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Now UCITA, Now You Don't

A Bankruptcy Practitioner's Observations on the Proposed Uniform Computer Information Transactions Act

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In 2004, we often take for granted the magic wrought by computers. While computers have made many machines (also, businesses and industries) disappear, so too has the primary legislation proposed to address transactions involving computer information all but disappeared. Yet the developments in the computer age that 12 years ago spawned the effort to create the Uniform Computer Information Transactions Act (UCITA)[2] and the issues they raise persist. They may be coming soon to a bankruptcy court near you.

UCITA began as a proposal for a Uniform Commercial Code that applies to any contracts for computer information (such as the licensing of computer software or databases). The American Law Institute (ALI) and the American Bar Association (ABA) jointly conceived UCITA for the laudable purpose of bringing uniformity and certainty to the rules that apply to software transactions. At some time during the past 12 years, however, certain constituencies, including ALI, began opposing UCITA for the stated reasons that it is heavily biased in favor of large software publishers and licensors. These oppositions culminated in the ABA's rejection of UCITA and its relative disappearance. Yet today UCITA's supporters maintain that the proposed law would provide much-needed standards relating to the licensing of digital information. Although it has not been adopted as a uniform law in the 50 states, certain state and federal courts have relied on UCITA in addressing disputes involving computer information transactions. The purpose of this article is to inform bankruptcy practitioners about the basic principles of UCITA, the support and opposition to its proposed rules, the types of issues UCITA seeks to address, and how UCITA could affect their daily bankruptcy practice.

Background of UCITA

UCITA began in the early 1990s with a study by a subcommittee of the ABA. The subcommittee concluded that there was a compelling need for clarity and certainty in licensing transactions of computer information and recommended to the National Conference of Commissioners on Uniform State Laws (NCCUSL) that a uniform act be drafted. Simply stated, because computer information transactions had become a significant factor in the national and even international economy, a codification of the law governing computer information seemed logical and desirable. Accordingly, as with all other uniform laws, NCCUSL and ALI jointly conceived of UCITA (as Article 2B of the Uniform Commercial Code (UCC))[3] as being largely patterned after Article 2 concerning sales of goods. In early 1999, ALI withdrew its participation in the drafting of UCITA, citing reservations relating to the substance and technical quality of the proposed law.[4] Nevertheless, NCCUSL continued on its own to complete the proposed act as a freestanding uniform law not encompassed within the UCC. On July 29, 1999, NCCUSL promulgated a model statute covering computer information transactions.

Since its promulgation, various groups have expressed displeasure with UCITA's drafting, asserting that the proposed law heavily favors licensors and violates consumer protection laws. In response to the numerous oppositions to UCITA, NCCUSL proposed 19 amendments in 2002. Despite the amendments, the ABA's Business Law Section, in concert with ALI, voted to postpone indefinitely any consideration of UCITA and ultimately, if UCITA's merits are ever raised for approval, to vote against such approval.[5] On Feb. 10, 2003, NCCUSL withdrew a resolution recommending approval of UCITA by the American Bar Association House of Delegates. On Aug. 1, 2003, NCCUSL discharged the standby committee for UCITA.

It appears unlikely that UCITA will become a part of the UCC. In fact, to date only two states, Maryland and Virginia, have adopted UCITA.[6] Of equal (if not greater) significance is the fact that several states enacted so-called "bomb shelter" legislation, declaring choice-of-law and choice-of-forum provisions of a contract purporting to be governed by UCITA to be void and unenforceable, as contrary to the state's public policy, if one of the parties to the contract is a resident of the state.[7]

Basic Principles of UCITA

In 2002, the ABA Working Group stated that UCITA "is a very complex statute that is daunting for even knowledgeable lawyers to understand and apply."[8] Nevertheless, a summary of the fundamental principles of UCITA should provide bankruptcy practitioners enough information to recognize the issues UCITA identified and attempted to resolve.

1 This article is strictly the opinions of the authors and should not be attributed to any of the clients of Hahn Loeser + Parks LLP. Daniel DeMarco is Board Certified in Business Bankruptcy Law by the American Board of Certification.

2 Unif. Computer Info. Transactions Act (NCCUSL, 2002); *See, generally,* "Computer Professionals for Social Responsibility," *UCITA Fact Sheet,* available at www.cprs.org/program/UCITA/ucita-fact.html (last updated April 10, 2002).

3 Article 2A of the Uniform Commercial Code governs the leasing of goods.

4 *See* Letter from Michael Traynor, American Law Institute President, to ALI Members, available at www.ali.org/ali/R2502_03_Letter.htm (last visited March 28, 2004).

5 In total, UCITA failed to garner support from six ABA sections, including the Business Law, Intellectual Property, Litigation, Torts and Insurance Practice and Science and Technology sections. In addition, two committees, the Section Officers' Council's Technology Committee and the ABA Standing Committee on Law and National Security, failed to support the passage of the resolution.

6 *See* Md. Code Ann., [Com. Law I] §22-101 *et seq.* (2003); Va. Code Ann. §59.1-501.1 *et seq.* (Michie 2002).

7 Specifically, Vermont, Iowa, North Carolina and West Virginia have adopted anti-UCITA bomb shelter legislation.

8 *See American Bar Association Working Group Report on the Uniform Computer Information Transactions Act (UCITA),* (Jan. 31, 2002), available at www.abanet.org/leadership/ucita.pdf.

UCITA's rules govern the licensing of, and contracts for, computer information from formation through performance, including remedies if there is a breach of contract. UCITA is predicated on the following basic principles: (1) the paradigm transaction is a license of computer information, rather than the sale of goods (as in UCC Article 2); (2) innovation and competitiveness have come from small entrepreneurial companies as well as larger companies; (3) computer information transactions engage fundamental free-speech issues; (4) a commercial law statute should support freedom of contract and interpretation of agreements in light of the practical commercial context; and (5) a substantive framework for Internet contracting is needed to facilitate commerce in computer information.[9] According to NCCUSL:

> Most of the rules in UCITA are the traditional and familiar rules of contract from the law of sales and from the common law, but adapted to the special nature of computer information licensing contracts. A licensing contract involves transferring computer information such as software from a vendor (called licensor) to recipient (called licensee). A license grants information[al] rights to the licensee. Informational rights include any intellectual property rights derived from copyright, patents and the like, but also all other rights in information that any other law provides to a person that allows control of the information or restrict[ion] on the use of the information by other persons. The difference between a licensing contract and a sale contract is that the license generally contains restrictions on use and transfer of the computer information by the licensee during the life of the contract, and it may or may not transfer title to the licensee.[10]

Below is a list of certain issues and how they are treated by UCITA according to NCCUSL:

- *Express Warranties:* As under UCC Article 2, an express warranty is created by any representation or promise that becomes part of the basis of the bargain of the parties. UCITA expressly recognizes that this might occur through statements in advertising.
- *Contract Formation (generally):* UCITA provides that a person does not manifest assent to terms of a contract in a record unless the person's manifestation of assent is made after having had an opportunity to review the terms. It provides guidance on what each of these standards means. These standards are consistent with the Restatement of Contracts.
- *Contract Formation (online):* UCITA provides guidance for the creation of contracts online that collect and reflect majority case law. Again, a consent to terms must come after an opportunity to review them, and the terms must be presented in a way that ought to call them to the attention of a reasonable person.
- *Contract Formation ("later terms"):* UCITA acknowledges that terms presented after the initiation of the contracting process can become part of a contract. UCITA will allow this to occur so long as (1) the other party had reason to know terms would be presented later, (2) that the party manifested assent to the terms after having an opportunity to review them and (3) that the party had a right to return and receive a refund if it did not agree to the terms.
- *Transferability of a License:* UCITA provides that contractual rights under a license are presumptively transferable unless (1) the transfer would materially harm the other party, (2) other law, such as Bankruptcy Code §365, precludes transfer or (3) the contract itself precludes transfer.
- *Electronic "Self-help":* Electronic self-help refers to the use of technology controls to prevent continued use of software or other digital information in the event of a breach of contract. UCITA originally supported the use of this technology. In its most recent draft, however (proposed in 2002 in a scramble to diffuse opposition), UCITA bans such action because NCCUSL believed that it presented too great a risk for licensees.[11]

While on its face UCITA may appear rather benign and practical, its opponents cite two prominent features that have caused serious concerns among different groups. First, UCITA validates terms held back until after payment and delivery, presented in so-called "shrink-wrap"[12] contracts. Second, it recharacterizes software and digital content contracts as "licenses" of use, rather than sales of copies, raising two issues that critics contend will require a vast amount of litigation to resolve. The first issue is whether consumer protection laws applicable to "sales" of goods and services apply to UCITA transactions. The second is whether software and digital content providers can use license terms to rewrite a user's basic intellectual property deal, *e.g.*, by taking away the right to transfer a copy or quote content. These two features, among others, started the swell of discontent that turned into a fatal (so far) tidal wave of opposition.

Support of and Opposition to UCITA

UCITA supporters believe UCITA sets up a uniform contracting regime for licenses of information and provides a "road map" for practitioners who may not be experienced in licensing. They believe it provides clear rules that must be followed in order for shrink-wrap contracts to be enforceable and puts limits around the exercise of electronic self-help. Certain supporters urged UCITA's passing based on the basic pro-contractual orientation of the proposed legislation. Relying on parties' ability to freely negotiate contractual terms, UCITA's supporters assert that it is proper to treat the UCITA provisions as "default provisions, which the parties should be able to vary at will."[13] Even in the case of an ordinary consumer who may not have a meaningful opportunity to negotiate a license, supporters claim the enforcement of shrink-wrap licenses and other forms of modern automated contracting are in concert with the most recent reported court decisions on the topic. Thus, in the view of UCITA supporters, UCITA provides the fundamental framework for providing needed standards for dealing with computer information licenses.

Conversely, UCITA's opponents claim that the proposed laws will undermine consumer and privacy protection by changing the rules for purchase and use of computer software and information products for businesses, individuals and nonprofits alike.[14] In essence, the opposition believes that UCITA would validate a shrink-wrap approach to electronic licensing, superseding consumer protections, copyright law and privacy protections. Most notably, UCITA's detractors claim UCITA would change

9 *See* Dively, Mary Jo Howard and Ring, Carlyle C. Jr., *Overview of Uniform Computer Information Transactions Act* (unpublished support material illustrating an overview of UCITA).

10 *See Summary of Uniform Computer Information Transactions Act*, available at www.nccusl.org/nccusl/uniformact_summaries/uniformacts-s-ucita.asp (last visited March 28, 2004).

11 *See UCITA FACTS*, available at www.nccusl.org/nccusl/ucita/UCITA_Facts.pdf (last visited March 29, 2004).

12 Shrink-wrap licenses are the licenses that typically accompany a piece of software and state that if you open the shrink-wrap or break the seal on the software envelope you are bound by the terms of the license, whether or not you had the chance to read the whole agreement.

13 *See* letter from Prof. Richard A. Epstein, professor of law, University of Chicago Law School, to House of Delegates, American Bar Assoc., available at www.nccusl.org/nccusl/ucita/ucita/Epstein_UCITA.pdf (last visited March 29, 2004).

14 Among others, the most vocal opposition to UCITA came from the ALI, ABA, American Association of Law Libraries, American Library Association, Association of Research Libraries, the Special Libraries Association, the Medical Libraries Association, the Art Libraries Society of North America and the Association of American Universities.

software and informational purchases in the following ways:

- The software would no longer belong to the buyer because consumers would become licensees who are bound to the terms of the contract provided in shrink-wrap products or "click-on" agreements. Furthermore, UCITA allows restrictions on use to be revealed after purchase and it allows software publishers to change the terms of the contract after purchase.
- UCITA would permit invasions of privacy because the legislation allows software publishers to legally track and collect confidential information about the personal and business activities of licensees. Similarly, UCITA would allow software and information products to contain "back-door" entrances, potentially making users' systems vulnerable to infiltration by unauthorized hackers.
- UCITA would allow software to be disabled without modification. For example, it allows software publishers to shut down mission-critical software remotely without court approval and without incurring liability for the foreseeable harm caused. In addition, UCITA allows software publishers to modify the terms of contracts after the sale simply by sending an e-mail—regardless of whether the consumer receives the notification or not. Essentially, UCITA would place consumers at the mercy of software publishers to "blackmail" users for more fees by their unhindered ability to disable or remove their product for unspecified "license violations."
- UCITA would threaten existing privileges granted under federal copyright laws for three distinct reasons. First, UCITA would permit an end-run around federal copyright law in mass-market licensing agreements that are used by virtually all consumers and that are the mainstay of most library and business operations.[15] Second, UCITA would threaten fair-use privileges that allow for the provision of fundamental library services like interlibrary loans, archiving and preservation. Third, UCITA would threaten "first-sale" privileges that permit donation, transfer or resale of a product.[16]
- UCITA sets forth several express and implied warranties. Under UCITA, licensor advertising can constitute an express warranty. The licensor warrants by implication that (1) computer information is free of infringement and misappropriation claims by third parties; (2) the licensor will not itself interfere with enjoyment of the license; (3) computer programs are fit for the ordinary purpose for which they are used; (4) a provided system of computer programs will function as a system; and (5) the provided computer information is accurate. The licensor may also expressly disclaim any of these warranties (as large vendor form contracts typically do).
- UCITA contains licensor self-help remedies. Generally, when a licensor cancels a license, the licensor may repossess all licensed information, including software. Under UCITA, in some limited circumstances, the licensor may do so on its own without court intervention. The licensor may even use electronic self-help such as a software "kill switch."[17]

Considering the fact that NCCUSL withdrew UCITA from the ABA's agenda during its February 2003 House of Delegates meeting and stated that it has "no intentions of bringing [UCITA] back to the House," it appears for the foreseeable future that UCITA's opponents have prevailed.[18] Notwithstanding UCITA's defeat, its ideas, policies and concepts have become airborne and permeate computer information licenses. Moreover, the software companies drafting the shrink-wrap licenses no longer need to concern themselves with injunctions on electronic self-help measures, software ownership issues, and standards for expressed and implied warranties. Accordingly, it will be important for bankruptcy practitioners to familiarize themselves with some of these concepts and how the concepts may affect bankruptcy law.

UCITA and the Bankruptcy Code

Historically, the Bankruptcy Code has changed to adjust to the trends in the economy and society. A timely example is the recent legislation to overhaul the Bankruptcy Code in the post-Enron economy. Regardless of the changes, the Bankruptcy Code retains its essential charge to weigh the goal of the debtor's fresh start against creditors' legal rights, and attempts to strike a fair balance between both these interests and the interests of third parties. The Bankruptcy Code also attempts to provide balance among different creditors' individual interests, seeking results that achieve a fair distribution among creditors based on the consistent application of well-settled principles in bankruptcy. The result is creditor treatment under the Bankruptcy Code that is different than under non-bankruptcy law, quite often including curtailment or elimination of non-bankruptcy rights.[19]

The question for a bankruptcy practitioner with respect to UCITA is how it will impact the Bankruptcy Code and vise versa. At the outset, the answer is simple: the Code is codified federal law, while UCITA is a (failed) attempt to provide uniform standards to a developing phenomenon that touches nearly every facet of the economy. Under the Supremacy Clause,[20] the Bankruptcy Code will supersede any and all theories set forth in UCITA. Although several aspects of UCITA merit further consideration in the bankruptcy context, this article will focus on two areas of bankruptcy practice that may be affected by the ideas cultured in UCITA: (1) property of the estate and (2) assumption and assignment of an executory contract.

Is a License Property of the Bankruptcy Estate?

Under §501 of UCITA, a licensor retains ownership to the computer information that may be included in a license, unless conveyance of ownership is specifically provided for in an agreement. To be clear, ownership (title) to a copy is distinguished from ownership of intellectual property rights. While a license may provide a licensee certain rights with respect to that copy, the license does not convey ownership of the underlying intellectual property rights. This is a fundamental principle of intellectual property law. A licensor's retained ownership of the underlying intellectual property right is also the major difference between a license and an assignment of the intellectual property rights.[21] Furthermore, §502 of UCITA provides that ownership of a copy is determined by the license itself. Thus, arguably, a licensee could never obtain title to a copy if the shrink-wrap license prohibits such a title transfer.

Conversely, pursuant to §541 of the Bankruptcy Code, a bankrupt's estate

15 "Mass-market" transactions under UCITA generally include transactions directed to the general public as a whole under substantially the same terms with no more than minor customization involved. Mass-market transactions typically involve "shrink-wrap" licenses or "click-on" licenses. For such transactions, UCITA provides the licensee a right of return if the mass-market license is not available for review before the licensee becomes obligated to pay.

16 *See* Americans for Fair Electronic Commerce Transactions (formerly 4CITE), "Why We Oppose UCITA," available at affect.ucita.com/why.html (last visited March 28, 2004).

17 However, electronic self-help is subject to several restrictions: (1) It is not available for mass-market transactions; (2) the licensee must separately agree to a contract provision permitting electronic self-help; and (3) notice must be given at least 15 days in advance of the self-help repossession.

18 Burnett, K. King, Statement by NCCUSL President Burnett to ABA House of Delegates Regarding UCITA, (Feb. 10, 2003), available at www.nccusl.org/nccusl/ucita/UCITA_withdrawal.pdf (last visited March 31, 2004).

19 Agin, Warren E., "Reconciling Commercial Law and Information Technology: An Essay on Bankruptcy Practice during the Next Business Cycle," available at www.swiggartagin.com/articles/reoncile.html (last visited March 28, 2004).

20 U.S. Const. Art. VI.

21 Be aware that case law exists wherein courts have determined that the licensor "licensed away" all if its ownership to a licensee, thereby creating an assignment of the intellectual property rather than a license of the intellectual property.

consists of "all legal or equitable interest of the debtor in property as of the commencement of the case," wherever located and by whomever held. Thus, if a licensee of certain computer information files for bankruptcy, one expects the debtor, or the trustee, to claim that the licensed copy becomes property of the bankruptcy estate and therefore should be afforded all the protections as set forth in the Code. Even if a licensor contends that its license expressly provides that title to the copy does not transfer to the licensee, a chapter 11 debtor's need to use the software in order to operate a business, and its mere possession of the copy, should provide the debtor the requisite basis to establish an equitable interest for purposes of §541. Otherwise, licensors could hold debtors hostage by threatening to implement self-help provisions. Thus, it is likely that a copy of a computer information license will constitute property of a debtor's estate notwithstanding specific language to the contrary in the license or UCITA.

Another "property of the estate" issue that bankruptcy practitioners should be aware of is when the licensee seeks financing to purchase the licensed product, and in return, the financier becomes a party to the license. In this instance, UCITA §507 clearly provides that the contractual rights of a licensor are dominant with respect to the licensed information, regardless of any arrangement between the licensee and a financier. Essentially, the financier's contract cannot expand any of the licensee's rights under the license nor can the financier's contract alter any of the rights of the licensor. Conversely, pursuant to UCITA §507(2)(c), any additional conditions set forth in a financial accommodation contract between the financier and the licensee are acceptable and may create additional restrictions to the licensee's right to use the licensed information or rights.

Problems arise when the financier becomes the "licensee" of the licensed information and then transfers any interest to the end-user who files for bankruptcy. A question could exist as to whether the licensed information has become property of the estate as of the time of filing because UCITA §508 imposes additional requirements before the transfer to the end-user becomes effective. Again, as long as the end-user has actual possession of the licensed information by the bankruptcy filing date, the debtor's equitable interest in the property should likely trump UCITA or any language in a license that attempts to limit the scope of the conveyance of a property interest to the debtor.

Property-of-the-estate issues are particularly relevant to the applicability of the automatic stay.[22] UCITA §802 provides for the cancellation of a contract "for breach if the breach is a material breach of the whole contract which has not been cured or waived or the agreement allows cancellation for the breach." Thus, if a license agreement allows for the cancellation of the contract for failure to pay (a material breach), then the licensor may elect to implement its electronic self-help remedies. Thus, the question arises: Are such remedies stayed by a bankruptcy filing by the licensee? Assuming the license is property of the bankrupt estate, the answer is straightforward: yes. As one of the fundamental principles of bankruptcy law, the automatic stay prohibits "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate."[23] Moreover, stopping self-help provisions such as these is exactly why Congress adopted the automatic stay. If the license is property of the estate, the trustee or debtor-in-possession should have an opportunity to determine whether the license can benefit the estate before the licensor unilaterally terminates the contract and use of the intellectual property. Accordingly, as long as the license constitutes property of the estate, §362 will prevent a licensor from implementing electronic self-help provisions.

After the *Sunterra* Decision, Can a Debtor Assume a Software License over a Licensor's Objection?

UCITA and bankruptcy law also intersect when a debtor attempts to assume a license pursuant to §365 of the Bankruptcy Code. UCITA strongly promotes reliance on the language contained in the software license agreements, even in cases of shrink-wrap licenses. Thus, a licensor may take aggressive steps to prevent a debtor's assumption of the license by including language in the license agreement that prevents assumption (as well as an assumption and assignment). A licensor's motivation to include such provisions in its licenses has gained momentum from a recent decision in the appeals court for the Fourth Circuit.

On March 18, 2004, the Fourth Circuit Court of Appeals decided, pursuant to §365(c)(1)(B), that a debtor-in-possession (DIP) may not assume a non-exclusive software license over the licensor's objection. *RCI Technology Corp. v. Sunterra Corp. (In re Sunterra Corp.),* 2004 U.S. App. LEXIS 5131; 2004 WL 527832 (4th Cir. March 18, 2004). In *Sunterra,* the debtor and licensor entered into a software license agreement pre-petition. Prior to plan confirmation, the licensor filed a motion to compel the rejection of the software license. The debtor opposed the motion, asserting that the software license was not executory and that §365(c) should be interpreted only to prohibit a DIP from assuming and assigning a contract. Here, because the debtor only intended to assume the license (not assume and assign it), the debtor argued that §365(c) does not apply. For reasons not relevant to this article, the bankruptcy court and district court agreed with the debtor. The Fourth Circuit reversed and remanded the case, reasoning that the terms "assumption" and "assignment" described two conceptually distinct events, and that the non-debtor must consent to each independently. Thus, according to the *Sunterra* rationale, a licensor may unilaterally prevent a debtor from assuming a license, regardless of the benefit to the estate conferred by the software license.

A licensor's power, single-handedly, to prohibit a debtor from assuming a software license is a very powerful weapon, especially when (as is often the case) the software is critical to the existence and/or reorganization of the debtor. UCITA strongly supports the licensor having and exercising this power.

While it may appear that UCITA disappeared on Feb. 10, 2003, the issues it attempted to address persist and are increasingly likely to surface in bankruptcy settings. We hope that these observations will be useful to bankruptcy practitioners, as we all can expect to encounter UCITA issues, and courts guided by UCITA's principles, more frequently as computer information transactions become more prevalent in today's economy. ■

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[22] 11 U.S.C. §362(a).
[23] 11 U.S.C. §362(a)(3).