A perspective of standard form contracts in the data processing industry

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ABSTRACT

The data processing industry has been weaned on the standard form contracts of one dominant vendor and many derivative and close variants of clauses from those written agreements are now found in the standard form contracts of many vendors. As such, standard form contract clauses deriving largely from a single source may well control the rights and liabilities of wholesale numbers of buyers within this industry. In so doing, these contractual provisions act not as terms bargained for and assented to, but as a type of unchecked commercial legislation within the industry.

The trend is for such standard form contracts to acquire the attributes of adhesion (preprinted forms presented on a “take it or leave it” basis) producing an attitude of complacency in contracting among the management of buyer companies.

Although courts are loath to rewrite contracts among business participants, there has been an increasing trend of judicial disapproval of unconscionable contracts. In non-class litigation, such judgments affect only one standard form contract while the objectionable clause may have far broader impact thereby leading one very respectable law journal to espouse legislative intervention to correct this marked imbalance.

Management of vendee data processing companies should be encouraged and motivated to negotiate the terms of standard form contracts of adhesion to have those documents reflect the particular transaction affecting the business in their charge. Correspondingly, management of vendor data processing companies should be alert to the capacity of clauses in its standard form contracts to be oppressive or wreak surprise and of the circumstances under which these documents are presented to buyers either of which could bring about an untoward judicial result.

With these thoughts in mind, there is a further discussion of the often misunderstood or overlooked limitation of liability clause, “hell or high water” clause, most favored nations clause, integration clause, and arbitration clause, many of which are found in most standard form contracts.

INTRODUCTION

Dismal as the future may sometimes seem, it is not unreasonable to expect an increase in the volume of claims and disputes between contracting parties in the data processing industry as a by-product of continued growth and expansion within the industry. With this hypothesis in mind, one would do well to look at the nature of the contracts upon which such claims and disputes will undoubtedly be founded.

In executing agreements for data processing equipment or services, the management of a company which is a buyer should (but all too often does not) take cognizance of fundamental matters found in the contract which may likely affect its company’s liability. A frequently heard reason for the lack of attention or inaction by such management is an anticipation of the vendor presenting its standard form of contract on an “accept this or nothing” basis and the concomitant judgment that an expenditure of effort to effect changes in a contract which is in general use by the vendor with its other customers may be futile.

Focusing upon such management attitude, this discussion will seek to place in perspective the use of standard form contracts in the data processing industry, highlight several obscure clauses, and conclude with certain recommendations to the management of both buyers and vendors regarding the use of such agreements.

THE STANDARD FORM CONTRACT

At one time, a contract in its most basic form was the product of a “bargain,” i.e., it was the written expression of parties who had negotiated an agreement to exchange promises. With certain exceptions wrought by the law which are not here relevant, the “bargain” was the sine qua non of an enforceable contract for breach of which legal remedies would likely follow. However, a contract embracing the concept of the “bargain” no longer characterizes the preponderance of such documents which are today executed in the ordinary course of business. Rather,
there is the prolific use of the standard form of contract.\(^2\) This type of written agreement has definite economic justification in that, among other things, it permits the vendor to select and control its assumed contractual risks, to exclude risks which are difficult to calculate, and to provide for situations arising from unforeseen contingencies such as strikes, floods, fires, labor disputes, and the like.\(^3\)

Just as mass production and mass distribution have become indigenous to the data processing industry, so too has mass contracting using standard forms of written agreements. In the infancy of this trend, the data processing industry was weaned on the standard form contracts of one dominant vendor\(^4\) and many derivative and close variants of clauses from those early written agreements are now found in the standard form contracts of many vendors.\(^5\) Accordingly, standard contract clauses deriving largely from a single source\(^6\) may well control the rights and liabilities of wholesale numbers of buyers of goods and services in the data processing industry. In so doing, these contractual provisions act not as terms bargained for and assented to, but as a type of unchecked commercial legislation within the industry.\(^7\)

In executing a standard form contract for data processing equipment or services which has been presented on a "take it or leave it basis," that which is signed falls within the eyes of the law as a contract of adhesion.\(^8\) A contract of adhesion, simply stated, is one which is presented by a party in a position of superior bargaining power, usually pre-printed in great numbers, and offered on an "accept this or nothing" basis.\(^9\) Standing alone, a standard form of contract drafted by a vendor to limit its risks and exposure is not, in and of itself, one of adhesion. However, when presented on a "take it or leave it" basis and pre-printed usually in smaller point type than the normal office typewriter to discourage attempts at typewritten changes, it acquires the attributes of adhesion.

With contracting in the data processing industry characterized by the extensive use of identical or similar clauses usually presented in written agreements under circumstances of adhesion, it appears not indecisive to observe that such written agreements may control more behavior than do the ordinances of many municipalities.\(^10\)

Historically, courts have been loath to re-write contracts or portions thereof between business participants.\(^11\) The theory is that businessmen as such are viewed by the courts as situated on equal footing\(^12\) with each other unless the contrary is proved,\(^13\) and this remains true despite the fact that the less well-informed or advised businessman did not read or understand the contract.\(^14\) The modern trend, however, is to provide a judicial remedy\(^15\) if the court finds the contract or certain terms contained within it to be unconscionable.\(^16\)

In private, non-class\(^17\) litigation, the judicial nullification or reformation of a standard contractual term which may be pervasive throughout the industry benefits only the party to that suit and not all others similarly situated who are subject to such a contractual term. This seeming inadequacy of judicial relief has spawned an articulate suggestion\(^18\) for legislative intervention to mandate minimum standard contractual provisions in all cases. If this were to come to pass, concerns of equity would override concerns of a freely functioning market and foster what many may find to be an unwelcome solution.

Data processing management is the freely functioning market force which, by tempering its attitudes of futility toward effecting changes in and consequent complacency for standard form contracts of adhesion, can correct an imbalance in contracting within the industry. Charged by emerging trends in the law both with protecting the interests of the business committed to its care and with refraining from depriving that business of the advantage that its skill or ability might properly bring to it,\(^19\) management may find personal liability ascribed to it by an enterprising attorney in litigation which could arise from standard form contracts of adhesion executed in the comfort of complacency and not in the best interests of the business.

Management of a company which is a buyer should be encouraged and motivated to negotiate the terms of standard form contracts of adhesion although there will be transactions where this is not possible.\(^20\) Recognizing that a vendor wants new or continuing business as much as the buyer may need the vendor’s goods or services, the management of a buyer company assertively seeking to change standard terms in the vendor’s standard form contract may well be surprised at the receptiveness of the vendor to engage in negotiations if not yield altogether to the buyer’s demands.

Correspondingly, management of a company which is a vendor should be alert to potentially oppressive clauses in its standard form contracts and the manner and circumstances under which these documents are presented to its customers, mindful of the increasing trend of courts to find standard contract terms unconscionable\(^21\) and the financial trappings of litigation. One simple approach when the vendor’s risk appears to significantly enlarge by a modification of terms in its standard form contract would be for the vendor and buyer to agree that the buyer will pay a modest price increase just as one might pay a higher insurance premium for increased risk to the insurer and increased coverage to the insured.\(^22\)

This discussion cannot possibly encapsulate all of the considerations of contracting within the data processing industry. However, if management or its counsel wish to consider a path of implementing the foregoing thoughts and desire reference materials on data processing contracts, there are several good sources.\(^23\)

The balance of this discussion will deal with several clauses usually found in standard form contracts the significance and consequence of which are oftentimes not understood or grossly understated.

**LIMITATION OF LIABILITY CLAUSE**

A vendor typically limits its liability to financial compensation for damages suffered directly by its customer exclusive of the claims of third parties, and then only for the amount paid by the customer under its agreement with the
vendor. In addition, in the case of a services contract, the vendor may seek to insure itself against the prospect of monetary liability altogether by offering to duplicate the services which were not rendered or which were rendered in a faulty manner. It does not seem at all unreasonable to limit the vendor's liability only to damages sustained directly by its customer, exclusive of the claims of third parties, but the further limitation of the customer's recovery to an amount not to exceed the fees paid under the contract may well be insufficient to compensate the customer for its losses and, indeed, may bear no reasonable relationship whatsoever to the customer's losses.

Consider a union payroll which is produced twenty-four hours late by a vendor of data processing services. In many construction industry union contracts, a penalty of time and a half for each hour the payroll is late is imposed upon the employer (in this case the customer). Accordingly, the customer's actual damages in this example may far exceed by multiples the amount it has paid under the contract.

The failure to fully understand and appreciate the consequences of standard form limitation of liability clauses can be seen in the following excerpts from a recent address by Richard L. Bernacchi to the Computer Law Association.

"Commercial risk allocation through . . . limitations of liability . . . presuppose an ability on the part of both parties to the transaction to articulate [their respective expectations] and understand the risks inherent in that transaction. . . . In the simple commercial transaction the distinction between the desired ends and the risks that are inherent in the transaction is relatively easy. . . . [However,] risk allocation in the data processing environment shares a problem which is endemic to all legal documents. What appears simple and easy to apply in the abstract, becomes muddled and difficult to apply in the concrete situation. . . . Many data processing transactions lack the . . . ability of both sides to foresee the risks inherent in the transaction. . . ."

". . . to the extent that the subject matter of a particular data processing contract involves risks that the vendee will normally not be able to foresee and evaluate, and to the extent that the vendor fails to articulate those risks, there can be no bargained for allocation of risks, notwithstanding the fact that both parties are presumed to understand the meaning and implication of the contractual language used to effect that allocation. . . ."

"While it can be assumed that the vendor understands or should understand the risk of distortion, no such assumption is justified with respect to the vendee. The proper index of vendee understanding should be the contract and the amount of specific and detailed allocation contained therein." 20

It may not be a reasonable prospect to seek an enlargement of the vendor's limitation of liability. However, it may be possible to reach agreement with a vendor to accept liability for consequential damages despite the traditional boilerplate in which the vendor will seek to disclaim liability for consequential damages. Particular inroads here may be made if the vendor's liability for consequential damages is conditioned upon a breach by the vendor or negligence by the vendor or its employees. In this regard, a bargaining point might be to further limit vendor's liability for consequential damages to compensate the customer by making it whole. Under these conditions, the vendor may be able to obtain insurance to cover its expanded liability.

"HELL OR HIGH WATER" CLAUSE

This provision is frequently found in lease agreements and essentially provides that the customer must pay under any and all circumstances. No matter what happens to the equipment, the customer-lessee still has to pay.

One now finds such clauses slowly creeping into other types of contracts in the data processing industry where, in essence, it is provided that the customer pay first and complain later. To the extent that the customer is dealing directly with the vendor, as distinguished from a third party lessee, the clause might well be unconscionable.

Here the customer should seek the contractual right to offset mandatory payments with claims it has against the vendor or, alternatively, to make disputed mandatory payments to an independant third party escrow pending determination of the claims of the customer against the vendor.

MOST FAVORED NATIONS CLAUSE

Many vendors in the computer industry contractually agree to make available decreases in price to all customers in much the same fashion as they pass on price increases to all customers. This is called a most favored nations clause.

What some may view as a gift horse others may see as a two-edged sword. Where a most favored nations provision is a clause in a standard form contract, a price decrease to one customer must be offered to all of the vendor's customers in whose standard form contracts such a clause appears. Accordingly, there is a negative incentive for the vendor to offer a price advantage to one customer if it correspondingly becomes obligated to pass that advantage on to other of its customers.

The customer would be advised to seek to have its agreement for price concessions set apart from the standard form clauses and, whether within the content of the agreement or by side letter, effectively amend the agreement so that the performance thereunder of the vendor with price concessions is different from the performance and price normally offered by the vendor to its other customers. By so doing, the negative incentive of the vendor to bargain with a particular customer on price is mooted.

INTEGRATION CLAUSE

As surely as the sun will rise tomorrow, the standard form contracts used in the data processing industry will contain a clause to the effect that the written agreement constitutes the complete and exclusive statement of the
agreement between the parties superseding all prior and contemporaneous proposals, understandings, representations, conditions, warranties, and all other communications, oral or written, between the parties. There is much to commend such a clause both on behalf of the vendor and the customer provided that, and only provided that, the written agreement is, in fact, the complete and exclusive statement of the understanding between the parties. If, instead, the written agreement is the standard form contract used by the vendor and the undertakings of the parties are founded upon a relationship emanating from other understandings, the documents expressing those other understandings, whether responses to requests for proposals, communications between the parties, or otherwise, should be mandatorily incorporated by reference as exhibits with the standard form contract. Further, there should be a reference within the standard form contract stating which documents should control in the event of conflict between the written agreement and the appended exhibits.

**ARBITRATION CLAUSE**

Under modern systems of jurisprudence, the remedy for a contractual dispute is that of litigation in the absence of contrary provisions in the contract. As many are aware, this can be a lengthy, tortuous, and extremely expensive process. Moreover, in the data processing industry one has to consider that a judicial tribunal, whether a judge or a jury, may be incapable of understanding some of the technical niceties, complexities, and innuendoes inherent in a relationship founded on the furnishing of data processing equipment and services. The remedy of arbitration has been utilized effectively to resolve business controversies for many years. "The past fifty years has seen arbitration growth spurred by legislation, a friendly judiciary, an over burdened court system, cost-conscious business executives, and perhaps, the realization that viable alternatives to litigation are possible in many commercial transactions."

Arbitration, as a remedy, seems to have two predominant virtues. The first is that in a long-term business relationship subsidiary differences between the parties can be resolved in a speedy, expeditious, and not terribly hostile manner without affecting that long-term business relationship. Second, it can bring to bear technically competent fact-finders to resolve a dispute between the parties going to the heart of the contract which may involve matters of such esoteric dimension that a lay judicial tribunal could not possibly be expected to make intelligent findings of fact.

Both vendors and customers should be alert to the advantages of the use of arbitration and mindful also of the principal objection to arbitration in that it may tend to be too "arbitrary". This ill-founded notion seems to derive from experiences inaccurately related as to how an arbitrator may have misjudged the facts and therefore improperly decided a matter before him. Carefully drawn arbitration agreements, however, can provide for equitable methods of review by the arbitrator or arbitrators of their own decisions.

Care, however, should be taken in the drafting of arbitration agreements to have them conform to local law. For example, in California there can be no use of pretrial discovery except in a case involving injury to, or death of, a person caused by the wrongful act or neglect of another, unless specific provision is made therefor within the arbitration provision. In Texas, a provision for arbitration is not binding unless the agreement has been executed by counsel for the signing parties.

**CONCLUSION**

Management of vendee data processing companies who are presented with standard form contracts from data processing vendors should be attentive to the terms contained in such documents specifically as they do or do not relate to the proposed transaction at hand rather than complacently executing such forms with comfort, albeit ill-founded, in the notion that such documents apparently are satisfactory for all of the vendor’s other customers.

Similarly, management of vendor data processing companies who use standard form contracts should be alert to the potential for oppressiveness in such documents and the manner in which they are presented, and not take comfort in the fact that similar contracts have been in general use throughout the industry with impunity.

Whether it be a judge, a jury, an administrative body, or an arbitrator who is charged with reviewing the written document which has been executed, the parties must realize that "their" transaction is set forth within the four corners of that document and any shortcomings in this regard are the fault of the parties and not that of the contract.

**REFERENCES**

6. Stedransky, supra.
7. The doctrine of caveat emptor will apply where there exists some parity
12. Id.
13. Id. at p. 394.
14. Due to the "lack of equality between the bargaining parties" plus clauses taking advantage of the lack of equality, the contract was unenforceable and unconscionable.
17. "The basic test of unconscionability is whether, in light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided . . . under the circumstances existing at the time of the making of the contract."
20.不是很, supra, at p. 362.
21. "The weaker party in need of goods or services is frequently not in a position to shop around for better terms, either because the author of the standard contract has a monopoly (natural or artificial) or because all competitors use the same clauses. His contractual intention is but a subjection more or less voluntary to terms dictated by the stronger party; terms whose consequences are often understood only in a vague way, if at all."
22. See also Blair v. Pitchess, 5 Cal.3d 228, 725-6.
23. Hawkind, supra.
24. supra, at p. 320.
28. 2 Computer Law Service App. §3-2a, supra.
29. Id.
31. Actual damages must still be proved. "but the designated sum [in a clause limiting liability] operates as a ceiling on the performing party's accountability."
32. In standardized contracts . . . which are made by parties of unequal bargaining strength, the California courts have long been disinclined to effectuate clauses of limitation of liability which are unclear, unexpected, inconsistent, or unenforceable.
35. See Footnote 23.
37. In Bernacchi's address, he offers the following examples: "If the contract contained or incorporated by reference a detailed set of functional specifications, including response times, display formats and the like, then the inference is strong that either the vendee was aware of the risk of distortion and made certain that he actively participated in the technical articulation of his needs, or the vendor was concerned about the risk of distortion and attempted openly to articulate the system design in a manner calculated to allow the vendee the opportunity to recognize any distortion which may have occurred. If, on the other hand, the contract merely provides for a 'system' which contains certain hardware referred to by model number and certain software consisting of applications referred to by title, then the inference is strong that the risk of distortion was inarticulate at the time the parties entered into the agreement. . . ."
38. "A similar situation exists with respect to 'system' implementation, which usually consists of the delivery phase, the conversion of the data base and the existing applications, and the development of new applications.
39. With new applications or with old ones that must be converted to new equipment, the implementation may turn out to be in the order of years rather than the months that the parties expected, or at least that the vendee expected. The particular difficulties in implementation may effectively change the vendee's expectation of the purchase of a computer 'system' into a contract for the development of that 'system'. If the contract either provides a specific time frame within which implementation is to occur, or specifically indicates that the amount of time required for implementation is unknown, then the inference of articulate risk and bargain-for-allocation is strong. If the contract simply provides that the vendor will install the system, or that he will provide a certain amount of man-hours to that end, then the inference is strong with the risk of a lengthy implementation due to technological difficulty was inarticulate at the time the parties entered in the agreement. . . ."
40. "Similar problems exist in the area of system performance, which generally boils down to system acceptance tests, including both simulated and live tests. Even when you have a detailed set of functional specifications, it is the general nature of data processing 'systems' to exhibit inadequacies in live operations that do not appear in simulated testing. If the contract provides that the vendee's obligations are contingent upon successful system performance under acceptance test criteria which include live testing, then the inference of articulate risk and bargain-for-allocation is again strong. If the contract simply provides for payment upon installation and certification that the system is 'operational', then the inference is strong that the risk of system inadequacy due to circumstances peculiar to the vendee's environment was inarticulate at the time the parties entered into the contract. . . ."
41. "There does not appear any way that the company can fairly price its services unless it does limit its liability in some way, because the efforts that it otherwise takes in order to protect against those anticipations of what the risks might be, will price the product right out of the market."
43. The California Arbitration Law (California Code of Civil Procedure, §11280 through 1295, specifically §§1283.05, 1283.1); Texas General Arbitration Act (Vernon's Ann. Civ. St., Art. 224 through 238-6, specifically Art. 224).