

To: The Commission
From: Staff
Date: January 18, 2000
Re: Uniform Computer Information Transactions Act

This memorandum analyzes two areas covered in the Uniform Computer Information Transactions Act (UCITA): forum selection clauses and federal copyright law preemption and the “first sale” doctrine.

1. Forum selection clauses

The Uniform Computer Information Transactions Act contains a provision allowing contractual choice of forum terms. Section 110 of UCITA provides:

(a) The parties in their agreement may choose an exclusive judicial forum unless the choice is unreasonable and unjust.

(b) A judicial forum specified in an agreement is not exclusive unless the agreement expressly so provides.

This provision is also subject to the general provisions concerning unconscionability, UCITA section 111, and fundamental public policy, section 106.

Under this provision, as a practical matter the vendor of computer information may select any forum to litigate disputes provided it is not “unreasonable and unjust,” nor “unconscionable,” nor a violation of “fundamental public policy.” Comment 3 to this provision states that “Choice of a forum at a party’s location is ordinarily reasonable.” Consequently, a New Jersey purchaser, subject to a contractual choice of forum term, might be required to litigate his dispute in a foreign forum, either U.S. or international, and be prohibited from using New Jersey courts.

a. Arguments pro and con.

UCITA Comment 3 describes forum selection clauses as “especially important in electronic commerce. Decisions on the issue of jurisdiction in the Internet reveal an uncertainty about when doing business on the Internet exposes a party to jurisdiction in all states and all countries. The uncertainty affects both large and small enterprises, but has greater impact on small enterprises which are the lifeblood of electronic Internet commerce.” Both Carnival Cruise Lines, Inc. v. Shute, 111 S.Ct. 1522 (1991) and Caspi v. The Microsoft Network, L.L.C. et al, 323 NJ Super 118 (App. Div. 1999), certif. denied, 1999 NJ Lexis 1478 (NJ Oct. 25, 1999) (see discussion below) are cited in support of this provision.

Professor Jean Braucher, in her memorandum “Proposed Uniform Computer Information Transactions Act (UCITA): Objections From The Consumer Perspective

(November 1, 1999) states that the “too flexible choice of law and forum” provisions, if enforced in mass market transactions, “will deprive many consumers of a forum they can afford by requiring suits to be brought in a remote location.”

Cem Kaner, a software engineer, lawyer, and activist in criticizing the Article 2B/UCITA project, made the following suggestion to limit the forum selection provision during the drafting process:

(4) Limit the nonnegotiable choice of forum

Let mass market customers sue in their home state when (a) the total amount in controversy is less than their state's small claims court limit, and (b) the licensor would be subject to suit in the customer's state in the absence of a forum selection clause to the contrary. The effect of 2B as written today will be to often (perhaps usually) provide the small customer with no realistic forum for dispute resolution. Please note that a similar proposal was made by the Institute of Electrical and Electronic Engineers. The Independent Computer Consultants Association has made a broader proposal, to include low-priced non-mass-market software.

Memorandum of Cem Kaner to To: Carlyle Ring, Geoffrey Hazard, Re: Comments on Article 2B (Oct. 8, 1998), <http://www.badsoftware.com/kanerncc.htm> (visited Jan. 14, 2000).

b. Forum selection clauses in the Uniform Commercial Code.

Article 2 of the UCC does not have any specific provision either validating or limiting forum selection clauses. Article 2A of the UCC contains the following provision limiting such clauses in consumer leases:

(1) If the law chosen by the parties to a consumer lease is that of a jurisdiction other than a jurisdiction in which the lessee resides at the time the lease agreement becomes enforceable or within 30 days thereafter or in which the goods are to be used, or if the goods are to be used in more than one jurisdiction none of which is the residence of the lessee, in which the lease is executed by the lessee, the choice is not enforceable.

(2) If the judicial forum chosen by the parties to a consumer lease is a forum that would not otherwise have jurisdiction over the lessee, the choice is not enforceable.

N.J.S. 12A:2A-106.

c. Forum selection clauses under current New Jersey law.

New Jersey courts enforce forum selection clauses as a general rule, in the absence of “fraud or overreaching.” See Kubis & Perszyk Assoc., Inc. v. Sun Microsystems, Inc., 146 N.J. 176, 191-92 (1996). In Caspi v. Microsoft Network, L.L.C., 323 NJ Super 118 (App. Div. 1999), certif. denied, 1999 NJ Lexis 1478 (NJ Oct. 25, 1999), the Appellate Division affirmed a lower court decision enforcing a forum selection clause in a Microsoft Network, internet services membership agreement in a consumer class action lawsuit. The Appellate Division stated that in general, forum selection clauses will be enforced unless “(1) the clause is a result of fraud or ‘overweening’ bargaining power; (2) enforcement would violate the strong public policy of New Jersey; or (3) enforcement would seriously inconvenience trial.” 323 N.J. Super. at 122, citing Wilfred Macdonald, Inc. v. Cushman, 256 N.J. Super. 58 (App. Div. 1992)(enforcing forum selection clause in dealership agreement). See also Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585 (1991), a highly influential decision under federal admiralty law, relied upon in New Jersey and other state cases, enforcing a forum selection clause in standardized cruise ship boarding ticket in a consumer personal injury action. The Court held that forum selection clauses in admiralty cases were “prima facie valid,” but “subject to judicial scrutiny for fundamental fairness.”

There are two categorical exceptions to the general rule developed by New Jersey courts. First, the New Jersey Franchise Act specifically prohibits forum designation in Motor Vehicle franchises. N.J.S.A. 56:10-7.3(2). The New Jersey Supreme Court has extended this rule to all franchise agreements, relying on the strong public policy expressed in the Franchise Act to protect franchisees against the superior bargaining power of franchisors, and to “level the playing field” between them. The Court stated that “we entertain little doubt that the Legislature would prefer to extend that prohibition to other franchisees rather than to permit forum-selection clauses to thwart the vindication of franchisee’s rights under the Act.” Kubis & Perszyk Assoc., Inc. v. Sun Microsystems, Inc., 146 N.J. at 196 (1996). Much of the court’s reasoning in Kubis stressed the inequality of bargaining power between franchisors and franchisees, concluding that forum selection clauses in franchise agreements usually “are not the subject of arms-length negotiations between parties of comparable bargaining power,” but are presented to the franchisee on a “take it or leave it” basis. 146 N.J. at 192-94.

Second, the New Jersey judiciary does not enforce contractual forum-selection clauses in insurance contracts covering risks located in New Jersey. In Param Petroleum Corp. v. Commerce & Indus. Ins. Co., 296 N.J. Super. 164 (App. Div. 1997), the Appellate Division found that “choice of forum and choice of law agreements in insurance liability policies should generally be ignored at least when the insured risk is in this State.”

New Jersey courts appear to have never directly considered the issue of whether a contractual forum-selection clause between a merchant and consumer in an individual action is enforceable. The closest approximation of these facts is found in Caspi, in which the Appellate Division upheld a forum selection clause in a consumer class action suit, where only four of the identified plaintiffs, out of a potential millions of plaintiffs in all the 50 states, were identified as a New Jersey resident. Although the facts presented in

Caspi beg comparison with those in Kubis (a class of plaintiffs given special legislative protections; gross inequality of bargaining power between the parties; take it or leave it presentation of forum selection clause in a standard form contract; lack of ability to negotiate the terms of the transaction), the Appellate Division in Caspi declined to treat consumers as protectively as the Supreme Court treated franchisees in Kubis and dismissed Kubis as involving “particularized policy reasons not applicable here.” 323 N.J. Super. at 123.

The Appellate Division adopted the lower court’s reasoning that the consumer plaintiffs “were not subjected to overweening bargaining power in dealing with Microsoft and MSN,” because “something more than merely size difference must be shown. ... A court’s focus must be on whether such an imbalance in size resulting in an inequality of bargaining power that was unfairly exploited by the more powerful party.” No such unfair exploitation was found, in fact the court found that because the plaintiffs were given “ample opportunity to affirmatively assent to the forum selection clause” and had the option to reject the contract entirely and contract with any number of other online information services, “this court finds it impossible to perceive an overwhelming bargaining situation.” 323 N.J. Super. at 122-23.

To that extent that it essentially ignores the inequality of bargaining power between the parties, the Caspi decision appears inconsistent with the general thrust of Kubis, which relied heavily on the inequality issue in a situation in which the franchisee, like the Caspi plaintiffs, could have walked away from the deal. On the other hand, it is difficult to argue that the individual New Jersey plaintiffs in Caspi would be effectively deprived of a remedy because the case must be brought in Washington rather than New Jersey. The very maintenance of the class action, combining many small potential claims, balances the effect of the non-negotiated forum selection clause in those kinds of cases, and makes it difficult for any one multistate plaintiff to argue the inconvenience of the forum. Although the opinion does not rely on the fact that the case involved a class action, it seems unlikely that the New Jersey judiciary would find a contractual forum-selection clause in a non-negotiated contract enforceable if its enforcement would effectively deny a judicial remedy to an individual consumer plaintiff, at least in a case of small value.

d. Approaches to the forum selection issue

Enforcing a forum selection clause in a contract action brought under UCITA could easily deprive the plaintiff of a practical remedy, at least in most mass market transactions. Many mass market transactions under UCITA are likely to be of relatively low value. For example, the cost of purchasing software often is less than \$300; the cost of purchasing a computer often is less than \$1500. Assuming that these transactions are governed by a contractual forum-selection clause, New Jersey consumers are unlikely to go to the expense of litigating a dispute in a foreign jurisdiction since the cost of the litigation is likely to exceed the price of the product. The question arises whether, the UCITA reasonableness requirement is sufficient to deal with these cases, or whether UCITA should be amended to give purchasers a specific right to litigate in New Jersey.

One approach would be to amend Section 110 to make forum-selection clauses unenforceable in cases involving in mass market transactions of moderate value. Such an amendment would recognize that the enforcement of a contractual forum selection clause in such cases has the inherent capacity to deny aggrieved persons their day in court and would not leave each case to judicial review. There is precedent for treating cases of small value differently from other cases. The Special Civil Part limits its competence to civil actions seeking legal relief when the amount in controversy does not exceed \$10,000 and to small claims, defined as all actions in contract and tort, where the amount in dispute does not exceed \$2,000. Pressler, Current N.J. Court Rule 6:1-2(a)(1) & (2). Assuring the availability of a New Jersey forum in cases within the jurisdiction of the Special Civil Part would provide a convenient local forum for the litigation of disputes of small value. Whether the resulting judgment in such a suit would be collectible, as a practical matter, is another issue altogether. This approach would have the advantage of a bright-line test for this class of cases.

A second approach would be to limit enforcement of forum-selection clauses in all mass market cases. That approach was considered in connection with the Commission's Report on Standard Form Contracts. At one point, in drafting that Final Report, the Commission included a provision that made a forum-selection clause invalid if it barred a New Jersey resident buyer from litigating a claim in New Jersey courts. The Commission deleted the provision, deciding that it was better to leave issues with forum-selection clauses to consideration under the general rule for enforceability of secondary terms.

Yet another approach would be to eliminate the forum selection clause entirely, leaving the enforceability of such clauses to current law. Article 2, as noted above, has no provision either validating or limiting forum selection clauses, leaving cases involving sales of goods to the prevalent case law outlined above.

2. Federal copyright law preemption and the "first sale" doctrine

Section 105 of the Uniform Computer Information Transactions Act provides:

(a) A provision of this Act which is preempted by federal law is unenforceable to the extent of the preemption.

This provision states the obvious. Federal intellectual property law preempts any conflicting UCITA provision. Federal law preempts all legal and equitable rights equivalent to the exclusive copyright rights in §106 in works that come within the subject matter of copyright as defined in §§102 and 103. The main right of §106 is to distribute copies by sale, rental or lease. The subject matter of copyright in §102 is original works of authorship excluding ideas, processes, concepts and principles, but including under §103 compilations and derivative works.

However, federal copyright law does not preempt all state common or statutory

law impinging on copyright subject matter. 17 U.S.C. 301 (b)(3) states “Nothing in this title annuls or limits any right or remedies under the common law or statutes of any State with respect to ... activities violating legal or equitable rights that are not equivalent to any of the exclusive rights within the general scope of copyright as specified by section 106.”

The UCITA reporters maintain that “cases routinely hold that copyright does not generally preempt state contract law.” Carlyle C. Ring, Jr. and Raymond T. Nimmer, Series of Papers on UCITA Issues 3 (1999). Federal copyright law does not preempt some state law causes of action. E.g. DSC Comm. Corp. v. Pulse Comm., Inc., 170 F. 3d 1354, 1365 (F.D. Cir. 1999)(holding that trade secret claim was not preempted by federal copyright law). But see, Alcatel USA, Inc. v. DGI Technologies, Inc., 166 F. 3d 772 (5th Cir. 1999)(determining that state misappropriation claim was preempted by federal copyright law because state claim did not require proof of element different from that under federal law). UCITA attempts to define information transactions within its scope as a matter of contract law.

However, the question remains to what extent, if any, does the federal law of copyright pre-empt provisions of UCITA which seek to define the rights of the parties in transactions involving federal intellectual property rights. This question is particularly pertinent with regard to the “first sale” doctrine under § 109 of the Copyright Act. This section gives the “owner” of a copy of the copyrighted work the right to sell it. The “first sale” occurs when the copyright owner sells the copy to the buyer. The buyer then is the “owner” of the copy and may sell the copy to another person. The “first sale” doctrine is important to the operation of secondary markets, such as the market for used books and music CDs, and to libraries which lend copyrighted materials. The sale and lending of “copies” of the copyrighted work is lawful because of the “first sale” doctrine. Thus, the question of whether a particular transaction involves the “sale of a copy” is key to determining whether the copy may be lent or subsequently transferred.

UCITA attempts to define the circumstances under which ownership of a copy is transferred as a matter of state law. UCITA Section 502 (a)(1) provides: “In a license: title to a copy is determined by the license.” Section 503(2) further provides: “Except as otherwise provided in paragraph (3) and Section 508(a)(1)(B), a term prohibiting transfer of a party’s contractual interest is enforceable, and a transfer made in violation of that term is a breach of contract and is ineffective to create contractual rights in the transferee against the non-transferring party.” For mass-market contracts, the term prohibiting transfer must be conspicuous. §503(4). In a license agreement, the copyright owner may reserve title to the copy and impose restrictions on its use. A person acquiring a license for the use of a software program under a reservation of title is not an “owner of the copy” and therefore, the licensee does not have a defense against infringement under the §109(a) “first sale” doctrine.

Critics of UCITA insist that whether or not a transaction constitutes the sale of a copy within the meaning of the Copyright Act is a matter of federal law. There is one well-reasoned case on point. DSC Communications Corp. v. Pulse Communications, Inc.,

107 F. 3d 1354 (D. C. Cir. 1999)(finding that the term “owner” in §109(A) of the federal copyright act is determined by looking at all factors surrounding transfer of software program including duration of use rights, method of payment and terms of license).

Several cases touch on the first sale doctrine without providing well-reasoned support for their conclusions. Novell, Inc. v. Network Trade Center, Inc., 25 F. Supp. 2d 1218 (D. Utah Cent. Div. 1997)(declaring license agreement invalid as adhesive agreement and, without analysis, treating the software program as an Article 2 transaction and declaring it a sale); Microsoft Corp. v. Harmony Computers & Electronics, Inc., 846 F. Supp. 208 (E.D.N.Y. 1994)(saying in dicta that question of ownership may be determined by reference to license terms); Microsoft Corp. v. ATS Computers, Inc., (S.D. Cal. 1993) (holding that, because licenses state that transfer is not sale and because defendants offered no evidence of sale, defendants could not rely on “first sale” doctrine); MAI Systems Corp. v. Peak Computer, Inc., 991 F. 2d 511 (9th Cir. 1993)(copying program into RAM is copy under federal law and Peak’s copying, even though for repair purposes, constituted infringement because of restrictions providing that only licensee could make any copy of program).

The cases support the following conclusions. First, the question of who is an “owner” under §109(a) is a federal question. It follows that neither UCITA nor private contract can determine that federal question. The DSC opinion supports this view. Non-ownership is not a matter of fiat by state law or contract term. Simply saying that the licensee is not an owner will not foreclose an inquiry into the question of whether the bundle of rights the person has under a license contract makes him an owner for purposes of the first sale doctrine. Consequently, UCITA §§ 502(a)(1) and 503(2) are not dispositive of the ownership question because ownership is not a matter of state law. To the extent that they conflict with federal law, for example the DSC decision, they are preempted.

However, federal law does not require a “sale” of a copy. As already mentioned, §106(3) permits transfer by “rental, lease or lending.” More important, §109(d), a subsection of the “first sale” doctrine provides: “The privileges prescribed by subsections (a) and (c) do not, unless authorized by the copyright owner, extend to any person who has acquired possession of the copy or phonorecord from the copyright owner, by rental, lease’ loan, or otherwise, without acquiring ownership of it.” The referred-to subsection (a) is the “first sale” doctrine. Consequently, the federal copyright statute comprehends transfers of copies resulting in something less than a sale of the copy. UCITA, without being considered binding, may operate to guide courts in their determination of whether any particular transfer is a sale or a license.

As a practical matter, at the present time many End User License Agreements accompanying sales of software permit licensees to sell their copies of software programs provided they do not retain duplicate copies. This term is a perfectly reasonable compromise between protecting the copyright owner’s exclusive rights in the work and giving licensees the right to sell their programs when they no longer want them. The extent to which licensing agreements impede the development of a secondary market in

software programs is unclear. Anecdotal evidence, such as auctions on Ebay, shows a thriving software secondary market but does not speak to the issue of whether sales on the market are lawful. Many people believe that when they buy a software program, they have the right to sell it to another person, just as they have the right to sell a book.

a. Arguments pro and con

The Comments to UCITA §502 do not mention the “first sale” doctrine. The emphasis in the Comments to this section, as well as related §§ 501 and 503, is on the ability of the licensor to control the transfer of rights to a purchaser through license terms. The materials distributed by Carlyle Ring at the last meeting discuss the issue of federal preemption, but do not expressly mention the first sale doctrine.

Professor David Rice, one of the ALI representatives to the 2B Drafting Committee, continuously criticized the “licensor-licensee” approach of Article 2B. Those objections are equally applicable to UCITA. See David A. Rice, “The Basic Source of Problems in Draft UCC Article 2B--Illustrated: Article 2B Transforms ‘License’ From Convenient Label Into The Primary Source of Substance (Oct. 28, 1996), <http://www.webcom.com/legaled/docs/dricsale.html> (visited December 1, 1999). Professor Rice traces the history of the license as a mechanism for controlling intellectual property rights at a time when the applicability of copyright and patent law to computer software programs was unclear. He criticizes the acceptance of this mechanism as the “lodestar” in the Article 2B draft because it “elevates form to substance.” Professor Rice’s most recent criticism (just prior to the resignation of the ALI representatives) focused on the Comments to §502, and strenuously objected to the Reporter’s characterization of current federal intellectual property law applicable to the question of the extent to which certain rights are transferable. See Memorandum dated January 20, 1999, from David A. Rice to Members of Article 2B Drafting Committee, “Official Comments - reporter’s Notes as Basis--Reporter’s Note 3 to UCC 2B-502 (December 1998 Draft) <http://www.2Bguide.com/docs/012099dr.html> (visited December 3, 1999).

Professor Rice’s concerns about the relationship between federal intellectual property law and UCITA are echoed in the Report of the Committee on Copyright and Literary Property of the Association of the Bar of the City of New York (June 21, 1999) 17-18 (distributed with the materials for the November Commission meeting): “...by validating mass market shrinkwrap licenses without sufficient safeguards for permissible copying, UCITA confers rights more akin to property than contracts right and thus facilitates market-wide restrictions at odds with copyright law.” The Committee also criticizes the attempt of UCITA to hand off the question of what constitutes the sale of a copy to state courts, as contrary to the strong federal policy of national uniformity in the law of intellectual property.

Stephen Y. Chow, a Uniform Law Commissioner for Massachusetts and a member of the 2B/UCITA Drafting Committee, has written extensively on the “licensor-licensee” approach of UCITA. He points out that the restrictions on transfer in §502 reverse the common law rule that possession, with payment, equals ownership, an assumption upon which §109 of the Copyright Act is based. He comments that §502

“casts a significant cloud on transfer of an enterprise’s assets in changes in entity form (change of partnerships), mergers, acquisitions or foreclosures.” Memorandum dated July 13, 1999, From Stephen Y. Chow to UCITA Drafting Committee, “Motions Relative To Proposed Draft for Promulgation,” <http://www.2bguide.com/docs/syc799.html> (visited December 1, 1999).

Professor Jean Braucher criticizes UCITA generally as validating restrictions on transfer “that conflict with normal customer expectations.” (The normal consumer expectation being that purchased software can be resold, provided no copies are kept by the original purchaser.) She states that “These license restrictions would interfere with the market in used goods that contain software (potentially, video games to cars). They would also prevent consumers from legally transferring or acquiring used software or digital works (whether on the second-hand market or as gifts), with the effect of reducing competition between new and used products and raising the price of access.”

Library associations are opposed this provision of UCITA. Although we have not yet received an official position paper as promised, a letter dated October 8, 1998, to Carlyle C. Ring, Jr. and Raymond T. Nimmer, expresses the opposition of several national library associations to the licensing concept of Article 2B. <http://arl.gni.org/info/letters/libltr.html> (visited January 5, 2000). The letter expresses the concerns of the library associations that the ability of libraries to acquire materials for loan will be impaired under Article 2B: “Libraries are looking for some affirmative statement that widely distributed information products that come with non-negotiable terms are not outside the reach of the first-sale and fair use doctrines merely because the publisher has labeled the transaction a ‘license.’ In addition, libraries are confident that specific limitations on the rights of copyright holders relating to library preservation and inter-library loan will preempt non-negotiated license terms, but an affirmative statement to that effect within Article 2B could help avoid any confusion.”

b. Title to goods under the Uniform Commercial Code

Article 2, by definition, governs the “sale of goods,” in which the very essence of the transaction is the passage of title from the seller to the buyer. See N.J.S. 12A:2-106: “A ‘sale’ consists in the passing of title from the seller to the buyer for a price.” The general rule in Article 2, is that any reservation of title by a seller “is limited in effect to a reservation of a security interest.” N.J.S. 12A:2-401. Article 2A of the UCC governs leases of goods, in which the seller retains title.

c. Current New Jersey law

There do not appear to be any relevant New Jersey cases which bear on this issue.

d. Approaches to the “first sale” doctrine issue

The threshold question is whether § 502 is preempted by the Copyright Act, to the extent that it seeks to define what constitutes the sale of a copy. If § 502 is preempted,

any provisions in UCITA or any other state law will be preempted by federal law, and inoperative to limit transferability. In this case, the provision should be deleted in order to avoid confusion over the proper source of law on this issue.

If the Commission concludes that § 502 is not preempted by federal law but disagrees with the restrictions it imposes on transferability, several approaches are possible. One approach would be to remove the provisions from UCITA which purport to define when a transfer constitutes the sale of a copy. This would involve deleting § 502, and amending other provisions which refer to it, and leave the matter to case law development. Another approach would be to reverse the presumption embodied in § 502 of UCITA that permits restrictions on subsequent transfer, and provide that such restrictions are enforceable only under certain circumstances (e.g., permitting such restrictions only in a truly negotiated transaction, or prohibiting such restrictions in certain “mass market” types of transactions).