are similarly limited. It is less clear whether § 2-207(1) is so limited.

warranty of merchantability regardless of the transaction's predominant purpose, then the parties would be less likely to dispute the predominant purpose of the transaction, and the uncertainty relating to that issue would become less material.

One way to accomplish this suggestion would be to borrow language from the definition of "inventory" in § 9-102(a)(48)(C) to expand § 2-314(1), so that the warranty of merchantability applies not merely in "a contract for . . . sale," but also when goods are "furnished under a contract of service."[10] A similar change could be made to § 2A-212, if that were deemed desirable.[11] Unfortunately, this approach addresses hybrid transactions involving goods and services but does not address hybrid transactions involving goods and software or other emerging technologies. To address those, perhaps the definition of "goods" in Articles 2 and 2A could be revised to more closely resemble the definition of "goods" in Article 9.

Regardless of how the amendment is drafted, contracting parties might still litigate whether the warranty was breached. And that might entail a fight about whether the claim arises from the goods or the non-goods aspect of the transaction (unless the warranty were expanded to cover the non-goods aspect of the transaction).[12] But in most cases, the predominant purpose of the transaction would become a non-issue.

CONCLUSION

My thanks to the Subcommittee for its work to date and for considering this memorandum. If it would be helpful, I would be happy to provide whatever additional materials the Subcommittee might desire in connection withs its deliberations on this matter.

[10] Because § 2-314 already references § 2-316, there should be no need to amend § 2-316 to make it govern whether a disclaimer of the implied warranty is effective.

[11] Because of how they are currently worded, expanding the implied warranties of fitness for particular purpose in §§ 2-315 and 2A-213, if that were desired, would seem to require a different approach.

[12] The warranty of merchantability, as currently phrased, deals only with the goods. So, even if the warranty applied in transactions that were predominantly about the non-goods aspect of the transaction, the warranty would relate only to the goods aspect. If the Committee deemed it desirable, the scope of the warranty could also be extended to cover the non-goods aspect of the transaction, but that would be a far more significant change, appropriate only after extensive study.