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.

ATTACHMENT A

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

Date: January 27, 2020

This subcommittee engaged in one live group discussion and in further email discussions generated by questions posed to the subcommittee members. This memorandum describes the issues that arose in those discussions. Some individuals and groups have indicated that they intend to supplement the points made in those discussions with additional memoranda. We will pass along those memoranda when they arrive.

Discussions within the subcommittee focused on the observation that an increasing number of transactions include both goods and technology services (such as access/cloud services) and the implications of that trend for the transactional needs for predictability and certainty of rights. This observation led to several questions:

1. In a dispute arising out of such a contract (traditionally referred to as a "mixed" or "hybrid" contract and more recently often referred to as a "bundled contract") 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. (The view was also expressed that, if the current practice of having one body of law govern the entire transaction is continued, consideration should

be given to having the UCC govern if matters within the scope of the UCC are a *substantial* aspect of the transaction even if they do not predominate.) In light of the prevalence of the predominant purpose test in most states, adopting a rule of the sort advocated by subcommittee members would probably require a change to the text of UCC Articles 2 and 2A.

2. 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 mixed/hybrid/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 that uncertainty with respect to this issue is harmful to the marketplace.
3. Consider a mixed/hybrid/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? Is explicit "hell or high water" language enforceable? 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. It should be noted, however, that
    a. Such potential harm is mitigated in transactions in which the agreement contains language providing that the lessee agrees not to assert against an assignee any claim that it may have against the assignor by the fact that, if the lessor assigns its rights to be paid under the contract, UCC § 9-403 will prevent most of the lessee's defenses from being asserted against the assignee.
    b. Nothing in Article 2A prevents giving effect between the parties to express "hell or high water" language in the contract. Rather, as noted in Comment 6 to UCC § 2A-407, that section does not address the enforceability of such express language and the "issue will continue to be determined by the facts of each case and other law which this section does not affect."

In addition, during the subcommittee conference call, the issue was raised whether the provisions of Article 2 and Article 2A are sufficient to protect a consumer's interest in "smart goods" (however defined). This did not generate much attention in response to the follow-up memorandum sent to subcommittee members. One member said that the matter should be

discussed further, while another stated that, while UCC provisions are not sufficient to protect a consumer's interest in hybrid "smart goods" transactions, the "UCC was never intended to be a statute one of whose purposes was to protect consumers, and it does not do so."