



SELLER BEWARE: Software Transactions May Be Subject to the UCC's Perfect Tender Rule

by Susan Nassar

When things go south in a software transaction and everyone ends up at the courthouse – does the Uniform Commercial Code hurt or help software vendors? It could do both and depends in large part on whether a court concludes that the software transaction at issue involves “goods” under article 2 of the Texas Uniform Commercial Code (UCC). See TEX. BUS. & COM. CODE ANN. § 2.102 (Vernon 1994) (stating that article 2 of the UCC applies to transactions in goods).

The protection of the UCC's provisions that allow a seller to limit its liability and exclude warranties can be very enticing. However, for those unfamiliar with Texas law and the perfect tender rule – beware! UCC section 2-601 states that a buyer may reject tendered goods “if the goods or the tender of delivery fail *in any respect* to conform to the contract.” TEX. BUS. & COM. CODE ANN. § 2.601 (Vernon 1994) (emphasis added). Although some Texas courts have rejected the notion that tendered goods must be perfect in every respect, they agree that a seller's tender must conform to the contract in every respect. See *Toshiba Mach. Co. v. SPM Flow Control, Inc.*, 180 S.W.3d 761, 776 (Tex. App.—Fort Worth 2005, pet. granted); *Printing Ctr., Inc. v. Supermind Pub. Co., Inc.*, 669 S.W.2d 779, 784 (Tex. App.—Houston [14th Dist.] 1984, no writ); *Tex. Imps. v. Allday*, 649 S.W.2d 730, 737 (Tex. App.—Tyler 1983, writ ref'd n.r.e.).

A determination of whether proffered goods are conforming is not necessarily limited to the four corners of the contract and may encompass the bargain of the parties as evidenced “from other circumstances including course of dealing or usage of trade or course of performance as provided in the Code.” *Printing Ctr., Inc.*, 669 S.W.2d at 784. Regardless of how they define conforming, Texas courts uniformly agree that sellers cannot rely on a “substantial performance” common-law defense to a breach of contract claim if it is determined that the transaction at issue involves goods governed by the UCC and Texas law. *Toshiba Mach. Co.*, 180 S.W.3d at 776; *Glenn Thurman, Inc. v. Moore Const., Inc.*, 942 S.W.2d 768, 771 (Tex. App.—Tyler 1997, no writ); *Printing Ctr., Inc.* 669 S.W.2d at 784.

Although the rule has been criticized by some scholars, Texas is not alone in its interpretation of UCC section 2-601 and its application of the perfect tender rule. See *D.P. Tech. Corp. v. Sherwood Tool, Inc.*, 751 F. Supp. 1038, 1041-42 & n.6 (D. Conn. 1990) (noting that Texas, Maine, Nebraska, Michigan, Arkansas, and New Jersey follow the perfect tender rule). See also *Ogden Martin Sys., Inc. v. Whiting Corp.*, 179 F.3d 523, 530 (7th Cir. 1999) (referring to Indiana UCC section 2-

601 as “the perfect tender rule”); *Marlowe v. Argentine Naval Comm'n*, 808 F.2d 120, 124 (D.C. Cir. 1986) (“local District of Columbia law follows the Uniform Commercial Code in generally adopting the ‘perfect tender’ rule”); *Chlan v. KDI Sylvan Pools*, 452 A.2d 1259, 1262 (Md. Ct. Spec. App. 1982) (“The perfect tender rule in § 2-601 may be eminently fair in commercial transactions for goods, where if one party does not receive precisely what he bargained for, he may reject and return the goods...”); *George E. Warren Corp. v. Olco Oil Co.*, No. 86-CV-660, 1988 WL 28940, at *5 at n.8 (N.D.N.Y. Mar. 15, 1988) (applying New York UCC). Some states, however, recognize limited exceptions to the rule. For example, Connecticut has adopted an interpretation of section 2-601 that does “not allow rejection for insubstantial breach such as a short delay causing no damage.” *D.P. Tech. Corp.*, 751 F. Supp. at 1041-42.

Unfortunately, it is not entirely clear under Texas law whether the UCC applies to software transactions, because case law on the issue is surprisingly scant despite the fact that the need to address software classification under the UCC was first recognized in the mid-1980s. Note, *Computer Software As A Good Under the Uniform Commercial Code: Taking a Byte Out of the Intangibility Myth*, 65 B.U.L.Rev. 129, 148 (1985). In Texas state and federal cases to date where the issue arose, courts cited other jurisdictions and assumed without deciding that the UCC applied to the software transaction, because the parties either did not dispute or agreed that it applied. See *Recursion Software, Inc. v. Interactive Intelligence, Inc.*, 425 F.Supp.2d 756, 786, n.17 (N.D. Tex. 2006); *Bray Int'l, Inc. v. Computer Assoc. Int'l, Inc.*, No. CIV.A. H-02-98, 2005 WL 3371875, at *3 (S.D. Tex. Dec.12, 2005); *Hou-Tex, Inc. v. Landmark Graphics*, 26 S.W.3d 103, 108 n.4 (Tex. App.—Houston [14th Dist.] 2000, no pet.). In *Hou-Tex, Inc. v. Landmark Graphics*, a software defect case, Hou-Tex initially argued unsuccessfully in the trial court that the UCC was only applicable to sales of goods, not software licenses. *Id.* Although the issue was not raised on appeal, the appellate court noted that “at least one court and several

academic commentators have concluded, when addressing the issue, that software is a ‘good’ within the definition of the U.C.C.” *Id.* (quoting *Advent Sys. Ltd. v. Unisys Corp.*, 925 F.2d 670, 674-76 (3d Cir. 1991)).

In holding that software is a good, the Third Circuit opinion cited by *Hou-Tex* pointed to strong policy considerations of uniformity in commercial transactions for treating software as a good under the UCC. *Id.* at 676. The *Advent Systems* court further reasoned that “[t]he fact that some programs may be tailored for specific purposes need not alter their status as ‘goods’ because the Code definition includes ‘specially manufactured goods.’” *Id.* at 675; TEX. BUS. & COM. CODE ANN. § 2.105 (Vernon 1994) (“‘Goods’ means all things (including specially manufactured goods) which are movable at the time of identification to the contract.”). The court also rejected the argument that software as intellectual property is intangible simply because it is the product of an intellectual process and copyrightable. *Id.* Because the transaction at issue in *Advent Systems* involved a mixture of goods and services, the court applied a dominant factor or “essence” test similar to that applied by Texas courts and other jurisdictions in hybrid contract cases. *Id.* at 676; *Graybar Elec. Co., Inc. v. LEM & Assoc., L.L.C.*, 252 S.W.3d 536, 542 (Tex. App.—Houston [14th Dist.] 2008, no pet.) (concluding that article 2 of the UCC applied after determining that goods were essence or dominant factor of the contract). Even though software vendor *Advent* had provided a number of services in conjunction with the contract, the Third Circuit concluded that the software-hardware transaction involved goods, because the “software was a major portion of the products described in the agreement.” *Advent Sys. Ltd.*, 925 F.2d at 676.

Although not a software case, the Fifth Circuit’s *Propulsion Tech., Inc. v. Attwood Corp.*, 369 F.3d 896 (5th Cir. 2004) similarly reasoned that the broad scope of the Texas UCC and the UCC’s definition of goods encompassed custom software and other specially manufactured products. *Id.* at 902 & n.34 (“Even where the production of goods is labor-intensive and the cost of goods is relatively inexpensive, such as for . . . custom computer software, jurisprudence has considered the contracts for production and delivery to be transactions predominately in ‘goods.’”). The Fifth Circuit, however, declined to apply a hybrid contract analysis to determine if the parties’ contract was primarily for the sale of goods or services. *Id.* at 901 & n.20. According to the Fifth Circuit, such an undertaking was unnecessary since the Code’s definition of goods included specially manufactured goods. *Id.*



Despite the current lack of clarity in Texas jurisprudence, the issue of whether the UCC and the perfect tender rule apply to software transactions is bound to eventually surface in Texas courts as it has in other jurisdictions, since technology increasingly touches every aspect of our daily lives. However, because typical software transactions come in so many shapes and forms, it is unclear whether a Texas court would adopt the Fifth Circuit’s reasoning in *Propulsion Technology*

or apply a hybrid contract analysis similar to that in *Advent Systems* if presented with the issue. For the same reason, it is unclear what the result of such an analysis would be since the issue of whether a particular transaction involves goods will likely turn on the specific facts of each case. Regardless of the test or analysis applied, software vendors should be prepared to establish, at a minimum, that they substantially performed their obligations under the parties’ contract. If they cannot meet this minimum threshold of proof, the issue of whether the UCC and perfect tender rule apply may well be a moot point.

Such was the fate of the software vendor in *SunGard Energy Sys. Inc. v. Gas Transmission Northwest Corp.*, 551 F.Supp.2d 608 (S.D. Tex. 2008), which involved a contractual dispute governed by Texas law that was arbitrated and subsequently confirmed on appeal. The software vendor in *SunGard Energy Systems* agreed to tender customized software that would both “accurately schedule the flow of gas through GTN’s pipeline according to GTN’s preferences and purchase orders and maximize the volume and pressure of the gas flowing in the pipeline.” *Id.* at 618. Because the parties’ software license and agreement also included services such as software implementation and maintenance, the software vendor contended that the Texas UCC and the perfect tender rule did not apply. The arbitration panel and federal district court on appeal, however, declined to address the issue, because “the evidence showed that SunGard failed to provide GTN with software that adequately performed those tasks.” *Id.* Thus, because the software vendor was unable to meet even the minimum threshold of proving substantial performance, it was irrelevant in the end whether the UCC and perfect tender rule applied.

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