UCC And The New Economy
The Old Rules Applied To New Technology: Concerns and Solutions

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Abstract. The Uniform Commercial Code ("UCC") has served purchasing entities well for many years. Traditionally, purchasers have been able to rely upon a variety of protections that the UCC affords, including, but not limited to:

- an implied warranty of merchantability (§ 2-314);
- an implied warranty of fitness for a particular purpose (§ 2-315);
- a reasonable price where the no price is specified (§ 2-305);
- the right of a purchaser not to specify a particular amount of product (§ 2-306);
- single lot delivery (§ 2-307);
- reasonable time of delivery where no specific date is specified (§ 2-309); and
- default remedies, from specific performance to consequential damages (§§ 2-715, 716).

By virtue of those gap-filling protections, for some purchasers "silence" became a golden rule. That is, the purchasers could well (and often better) protect their interests by avoiding a supply agreement with extensive, specific terms that might not be as favorable as those the UCC implies. At the same time, to the extent that a purchaser wanted a vendor to enter into a detailed supply agreement, the UCC provided the comfort by, in most cases, enforcing the parties' agreement.

In today's world, it is a legitimate question to ask whether or not the complexity of the supply chain requires a re-examination of the utility of these basic UCC principles.

Indeed, we often skip over true complexity in training sessions and avoid the complexity inherent in what are now ordinary transactions. In discussing these UCC principles, for example, lecturers, such as the undersigned, would often use simplified examples such as "widgets," bicycle wheels, and cables. Thus, to explain the implied warranty of merchantability, § 2-314, the lecturer could explain that a bicycle wheel should support a person when used

with a bicycle. If the supplier knew that the bicycle was going to be used off-road, then the warranty of fitness for a particular fitness, § 2-315, would ensure the ability to use the wheels in an off-road capacity. While this is a good introduction to the UCC, is it a sound approach to a business model?

The authors believe that, in at least the following three ways, changes in the business world have diminished the utility of UCC-related legal principles that have been taken for granted for over three quarters of a century:

1) the complexity of products (as well as services);

2) the complexity of the supply chain itself; and

3) the complexity of recordkeeping.

These complexities thus call into question whether "silence" for a purchaser is still golden. As explained below, the authors believe that initial communications with a supplier should be accompanied by a basic supplier "term sheet" that offers the purchaser basic protections against the potential vagaries that a complex supply chain inevitably causes.

1. **The Complexity Of The Product**. As originally envisioned, the UCC promised the application of common sense principles, and industry custom and practice, to transactions between merchants. As such, a purchaser could expect that a carburetor would function as a carburetor, that certain specialized dye would function with the specific fabric used by the purchasing company, or that the failure of a product would lead to a swift and sure remedy in court. What if, however, the product is exceptionally specialized and not part of an industry? Recent UCC cases involve specialized or complex products, including, by way of example:

- Highly specialized fabric provided by a Japanese company to a body armor manufacturer located in the United States.

- Software for "password cracking" and "decryption" around the world.

- "Optical sub-assemblies" used in "military" communication applications, tied to lasers.

- A home builder warranty case revolving around dozens of companies (and even more lawyers).

What if only a true expert is able to understand the purpose of the product? If a product contains fifty, one hundred or even thousands of parts, what type of warranty is at issue? If all the knowledge regarding a product is held by the purchaser, each of the dozens of suppliers can claim they did not know the purpose. The UCC does not answer those questions easily.

In addition to those issues, there is the role of proprietary information. If your supplier does not perform, and the supplier demands to see your internal metrics to verify that it did not perform, what is your response? Do you need to show the supplier your internal transaction process, or is it enough to say simply that the product or service was inadequate?

The obvious answer to these issues is drafting careful and detailed contracts. But that approach raises its own set of issues. Is it possible to hash out these complex issues each and every time? Not likely. Indeed, the UCC was intended to avoid the difficulties such case-by-case circumstances and analyses present by transporting common sense and industry practice into merchant relationships.

2. The Complexity Of The Supply Chain. Of course, complex products have been around for a while. However, the current complexity of the supply chain is, in the view of the authors, new and raises a second set of issues. If you are purchasing parts and services for a complex product, how do you locate the responsible entity in the event of a failure? Also, suppliers to your supplier may not be bound to your contract, and while you can press your own supplier, that supplier may, in turn, attempt to use the complexity of the supply relationship to blame the purchaser for the problem or otherwise assert that the problem is beyond the control of the supplier.

Moreover, you may not have sufficient information or leverage to control what your suppliers' suppliers are doing. The authors were involved with a dispute relating to an appliance that suffered from periodic, and hard to diagnose, failures. One of the potential root causes of the failure was a pre-programmed circuit board that was built in Korea. The lawyers and the client had no simple of way of pressuring the Korean supplier to do anything or even obtaining access to the software at issue.

Consider also the issue of industry standards. Recent cases have involved software purchased in the United States but intended to be sold in Europe under European standards. If the software does not meet European standards, but would work in the United States, does it meet appropriate standards? The UCC does not easily answer that question. Similarly, another recent case involved large industrial fans used in India and China, as well as in the United States. If the fans fail in India and China, can the fan supplier justifiably claim that it was not providing a warranty for performance in those harsher industrial environments?

Supply chain complexity also may result in the application of non-UCC law. When you have multiple jurisdictions involved, even the choice of law and choice of forum become exceedingly complex. Can your Mexican supplier sue you in Mexico if you buy in the United States? If your Canadian partner sues you in the UK, do you have to participate? Can a judgment in the UK be enforced here in the United States? What law applies if the Mexican company, a Canadian partnership, and an Indian bank are all involved? Lawyers love digging into these questions. Clients hate it.

Again, the obvious answer here is to include a detailed dispute resolution procedure, perhaps a carefully drafted arbitration clause, in your contract and bring all the parties into one location. The challenge with achieving this result is that it is, frankly, likely never going to happen. In order to make sure that everyone you deal with is party to the same dispute resolution clause, you would need to initiate complex negotiations every time you contemplated a project.

3. The Complexity Of Recordkeeping. The third issue involves the complexity of recordkeeping. It is a fact of life that all employees, individually, send thousands of e-mails and no one individual is likely to know the content of all of the those e-mails. Companies send hundreds of thousands or millions of e-mails. From a legal point of view, it is difficult to keep a

contract from being modified by subsequent communications. Even if your contract provides, fifty times over, that subsequent communications will not modify the contract, they may well do so. Moreover, despite the blizzard of written electronic communications, parties are still making, and courts are still upholding, alleged oral promises.

Further, in the event of a dispute, you have obligations now to maintain your records or face loss of your claim or defenses. While the full scope of so-called "e-discovery" issues are beyond the scope of this paper, the basics are easy to state. If you believe that you may be in a lawsuit, you need to preserve all your records, including electronic records, and create a contemporaneous written record that sets forth the efforts undertaken to preserve your records. If you do not do so, a court may strike your claim or defense.

Conclusion. How does this tie all together? With today's supply chains (i) stretching across many countries, (ii) involving complex products and services and (iii) being bombarded with electronic and other communications, today's supply relationships do more than simply create complex backgrounds. They challenge the very premise of the UCC. The idea that default business rules are simple and likely to lead to just and predictable outcomes may not be true. If you just buy and sell goods assuming that the UCC will provide certainty, you will likely face challenges in applying it to your products, determining what law applies, and analyzing a contract based upon thousands of e-mails swirling around Cyberspace. At the same time, this very complexity seems to make it difficult to constantly enter into arms-length negotiations with any potential partner to resolve these issues. Of course, if a company is big and strong enough, it can force a detailed agreement onto a partner. But, apart from the behemoth, we believe a solution, albeit imperfect, is at hand.

The authors submit that purchasers should create a baseline set of rules that the purchaser can use at the outset of interaction with a supplier or potential supplier, prior to the negotiation of a more complete supply agreement. The goal is to craft a set of rules short enough that suppliers will freely sign, but detailed enough to provide meaningful protections.

The authors believe this goal is realistic. For example, it is common for parties to a potential relationship to agree to an initial reciprocal confidentiality agreement. The authors submit that purchasers should strive to add, at a minimum, the following additional terms to such initial agreements:

1) a forum and choice of law clause that indicates that any and all disputes would be decided in the forum and law of your choice.

    - ✓ Advantage: consistency for purposes of planning and conduct in knowing what law govern the relationship and the venue in which any dispute will be resolved.

2) a standard indemnification clause that protects the purchaser from failings or wrongdoings of your suppliers' partners.

    - ✓ Advantage: reduces worry regarding distant events.

3) a statement of your expectations and use of the product or services, even in general terms.

   - ✓ Advantage: provides support for warranty claims because the supplier cannot claim ignorance of purpose.

4) a requirement that your supplier disclose any "material adverse developments" related to its suppliers or its production.

   - ✓ Advantage: while this is a "loose" obligation, it should help prevent surprise.

5) a representation and warranty that the supplier is solvent.

   - ✓ Advantage: the parties can gain comfort that the relationship will move forward.

6) an enforceable damage limitation clause.

   - ✓ Advantage: limits exposure arising from unforeseen developments, i.e., a claim of an oral promise to purchase.

7) a "notice" provision that requires each party to notify the other should any issues with the relationship arise.

   - ✓ Advantage: "notice" of a dispute or potential dispute will assist parties to determine when the duty to preserve documents is triggered and to avoid claims that evidence was improperly destroyed.

8) a clause that provides that no modification of the agreement is permitted save where both parties execute a written amendment and that specifically addresses the "stray e-mail" phenomenon.

   - ✓ Advantage: certainty in contracting, to the extent possible under the law of the chosen jurisdiction. While these clauses are subject to challenge, it is better to have some protection from claims that careless comments or unauthorized promises are enforceable.

Why do we believe use of an initial term sheet will work? To begin with, these terms are relatively non-controversial. A reasonable party should agree to these terms, particularly if they are reciprocal. These terms do not obligate anybody to do anything – for example, to buy or sell product. Instead, each recommended provision provides a rudimentary solution to the issues posed by the complexity of the supply chain and sets the foundation for the parties to move forward with confidence in the relationship. Moreover, if an economic relationship does develop, purchasers and suppliers can override the initial term sheet with a signed supply agreement that addresses the issues in detail. In that vein, should a supplier refuse to execute the initial term sheet recommended, the authors submit that it would be prudent, absent extenuating circumstances, to steer clear of that supplier.

In the end, use of the initial term sheet proposed when starting communications with a supplier is not a perfect foil for complexity of today's supply chain. Nevertheless, use of an initial term sheet with provisions such as those recommended herein is likely to bring some certainty to supply relations that continue with each passing day to grow more complex and challenging.