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RECENT CASES

Software consumers must comply with shrinkwrap license terms

by Jennifer Bonjean

In *ProCD, Inc. v. Zeidenberg*, 86 F.3d 1447 (7th Cir. 1996), the United States Court of Appeals for the Seventh Circuit held that shrinkwrap licenses enclosed in computer software boxes are enforceable contracts. In an action between ProCD, Inc. ("ProCD"), a computer software vendor, and Matthew Zeidenberg ("Zeidenberg"), a software consumer, the United States Court of Appeals reversed the district court's ruling in favor of Zeidenberg. The district court held that shrinkwrap licenses are unenforceable contracts where the terms of the contract are not printed on the outside of the box. Moreover, the district court stated that even if the licenses could be viewed as valid contracts, federal law prohibited their enforcement. In overturning the district court's decision, the Seventh Circuit held that shrinkwrap licenses constitute valid contracts under the Uniform Commercial Code ("U.C.C.") and are not preempted by federal law.

Software companies engaging in price discrimination use licenses to control arbitrage

ProCD has assembled a database of more than 3,000 telephone directories which it markets to

manufacturers, retailers, and the general public. The consumer version of the database, entitled SelectPhone, is available on CD-ROM. SelectPhone contains special features which allow consumers to create customized listings of data. Although the application itself is copyrighted, the data from the telephone directories is not. The database costs more than \$10 million to compile and maintenance of the system is an additional expense. In an effort to make the product available and affordable to the general public, ProCD engages in price discrimination. Consumers may purchase SelectPhone on CD-ROM for roughly \$150 while manufacturers and retailers pay a higher price for the product. Presumably, price discrimination is advantageous to both the general consumer and the retailer. If ProCD were forced to charge a single price to all users, the consumer version of the database would undoubtedly cost much more than \$150. As a result, the general public would cease purchasing the product in significant volume. A decrease in purchasing would ultimately result in higher prices for retailers.

In order for price discrimination to be cost effective, ProCD must control misuse of its discounted consumer version by retailers. Rather than attempting to distin-

guish between the commercial and consumer user, ProCD utilizes a contract to control arbitrage. Each consumer version of SelectPhone is accompanied by a license containing specific terms that limits the use of the consumer product. Customers are given notice of the license on the outside of the software box, but the terms themselves are found inside the package. Moreover, the license is printed in the software manual and appears on the user's screen when the user initiates the software.

In 1994, Zeidenberg purchased a consumer version of SelectPhone. He formed Silken Mountain Web Services, Inc. ("Silken Mountain") in order to sell the SelectPhone database to consumers on the Internet. Zeidenberg charged a significantly lower rate to Internet users than ProCD charges its commercial customers for the information. ProCD sought an injunction against Zeidenberg's continued distribution of ProCD's database over the Internet. ProCD argued that Zeidenberg's use of the consumer version of SelectPhone should be limited to the terms in the license. The district court rejected ProCD's argument and dismissed the suit against Zeidenberg. The district court held that because the license was not printed on the outside of the box, Zeidenberg was not bound to its terms which were

located inside the box and, thus, the license was inaccessible at the time of purchase.

Seventh Circuit holds Zeidenberg received sufficient notice of license

In reversing the district court's decision, the Seventh Circuit ruled that Zeidenberg was aware when he purchased the software that the transaction was subject to the terms of the license located inside the box. The court found that because notice of the license was printed on the outside of the box and ProCD afforded customers an opportunity to return the software if the terms of the contract proved unacceptable, Zeidenberg was bound to the terms of the license when he continued to use the product. Zeidenberg argued that contract formation occurred immediately after he purchased the product from the store. Accordingly, he contended that any terms of the contract unavailable for review at the time of purchase were unenforceable since, under basic contract law, parties must mutually agree to the terms of a contract in order for a contract to be binding.

The Seventh Circuit rejected Zeidenberg's argument and noted that transactions in which specific terms of an agreement are communicated subsequent to the exchange of money are a common practice between sellers and buyers. The court criticized Zeidenberg's assertion that all terms of the license should be printed on the outside of the box for its obvious impracticalities. First, printing all terms of the contract on the outside of the box could only be achieved by using

microscopic print. Furthermore, such a requirement would displace more valuable information needed by the customer, such as the function of the software. The court emphasized the practical need for standardizing agreements between buyers and sellers quoting from the *RESTATEMENT (SECOND) OF CONTRACTS* § 211 cmt. a (1981): "Standardization of agreements serves many of the same functions as standardization of goods and services; both are essential to a system of mass production and distribution. Scarce and costly time and skill can be devoted to a class of transactions rather than the details of individual transactions."

In support of its finding, the Seventh Circuit provided several examples of industries which commonly exchange money prior to the specific terms of the agreement. For example, when an individual purchases a radio, she expects to find certain terms of the transaction inside the box, the most important of which includes the warranty. Application of Zeidenberg's argument would render the warranty null and void since the warranty terms are not generally printed on the outside of the box. Moreover, in the software industry many software sales take place by phone or over the Internet where there is no packaging. Under Zeidenberg's argument, these transactions would not be subject to any terms, thereby exposing software manufacturers to boundless liabilities.

U.C.C. allows for money now, terms later

The Seventh Circuit rejected the

district court's assertion that the U.C.C. does not recognize contracts in which money is exchanged prior to the terms of the agreement. The American Law Institute and the National Conference of Commissioners on Uniform Law recently proposed an article to the new U.C.C. that would specifically make standard-form user licenses valid. The district court stated that this proposal verified the invalidity of shrinkwrap licenses under current law. The Seventh Circuit disagreed and held that the proposal simply clarified existing law. The appellate court instead turned to the current version of the U.C.C. to substantiate shrinkwrap licenses as bona fide contracts.

The court referred to U.C.C. § 2-204(1) which states that "[a] contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract." U.C.C. § 2-204(1) (1977). Accordingly, a vendor may invite acceptance of an offer in any way that would evidence agreement between the buying and selling parties. Admittedly, contracts may be formed when a purchaser buys a product. However, vendors are not limited to this type of transaction and may form contracts by various means. ProCD invited consumers to accept the contract terms by purchasing its product, reviewing the terms of the license enclosed inside the box, and then continuing to use the product.

Zeidenberg met each of these requirements and, therefore, indicated by his conduct that he accepted the terms of ProCD's offer. Thus, Zeidenberg was bound by the

license's terms. The court acknowledged that certain contract terms may be subject to a special prominence requirement under the U.C.C., but concluded that the customary terms found in shrinkwrap licenses are not included in this exception.

Court held shrinkwrap licenses not preempted by federal law

The Seventh Circuit held that shrinkwrap licenses function as two-party contracts and are not "equivalent to any of the exclusive rights within the general scope of copyright." Thus, shrinkwrap licenses are enforceable under federal law. The Copyright Act § 301(a) preempts any "legal or equitable rights [under state law] that are equivalent to any of the exclusive rights within the general scope of copyright" The district court held that ProCD's software was "within the subject matter of copyright" and, therefore, its shrinkwrap licenses are unenforceable under federal law.

The Seventh Circuit agreed with the district court's holding as it pertained to the copyrighted part of the application. Nonetheless, the court explained that rights created by contracts (i.e., licenses) are not "equivalent to any of the exclusive rights within the general scope of copyright." Unlike copyrights, rights created by contracts are not legal rights, but are rights imposed by private parties on one another. Accordingly, contracts may not be construed as containing "exclusive rights." To do so would produce absurd results. For example, a customer who rents a video from a video store and agrees to view the

tape in her home only and return it within two days may disregard the terms of the contract under the reasoning of the district court, since videos are subject to copyright laws.

The Seventh Circuit acknowledged Congress' power to preempt the enforcement of contracts even in consumer transactions, but contended that courts generally construe preemption clauses as immaterial to private contracts. The court emphasized that "terms and conditions offered by contract reflect private ordering, essential to the efficient functioning of markets." Accordingly, the court held that the contract between ProCD and Zeidenberg is enforceable because the rights created by the contract are not "equivalent to any of the exclusive rights within the general scope of copyright."

Seventh Circuit enforced arbitration term in computer purchase

Consistent with their holding in ProCD, the Seventh Circuit held that the terms of a computer purchase made over the telephone were binding on a buyer because the buyer failed to properly review the terms and return the computer within 30 days of purchase. In *Hill v. Gateway 2000, Inc.*, No. 96-3294, 1997 WL 2809, at *1 (7th Cir. Jan. 6, 1997), a class action suit, the plaintiffs claimed that Gateway's faulty product made Gateway a racketeer and entitled the plaintiffs and a class of all other purchasers to treble damages under the Racketeer Influenced and Corrupt Organization ("RICO") Act. However, one term of the computer purchase was an

arbitration clause that, if enforced, would prevent Hill's RICO action. The district court refused to enforce the arbitration clause and Gateway appealed.

In *Gateway*, the Seventh Circuit reversed the district court's ruling. The court rejected the plaintiff's argument that the arbitration clause was not sufficiently prominent in the statement of terms and, therefore, should not be enforced. Rather, the court found no special requirement that an arbitration clause be prominent. The court concluded that the terms of the computer purchase constituted a valid contract, and, accordingly, enforced the arbitration clause.

In support of its holding in *Gateway*, the court relied on its decision in ProCD. Gateway conducted sales transactions similar to ProCD. After the plaintiffs purchased the computer over the telephone and received it in the mail, Gateway expected them to review the statement of terms and afforded them an opportunity to return the product if the consumer found the terms unsatisfactory. The plaintiffs in *Gateway* failed to return the product within 30 days and, therefore, agreed to the terms of the contract, including the arbitration clause. Again, the court pointed to the legality and practical considerations of transactions in which payment is made before communication of specific terms. The court held that the approve-or-return device is valid under contract law and the statement of terms bound the plaintiffs, regardless of whether or not they read the document.

In summary, the Seventh Circuit held in *ProCD* and *Hill* that

shrinkwrap licenses and statements of purchase terms enclosed in computer product packaging are enforceable contracts. The court found that the U.C.C. recognizes

contracts formed where specific terms of agreement are communicated subsequent to the exchange of money. Moreover, the court held that shrinkwrap licenses are two-

party contracts that do not fall within the subject matter of copyright and, thus, federal law does not preempt them. •

Italian Internet site held to be a "distribution" of images within United States

by Alex Goldman

In *Playboy Enterprises, Inc. v. Chuckleberry Publishing, Inc.*, 939 F. Supp. 1032 (S.D.N.Y. 1996), the United States District Court for the Southern District of New York denied both parties' motions for reconsideration of a previously rendered order. The court affirmed the previous order, finding the defendants' Internet site in contempt of a 1981 injunction.

Court issued injunction

One of the defendants, Tattilo Editrice, S.p.A. ("Tattilo"), publishes a men's magazine called "Playmen" in Italy. In 1979, in response to Tattilo's intention to market the magazine in the United States, Playboy Enterprises, Inc. ("Playboy") brought suit to enjoin Tattilo from using the name "Playmen" in the United States. The injunction, awarded in 1981, permanently enjoined Tattilo from, in relevant part, distributing, or offering for sale or distribution, an English language male magazine with the word "Playmen" on the cover, or using the word "Playmen" in connection with the offering for sale or distribution of any English language publications and related products.

Playboy files contempt motion related to Tattilo's Internet site

On the basis of the 1981 injunction, Playboy moved for a finding of contempt against Tattilo in 1996, when it discovered that Tattilo had set up an Internet site to

feature "Playmen." The site, set up through a World Wide Web server in Italy, contained two areas. The "Playmen Lite" ("Lite") portion offered moderately explicit pictures for viewing and downloading onto a user's hard drive. Lite was offered free of charge and allowed potential subscribers to view the material before paying for a subscription to the site. By contrast, the "Playmen Pro" ("Pro") portion was available only to subscribers and contained more explicit images. In order to subscribe, users had to fax Tattilo a credit card number in return for a password and a user ID. The site was readily available to any United States resident with access to the Internet.

In order to determine whether a party is in contempt of an injunction, the court looks to whether the moving party has shown, by clear and convincing evidence, that the defendant has violated a court order. *See King v. Allied Vision, Ltd.*, 65 F.3d 1051 (2d Cir. 1995). Applying this standard, the court found the site to constitute "distribution" of "Playmen" in the United States and, therefore, to be a violation of the 1981 injunction. The court also held Tattilo in contempt. The court ordered Tattilo to: (1) shut down its site or refuse new subscriptions from U.S. customers; (2) invalidate existing U.S. users' passwords and refund to them the unused portions of their subscription charges; (3) remit to Playboy all gross profits from U.S. subscriptions as well as all gross profits from the sale of goods and services advertised on the site to U.S. customers; (4) amend its site to reflect that U.S. residents will be denied subscriptions; and (5) remit to Playboy attorneys' fees incidental to this