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***ProCD v. Zeidenberg:*  
Do Doctrine and Function Mix?**

Background of the Case

The purpose of this essay is to recount with some particularity the philosophical, economic, and legal issues raised in one of the most important contract cases of the past generation. *ProCD v. Zeidenberg* explores in a new technological context two critical and recurrent issues of contract law: how the formal rules of offer and acceptance apply to shrinkwrap and clickwrap transactions, and whether an otherwise valid contractual provision is preempted by federal law.<sup>1</sup> The first issue

\* James Parker Hall Distinguished Service Professor of Law, The University of Chicago; Peter and Kirsten Bedford Senior Fellow, The Hoover Institution. In the interests of full disclosure, I should mention that I had written, as a consultant for the Digital Commerce Coalition, a letter dated September 11, 2000, responding to the Federal Trade Commission's request for public comment regarding its High-Tech Warranty Project, extensive portions of which have been incorporated into an article on the UCITA, Richard A. Epstein, *Contract, Not Regulation: UCITA and High-Tech Consumers Meet Their Consumer Protection Critics*, in CONSUMER PROTECTION IN THE AGE OF THE "INFORMATION ECONOMY" 205 (Jane K. Winn ed., forthcoming 2006). I also wrote two letters in defense of the UCITA approach to the American Bar Association in January 2003. The views in this paper are my own. My thanks to David Strandness, Stanford Law School, Class of 2007, for his outstanding research assistance.

<sup>1</sup> *ProCD, Inc. v. Zeidenberg*, 908 F. Supp. 640 (W.D. Wis. 1996), rev'd and remanded, 86 F.3d 1447 (7th Cir. 1996). Since the two cases have the same name I shall reference them as *Crabb* and *Easterbrook*, after the judges who wrote the trial court and appellate decisions.

concerns the application of the perennial rules of offer and acceptance to the brave new world of computer software. It conveniently breaks into two parts. The initial inquiry is whether two parties have entered into any agreement at all. Then if it is established that the parties made some agreement, which terms proposed by either side are included or excluded? The particular contracts involved in *ProCD* were formed between the "seller" of computer software and the ultimate "buyer," who purchased the software package through a retailer who was conveniently allowed to drop out of the picture.<sup>2</sup> At issue in this case was how the rules of offer and acceptance, as captured in the Uniform Commercial Code, apply to shrinkwrap contracts where the seller seeks to impose restrictions on how particular products may be used.

The second question in *ProCD* arises only if the plaintiff overcomes the initial hurdle and persuades a court that the parties have indeed entered into an agreement that contains the seller's desired provisions. Phase two asks what types of substantive limitations the vendor may place on its product use that are consistent with public policy. More concretely, does the copyright law of the United States place any federal limits on the use restrictions that the software seller may impose on its buyer with respect to the data that has been transferred (or licensed) to the buyer? The issue is technically described as one of federal preemption: Does the command of a valid federal statute block, expressly or by implication, the use of certain contractual terms otherwise allowable under state law?

*ProCD* raises both issues in vivid fashion because it is twice blessed by two strong opinions that point in opposite directions. Judge Barbara B. Crabb of the Western District of Wisconsin held that Zeidenberg had purchased the software free of *ProCD*'s effort to restrict his use of the transmitted data. Judge Frank H. Easterbrook, writing for himself and Judges John L. Coffey and Joel M. Flaum, ruled four-square for the plaintiff on both the contract interpretation and the copyright preemption issues. The two contrasting opinions reflect a profound difference in the role economic analysis plays in influencing the legal analysis. That difference is encapsulated in the distinction between doctrine versus function: Judge Crabb is the faithful doctrinalist and Judge Easterbrook the ardent functionalist.

<sup>2</sup> For how the retailer might be brought back in, see *infra* text accompanying notes 46-48.

Before getting too far ahead of the story, however, it is important to recall the undisputed facts of the case.<sup>3</sup> That innocent-sounding task is fraught with hidden obstacles because Judges Crabb and Easterbrook had profound differences as to which facts really mattered and why. Both judges noted that ProCD, the plaintiff, was a software vendor who had compiled on its Select Phone™ CD-ROM software program a single database containing comprehensive information about some 95 million phone numbers drawn from 3,000 separate telephone directories. The data collected contained more information than is normally found in phone books. In addition to the usual names and addresses, it offered nine-digit zip codes and various industrial codes. The purchasers of Select Phone™ could sort the information by category for use in organizing mailings, research, and other applications. This extensive compilation of data was treated throughout the case as falling outside the scope of copyright protection because it did not have what the Supreme Court termed in *Feist Publications, Inc. v. Rural Telephone Service Co.*<sup>4</sup> the minimum level of “originality” to receive copyright protection.<sup>5</sup> In its view, the compilation of names, addresses, and places was just raw information that others could copy at will on the ground that “sweat of the brow” information did not receive copyright protection.<sup>6</sup> That information, however, did not come cheap, but cost ProCD over \$10 million to compile, and more for regular updates needed to reflect the constant shifts in population and phone usage. This data package was accompanied by a copyrighted program that allowed the buyer to download this data onto his or her computer.

The defendants in this case were Matthew Zeidenberg, then a graduate student in computer sciences at the University of Wisconsin, Madison, after studying undergraduate physics at Harvard, and his solely owned corporation, Silken Mountain Web Services. (The differences between Zeidenberg and his corporation don't matter, and so will not be mentioned further.) Zeidenberg did not come to this litigation by

<sup>3</sup> For these facts, see *Crabb*, 908 F. Supp. at 644–46, and *Easterbrook*, 86 F.3d at 1449–50.

<sup>4</sup> 499 U.S. 340 (1991).

<sup>5</sup> In fact, Judge Easterbrook subsequently opted for a narrow reading of *Feist* in *American Dental Association v. Delta Dental Plans Association*, 126 F.3d 977 (7th Cir. 1997) (holding copyrightable the ADA's taxonomy of dental procedures, by number, long and short description).

<sup>6</sup> 499 U.S. at 359–60.

mere happenstance.<sup>7</sup> Rather, he originally purchased the Select Phone™ program from a local retailer to do work in a voter registration program, because it allowed him to download the names, phone numbers, and addresses of everyone within a particular zip code. He later observed that he had been drawn to the program because ProCD had advertised “that there are no limits on how many records you could download from the CD.”<sup>8</sup> Once his voting drive was over, he hatched a scheme (which never proved profitable) to place the ProCD listings on the Internet from which he hoped to make money by selling banner advertising.<sup>9</sup> In a subsequent interview, he made it clear that he came up with the idea of posting the phone numbers online after he had read *Feist*, a case that had been discussed in Select Phone's™ user manual.<sup>10</sup> Not content with his own reading of the case law, he consulted with John Kidwell, a professor of law at the University of Wisconsin, to learn about the legality of his proposed Internet posting in light of the opening in the copyright law that *Feist* created—a vivid reminder of how individual actors respond to the incentives created by legal rules on property rights. Kidwell told him, with partial omniscience, “Yeah, you're probably legally in the clear, but you'll definitely be sued.”<sup>11</sup> Zeidenberg used ProCD's copyrighted program to download the data onto his personal computer, and then made the data available to the world by placing it on an Internet host computer. The lawsuit was commenced when ProCD got wind of his venture after it had been made public.

The Select Phone™ boxes did not set out all the terms on which the package was sold. But it did point in small print (a phrase that Judge Crabb pointedly used,<sup>12</sup> but that Judge Easterbrook omitted) that the transaction was made conditional on terms that were contained in the user guide inside the box. The user guide included a “Single User License Agreement,” which told the user that he did not have outright ownership of the listings supplied to him, but was authorized only as a

<sup>7</sup> Zeidenberg offered his thoughts about the case in an interview with William Whitford, Emeritus Professor of Law at the University of Wisconsin. *Freedom from Contract Symposium: Appendix, ProCD v. Zeidenberg in Context*, 2004 Wis. L. Rev. 821.

<sup>8</sup> *Id.* at 822.

<sup>9</sup> *Id.* at 823–24.

<sup>10</sup> *Id.* at 823.

<sup>11</sup> *Id.* at 824.

<sup>12</sup> See *Crabb*, 908 F. Supp. at 645.

licensee to use that information in ways consistent with his license.<sup>13</sup> Software vendors call these "end-user licenses," but the common term for them is shrinkwrap licenses, which refers to the fact that they can be accessed only after the shrinkwrap, which protects the package before use, is removed. (The equivalent for downloaded programs is a "clickwrap" license.) Once installed, the computer program spreads across the opening screen a notice that hammers home the point that the licensed program could be used only in accordance with the limitations found in the Single User Agreement. In some instances (much less common today), the licenses state that they take effect the instant the shrinkwrap is removed, but ProCD took a more cautious provision that left the user an escape hatch after booting up the program:

Please read this license carefully before using the software or accessing the listings contained on the discs. By using the discs and the listings licensed to you, you agree to be bound by the terms of this License. If you do not agree to the terms of this License, promptly return all copies of the software, listings that may have been exported, the discs and the User Guide to the place where you obtained it.<sup>14</sup>

The key provision of the license at issue here reads as follows:

[Y]ou will not make the Software or the Listings in whole or in part available to any other user in any networked or time-shared environment, or transfer the Listings in whole or in part to any computer other than the computer used to access the Listings.<sup>15</sup>

Both parties agreed that Zeidenberg did not know of this particular restriction when he made his initial box purchase in late 1994. Nonetheless, it was agreed that he was "aware" of the restriction before he used the program to download the listings onto the Internet. Zeidenberg also purchased two upgraded versions of ProCD in March and April 1995, both of which contained the same constellation of notifica-

<sup>13</sup> *Id.* at 644.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at 645. This provision is perfectly standard in most software contracts. See, for a similar provision, *Vault Corp. v. Quaid Software Ltd.*, 847 F.2d 255, 257 n.2 (5th Cir. 1988), which reads, "You [the user] may not transfer, sublicense, rent, lease, convey, copy, modify, translate, convert to another programming language, decompile or disassemble the Licensed Software for any purpose without Vault's prior written consent."

tion on the box, user guide, and computer program, of which Zeidenberg was again aware when he put the upgraded programs into use.<sup>16</sup>

It is instructive to note that Judge Easterbrook did not trouble himself with setting out either of these two license provisions quoted by Judge Crabb. His judicial economy was justified because the disputed terms in ProCD, like contractual provisions subject to litigation, did not raise any devilish issues of contractual interpretation: The clause said what it meant, and meant what it said. It was therefore rightly stipulated by both sides that Zeidenberg was in violation of this clause if it were a valid portion of the entire contract, but that the result was otherwise if the clause had not been incorporated into the agreement. The issue thus quickly came to a head when ProCD, through the distinguished Boston firm of Hale & Dorr,<sup>17</sup> demanded that Zeidenberg cease making any unauthorized use of the program. It's clear why the plaintiff resorted to heavy artillery from its opening salvo. If either of the defendants' arguments worked in this case, then the restrictions on use would hold in few if any cases. On the other side, Zeidenberg cared about only his case, not about the fate of an industry, so for him the stakes were lower. He was represented chiefly by David Austin, a recent graduate of Boston's Northeastern Law School trying his first case after passing the Wisconsin Bar.<sup>18</sup> Notwithstanding the evident disparity in firepower, Zeidenberg stuck to his guns and insisted that the restriction on networked uses was not part of the contract. ProCD quickly obtained a preliminary injunction, for Judge Crabb rightly thought that "its entrepreneurial effort"<sup>19</sup> was entitled to at least that much protection. Less than four months later, in January 1996, Judge Crabb wrote an exhaustive opinion before granting summary judgment for the defendants on both their grounds. Judge Easterbrook matched her speed by reversing her judgment on both grounds, with orders to enter the injunction in June 1996.

More important, for our purposes, this complete flip-over represented a vast difference in world view, which is reflected in how the two decisions were organized. Judge Crabb discussed the copyright preemption question first and the contract question second. Let's turn first to the contract formation issue and then to the copyright issue.

<sup>16</sup> *Crabb*, 908 F. Supp. at 645.

<sup>17</sup> The point was not mentioned in the decision but can be found in Zeidenberg's account, *Freedom from Contract*, *supra* note 7, at 829. The firm had a partner, senior associate, and junior associate on the case.

<sup>18</sup> *Id.* at 827.

<sup>19</sup> *Crabb*, 908 F. Supp. at 646.

### Judge Crabb's View of Contract Formation

Judge Crabb's view of the contract formation issue was shaped in part by her initial conclusion that *Feist* showed that the current copyright law did not respond to the "equitable" claim that the compilers of databases had for legal protection. In her view, the Supreme Court left the matter of further database protection to Congress, and not to lower courts. Thinking globally, she viewed ProCD's contract claim as an unwise attempt to use shrinkwrap licenses to circumvent the limitations of the copyright law. The contract and the copyright, of course, do not cover identical domains, because shrinkwrap licenses contain other clauses, such as arbitration requirements or limitations on consequential damages, that the copyright laws leave untouched. But the overlap between the contract and copyright remains undeniable.

At this point, Judge Crabb's view of these shrinkwrap provisions was heavily influenced by an article written by Professor Mark Lemley,<sup>20</sup> which took a critical view of shrinkwrap licenses, in Judge Crabb's words "because the typical software transaction does not involve bargained agreements concerning use limitations, but a purchase made by a computer user at a retail store or through the mail, with little discussion or bargaining between the producer and the user."<sup>21</sup> Professor Lemley and Judge Crabb's implicit image of a prototypical contract is a dickered agreement between the two sides where all possible terms are in play; shrinkwrap agreements fall well short of this ideal because of the lack of opportunity for real bargaining.

This initial attitude then sets the stage for the more detailed arguments that followed. The first of these addressed the characterization question mentioned above: Do these shrinkwrap transactions fall into the category of sales or of licenses?<sup>22</sup> In one sense, the initial query is why ask this question at all. One naïve view is that matters of classification don't count so long as the parties are clear as to what their obligations are. So long as the parties know what is required of them, what difference does it make what these obligations are called? Yet in a profound sense, this attitude of studied indifference overlooks the regula-

<sup>20</sup> Mark A. Lemley, *Intellectual Property and Shrinkwrap Licenses*, 68 S. Cal. L. Rev. 1239, 1241 (1995).

<sup>21</sup> *Crabb*, 908 F. Supp. at 650; see also Lemley, *supra* note 20, at 1248-49 ("Blackletter contract law sets out three predicates to the formation of a contract: offer, acceptance, and consideration. Behind these requirements is the overarching notion of a bargain between the parties. . . . But where is the bargain in a standard form shrinkwrap license that is not even signed by the party against whom it will be enforced?").

<sup>22</sup> *Crabb*, 908 F. Supp. at 650-51.

tory superstructure in the law of contracts. More specifically, remember that sales are governed by the Uniform Commercial Code while licenses fall outside its scope. If therefore this transaction is a sale, all the rules on offer and acceptance that are adopted by the Code come into play. If, however, the transaction is a license, then the rules of offer and acceptance at common law govern. Since the UCC contains a number of distinctive provisions on contract formation, the choice of boxes really matters.<sup>23</sup>

How then did Judge Crabb decide this characterization question? As is common on matters of this sort, she drew a mental picture of a paradigmatic sale and license transaction, and then asked whether the disputed transaction is more analogous to one rather than the other. That task is more difficult than one might imagine because both sales and licenses are enormous fields in which the variation within areas is as great as the variation across areas. In patents and copyrights, for example, licensing by an owner is much more typical than a sale, although both are possible. Software is not quite either, but close enough that the license analogy could not be ignored, especially since that term is used in the disputed agreements. Nonetheless, Judge Crabb argued for the sale transaction because "purchasers of mass market software do not make periodic payments but instead pay a single purchase price, the software company does not retain title for the purpose of a security interest and no set expiration date exists for the 'licensed' right."<sup>24</sup>

Unfortunately, the commercial world is not quite that dichotomous. Although most sales are typically made for a lump sum payment, installment sales are also common. On the other side, licenses may feature lump sum payments as well as periodic ones. Of course, a software company doesn't hold a security interest in the software because there is no unpaid debt after purchase; but that is also true of most sales as

<sup>23</sup> See, e.g., UCC §2-207 Additional Terms in Acceptance or Confirmation, which departs from the mirror-image rule of offer and acceptance used at common law.

<sup>24</sup> *Crabb*, 908 F. Supp. at 651 (citing Gary W. Hamilton & Jeffrey C. Hood, *The Shrink-Wrap License—Is It Really Necessary?* 10 Computer L. 16 (1993)). Judge Crabb also explains that most courts have applied the UCC to mass market software transactions, 908 F. Supp. at 650 (citing Lemley, *supra* note 20, at 1244 n.23 (citing numerous federal and state law cases)), and that most scholars agree that the UCC should apply to such transactions, 908 F. Supp. at 651 (citing Bonna Lynn Horovitz, 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 (1985); Lemley, *supra* note 20, at 1244 n.23).

well. From Roman times onward, some perpetual leases, for example, remain in force so long as an annual fee has been paid, often to evade state restrictions against the outright sale of land.<sup>25</sup> For all it mattered, ProCD could easily have a term demanding the return of the software after ten years, knowing full well that the product would have been worthless at that time. Once the categories start to matter, parties will seek to guide their contract into their preferred box.

Once Judge Crabb classified this transaction as a sale of goods covered by the UCC, she applied its rules of contract formation to the exclusion of the common law. Under §2-206, the offer is made when the retailer places Select Phone™ on the shelf, which is in turn accepted when Zeidenberg took possession of the package and paid the purchase price.<sup>26</sup> The contract was therefore complete at that time, and the only question was whether it included any of those terms found inside the box that were not apparent on its cover, or had not been mentioned by the retailer during the course of the sale transaction. Finding that the small print that referred to terms not immediately in evidence, Judge Crabb concluded that the contract was complete without them. The terms contained inside the package were offers for a contract modification that came too late, and were in any event not accepted.<sup>27</sup>

Her view comported with earlier cases on the subject. In *Step-Saver Data Systems, Inc. v. Wyse Technology*,<sup>28</sup> the disputed terms were only known to the buyer after the package was opened, which was held too

<sup>25</sup> See, e.g., FRANCIS DE ZULUETA, *THE INSTITUTES OF GAIUS* 145 (Clarendon Press 1946).

<sup>26</sup> *Crabb*, 908 F. Supp. at 651-52. "Under §2-206, the placement of product such as Select Phone™ on a store shelf constitutes an offer." By whom? See *infra* text accompanying notes 46-48; see also UCC §2-206:

Offer and Acceptance in Formation of Contract

- (1) Unless otherwise unambiguously indicated by the language or circumstances
  - (a) an offer to make a contract shall be construed as inviting acceptance in any manner and by any medium reasonable in the circumstances.

UCC §2-204:

A contract for the 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.

<sup>27</sup> *Crabb*, 908 F. Supp. at 654-55. See UCC §2-209, dealing with modification, rescission, and waiver.

<sup>28</sup> 939 F.2d 91 (3d Cir. 1991).

late, so the terms were not part of the contract. In *Arizona Retail Systems, Inc. v. Software Link, Inc.*<sup>29</sup> those terms were "visible" on the outside of the software envelope and hence bound the person who thereafter opened it. The decisive line of inquiry had to do with the level of notice on receipt of the package. Each purchase was evaluated on its own, wholly apart from any ongoing course of dealing of which it was a part. The early date of contract formation thus worked systematically in favor of the buyers in this case. But at no point did she treat the limitations on transfer as inconsistent with public policy, for so long as early and prompt notification was given, it was as binding as any other restriction.

Yet recall that Zeidenberg made three separate purchases. Does he therefore have knowledge before opening the package the last two times? In summarizing a passage from *Step-Saver*, Judge Crabb stated "exposure to proposed terms in previous transactions did not change the fact that these terms were not agreed to at the time of subsequent contract formations."<sup>30</sup> She then expressed her own uneasiness on the matter as follows:

The decision on this issue is a close call. Defendants may have known the exact terms of the user agreement at the time of their second and third purchases of Select Phone™. In that case, I would not find it inherently "unjust," as did the court in *Step-Saver*, to hold a party to the terms a seller incorporates into a standard form contract. However, I would agree with that court that it is unwise to hold a buyer to those terms when software companies are free to change the terms of their shrinkwrap licenses between initial and later versions of their products. Like any other parties to a contract, computer users should be given the opportunity to review the terms to which they will be bound each and every time they contract. Although not all users will read the terms anew each time under such circumstances, it does not follow that they should not be given this opportunity. Defendants cannot be held to the user agreement included with the second and third copies of Select Phone™ they purchased merely because they were aware of the terms included with the initial version. Each software purchase creates a new contract. Computer users should be given a fresh

<sup>29</sup> 831 F. Supp. 759 (D. Ariz. 1993).

<sup>30</sup> *Crabb*, 908 F. Supp. at 654 (citing *Step-Saver*, 939 F.2d at 104).

opportunity to review any terms to which those contracts will bind them.<sup>31</sup>

### Judge Easterbrook's View of Contract Formation

In issuing her judgment, Judge Crabb paid little attention to two important facts. First, the disputed provision is perfectly standard and does not in fact vary from one transaction to another. Second, there are no recorded instances in which any potential software purchaser has been ever able to obtain a waiver of any of the restrictions found in these agreements, including the use limitation at issue in *ProCD*.

To Judge Easterbrook, those two points shaped his approach to the case. His functional view of the law of contract is that it allows bargains by which both parties are able to improve their economic position. It therefore seems odd that any body of contract doctrine, either at common law or under the UCC, should adopt a version of the contract that does not appear to satisfy that condition of mutual gain. So Easterbrook writes a mini law review article on equitable issues that caused Judge Crabb some minor discomfort. As one of the leading members of the Chicago School of Law and Economics, his purpose is to explain why the deal that *ProCD* envisions makes economic sense, while that which Zeidenberg champions does not. Accordingly, he starts out with an examination of the role of price discrimination in product markets.<sup>32</sup>

It should be no surprise that the words "price discrimination" were never used in either Judge Crabb's opinion nor in Professor Lemley's article on which she so heavily relied. To set up that discussion, Easterbrook points to one undisputed fact about *ProCD*'s business plan that was not mentioned below. "*ProCD* decided to engage in price discrimination, selling its database to the general public for personal use at a low price (approximately \$150 for the set of five discs) while selling information to the trade for a higher price."<sup>33</sup>

Easterbrook raises this point to show that Judge Crabb's view of contract law makes the software market unsustainable in the long run. Easterbrook thus first explains the well-known advantages of price discrimination. First look at the demand side. Like many vendors, *ProCD* operated in a market in which some buyers make extensive use of its property, for which they will pay a proportionately handsome sum. Those individuals who use it for limited purposes are not pre-

<sup>31</sup> 908 F. Supp. at 654-55.

<sup>32</sup> *Easterbrook*, 86 F.3d at 1449-50.

<sup>33</sup> *Id.* at 1449.

pared to pay the same large fees as these high demanders. Next look at the supply side. Select Phone™ cost huge sums to develop in the first instance. Nonetheless each additional unit of the product can be supplied at close to zero marginal cost. Faced with a pattern of high fixed and low marginal costs, the firm needs to do two things at once. First, it must find a way to recover the high fixed costs of the initial production (which for this purpose includes updates of the original database that are not sensitive to the usage levels of individual customers). Yet at the same time it would like to reach as many potential purchasers for its products as possible.

As Easterbrook notes, it is not possible to achieve both these goals simultaneously if *ProCD* is constrained to charge a uniform price to all potential users. That single price could be set at any one of three levels, all of which are unsatisfactory. The first pricing strategy sets the uniform sale price low enough to reach all the casual product users. The problem is that high level of market penetration comes at a high revenue loss, which makes it unlikely that *ProCD* could recover either its initial \$10 million investment or its updating fees. The second pricing strategy abandons the low end of the market and sells exclusively to high-volume users at high prices. That strategy might allow it to recover its fixed costs, but it carries with it two serious weaknesses from a social point of view. First, any additional revenue from low-intensity users could make the difference between a profitable and a failing venture, so that limiting the seller to high-intensity customers reduces the likelihood that the venture will get off the ground in the first place. Second, that strategy, even if successful, has the unfortunate side effect of precluding all of *ProCD*'s low-intensity users who were prepared to pay \$150 for the program, but not the headier sums demanded from high-intensity users. In desperation, a third strategy allows the firm to charge a price midway between the ideal price for high- and low-intensity users. But this Solomonic solution may well yield the worst of both worlds. It could keep the high demanders but reduce the revenue obtained from them, without letting the lower demanders back into the market.

As Easterbrook well recognized, this simplified model assumes for convenience that all users are grouped into these two classes, when in practice *ProCD* is much more likely to find a continuum of demand for its programs. Ideally, if *ProCD* knew the reservation price for each potential user—that is, if it knew the maximum that each party was prepared to pay—it could abandon the simple high-low strategy and charge each potential buyer one penny less than the highest amount it was prepared to pay. But that information is denied to us all, so *ProCD* did the next best thing (i.e., found a "second-best" solution) and sorted its buyers into two or more classes: sales to the trade at a high price;

sales to individuals at a lower price. That common distinction is, for example, often used in product warranties, where the ordinary homeowners receive warranty protection for their appliances only if they do not turn them to commercial use.<sup>34</sup> Once ProCD breaks down the market into two broad categories, it should increase the likelihood that it will both recover its fixed costs and reach the broadest possible segment of the market. As this contracting strategy has no negative external effects on third parties, it works a Pareto improvement: The ProCD contracting scheme leaves everyone better off—block its innovative contracting system and social welfare falls.

It's just at this point that the anti-networking provision plays a crucial role. This clause prevents anyone who purchases ProCD's software program for personal use from using it for the trade. Only by shutting down such activity could it maintain the two-part pricing schedule so critical to its success. Read that clause out of the deal, and then we are back to the unhappy world of a single price for all users.

Now the atmospherics of the case change. In a subsequent interview, Matt Zeidenberg projected himself a folk hero in this "David versus Goliath" story.<sup>35</sup> But under Easterbrook's price-discrimination story, his conduct poses a mortal threat to all potential low-intensity users of the product, by forcing ProCD to abandon that segment of the market, assuming that it stays in the market at all. At this point, the contract analysis has a different form of urgency, which is to make sure that efficient contractual provisions are not routinely left on the cutting room floor.

So Judge Easterbrook then turns his attention to the process of contract formation, where, informed by his analysis of price discrimination, he goes in the opposite direction from Judge Crabb. Right off the bat, he announces that he does not care whether this transaction is a sale or a license, and thus is happy to examine the transaction under the UCC with a different set of eyes.<sup>36</sup> His view is to find low-cost solutions that get to optimal contracts. Recall that Judge Crabb stressed that a key element of a successful commercial transaction is the pres-

<sup>34</sup> See George L. Priest, *A Theory of the Consumer Product Warranty*, 90 *Yale L.J.* 1297 (1981).

<sup>35</sup> *Freedom from Contract*, *supra* note 7, at 829 (Zeidenberg describing the lawsuit as a heroic battle between David and Goliath). That characterization is contested by academics sympathetic to ProCD. See, e.g., James J. White, *Contracting Under Amended 2-207*, 2004 *Wis. L. Rev.* 723, 741 (while writing in the *Wisconsin Symposium on Freedom from Contract*, called Matthew Zeidenberg "a naughty fellow who should have his hands slapped.")

<sup>36</sup> *Easterbrook*, 86 *F.3d* at 1450.

ence of real bargaining over terms, or at least the opportunity to bargain over terms between the parties. Professor Lemley had made the same point earlier: "In the prototypical contract, where the parties meet face to face and discuss the terms before coming to an agreement, the bargain is obvious. But where is the bargain in a standard form shrinkwrap license that is not even signed by the party against whom it will be enforced?"<sup>37</sup>

Judge Easterbrook, rightly, rejects this position for its deep theoretical confusion about the relationship of contracting to contract. The key point here has to do with the role of transaction costs in economic affairs. The Crabb/Lemley position takes the view that actual negotiation is a sign of market health. But Judge Easterbrook, who writes very much in the transaction cost tradition of Ronald Coase,<sup>38</sup> takes the diametrically opposite position; bargains are good because of the mutual gains they generate, but bargaining is a necessary evil whose costs invariably erode the mutual gains that make voluntary bargains the key driver of social progress. We want to maximize bargains, and one way to do that is to get rid of costly bargaining that follows when contract rules are indefinite.

To see why, it is worth noting that voluntary markets that approach perfect competition—with multiple buyers and sellers, and fungible markets—display little or no bargaining of either price or terms—and a high volume of bargains. No one thinks that ordinary bulk purchases of foodstuffs done at low prices in a supermarket are suspect because the checkout clerk is purposefully denied any authority to alter the price or terms of sale. Precisely because these goods are sold in mass markets, individual bargaining is not a sustainable strategy when speed is of the essence for high-volume transactions. No one wants to stand in line behind the asocial customer who has a hankering to bargain over prices. Successful firms will not tolerate such behavior for the administrative breakdown it signals, for the loss of control that it has over its internal operations, and for the massive customer resentment it spawns. Using nonnegotiable terms and uniform (low) prices shores up the customer base by allowing uninformed consumers to piggyback on their more knowledgeable compatriots. Of course, all the world is not a checkout line, so with nonfungible assets, such as the sales of homes and businesses, costly bargaining over price and terms is inescapable. But mass marketing avoids these hassles—at least if

<sup>37</sup> Lemley, *supra* note 20, at 1248–49.

<sup>38</sup> See, yet again, Ronald H. Coase, *The Problem of Social Cost*, 3 *J.L. & Econ.* 1 (1960).

the integrity of its contract structure is observed. What Crabb and Lemley see as a sign of contract health is in many instances a social cancer.

Armed with this perspective, Judge Easterbrook has a very different take on the view of the UCC that requires all terms to be visible to be part of the contract:

But why would Wisconsin fetter the parties' choice in this way? Vendors can put the entire terms of a contract on the outside of a box only by using microscopic type, removing other information that buyers might find more useful (such as what the software does, and on which computers it works), or both. The "Read Me" file included with most software, describing system requirements and potential incompatibilities, may be equivalent to ten pages of type; warranties and license restrictions take still more space. Notice on the outside, terms on the inside, and a right to return the software for a refund if the terms are unacceptable (a right that the license expressly extends), may be a means of doing business valuable to buyers and sellers alike.<sup>39</sup>

The differences in attitude should be crystal clear. Judge Crabb thought that insisting that all relevant terms be visible on the box struck a blow for consumer freedom. Judge Easterbrook treats such a requirement in the opposite fashion, as a restraint (or fetter) on freedom of contract. As with all such restraints, these operate to the disadvantage of both seller and purchaser by reducing the gains from trade. In this case, the hidden costs derive from the scarcity of high rental space on the box top. By analogy, modern real estate developers commonly place commercial businesses on the ground floor and residential homes up top, with offices sandwiched in between. They want places that serve high traffic to have easy access to the customer base. Merchants operate in exactly the same way, by accentuating the positive. They know that customers think first of what products are intended to do, not what legal restrictions are placed upon their use. If the law required them to place second-order warnings on the box, then it necessarily displaces the kind of information that consumers are likely to find more useful, especially for the 99-plus percent of consumers who are happy to play by the seller's rules. Cluttered boxtops reduce consumer awareness of the positive product feature: They must therefore be offset by more advertisement, which raises cost and thus shrinks

<sup>39</sup> *Easterbrook*, 86 F.3d at 1450-51.

demand. Easterbrook is right to point out the consumer harm that flows from ostensibly pro-consumer rules.

The question then arises what should be done. In many ordinary sales contracts, it is tolerable to keep the traditional rule that the contract is formed when the product is purchased at the store. It is not as though the green grocer is determined to contract out of a warranty of merchantable quality. But with software, which is an information good, the contracts for sale are more complicated because of how easy it is to share that information with others in ways that defeat any socially valuable scheme of price discrimination.

At this point, it is critical to deviate from the traditional doctrinal rule that holds contract complete at the time of sale, because it disrupts the orderly pattern of exchanges that markets have found to deal with high-information goods. The great vice of the Crabb position is that it embraces a default rule of contract formation that flies in the face of the traditional and sensible practices long used by industries to flog their software. That view overlooks the transaction nightmare it spawns, and proceeds as if there were no reputational constraints that serve as a bulwark against sharp practices. Judge Crabb should have followed her equitable instincts in this case, because the true spoiler of the situation was not ProCD, but Zeidenberg. Accordingly, when Easterbrook reads §2-204, his functional instincts lead him to come out the exact opposite way from Judge Crabb:

A vendor, as master of the offer, may invite acceptance by conduct, and may propose limitations on the kind of conduct that constitutes acceptance. A buyer may accept by performing the acts the vendor proposes to treat as acceptance. And that is what happened. ProCD proposed a contract that a buyer would accept by using the software after having an opportunity to read the license at leisure. This Zeidenberg did. He had no choice, because the software splashed the license on the screen and would not let him proceed without indicating acceptance. So although the district judge was right to say that a contract can be, and often is, formed simply by paying the price and walking out of the store, the UCC permits contracts to be formed in other ways. ProCD proposed such a different way, and without protest Zeidenberg agreed.<sup>40</sup>

The Easterbrook analysis of delayed acceptance thus solves the central problem with shrinkwrap contracts, by allowing for the incorporation of the critical terms that are revealed only after the package is

<sup>40</sup> *Id.* at 1452.

opened or the product is installed. As such, it represents an enormous advance over Judge Crabb's view, which, by placing the time of contracting earlier, knocks out the entire set of terms that is so essential to the business bargain. But function alone does not carry the day. Doctrinal issues always rear their ugly heads. Postponing contract until the later time creates fresh problems, ones that Easterbrook does not discuss, because now there is no agreement between the parties to cover any events that occur between the time of sale and the moment the package is opened or installed. Thus suppose that the software package were lost or damaged before it was opened. If the contract had been complete at the time of sale, as Judge Crabb had found, then the risk of loss passes to the buyer. But if the contract is complete only when the box is opened, then how should the contract allocate the risk of loss? At that point, the status of the box remains unclear, and the not-yet buyer could argue that he or she was only a bailee of the goods who did not bear the risk of loss in the absence of negligence in caring for the goods.

More generally, sound commercial relations make it desirable to push the time of contract forward, not backward, so that the agreement can cover all aspects of the transaction once any part payment or performance has occurred. For example, the great case of *Carlill v. Carbolic Smoke Ball* allowed the buyer of the smoke ball to claim the £100 reward when she caught influenza after she used the smoke ball.<sup>41</sup> The English Court of Appeal treated the use of the smoke ball in accordance with its terms as an acceptance by conduct, in line with the Easterbrook opinion. But that solution, which got Mrs. Carlill £100, had a systematic failing insofar as its belated contract did not govern relationships before it was accepted, i.e., after the sale and before the course of treatment had been completed. That left open the question of whether Carbolic could "revoke" its offer in that interim period, after use had been started but before it was completed. Since there is no good commercial reason to allow Carbolic that bit of contractual opportunism, the long-standing legal solution implies a subsidiary term or agreement to keep the principal undertaking open until the buyer had a chance to complete the prescribed course of treatment. Moving the contract forward to the time of sale has the advantage of letting it govern the usual portions of the business, e.g., risk of loss, for which no special rules are needed. Hence it is possible to combine the best of Easterbrook's relentless functionalism with Judge Crabb's unyielding formalism. The initial contract is complete on sale, but it contains an

<sup>41</sup> See *Carlill v. Carbolic Smoke Ball Co.*, [1893] 1 Q.B. 256 (C.A. 1893) (Bowen, L.J., Lindley L.J. & Smith, L.J.).

implicit option to allow the buyer to back out of the deal once he or she examines the terms—an option that is almost never likely to be exercised. That solution is parallel to the one that eventually prevailed in dealing with the transaction in *Carlill*. Thus *Restatement (Second) of Contracts* §45<sup>42</sup> treats the original promise as containing an implicit option that allows the offeree a clear opportunity to finish an engagement that he has started before any revocation was made.<sup>43</sup> And there is little doubt that the response to this particular problem was one of the driving forces to the adoption of the offer and acceptance rules in the Uniform Commercial Code.<sup>44</sup>

Both this option view and Judge Easterbrook's deferred acceptance solve the big problem of getting the full range of terms into the contract. But patching the big hole still leaves a smaller one to plug. What should be done when, against all odds, the buyer decides to leave that take-it-or-leave-it offer? The contract in *ProCD* suggests only that the buyer return the product to the dealer from which it was purchased. It does not say in so many words that he is entitled to his money back, although that is certainly the initial correct response in cases of this sort. The only complication that could arise is if it is possible to unlock the contents of the CD, bypassing the lockout devices intended to prevent use of the product. But in general, the right response is that the original seller is duty bound to take back the CD so long as it is in undamaged condition, even if it is no longer in the original container.

The actual contract in *ProCD* did not quite hit the nail on the head because it did not flat out say that *ProCD* would take back the software if the buyer decided to reject the terms. It said only to return the box "to the place where you obtained it," without naming the retailer.<sup>45</sup> In fact this conscious evasion adds some notable complications into the

<sup>42</sup> §45. Option Contract Created by Part Performance of Tender

- (1) Where an offer invites an offeree to accept by rendering a performance and does not invite a promissory acceptance, an option contract is created when the offeree begins the invited performance or tenders a part of it.
- (2) The offeror's duty of performance under any option contract so created is conditional on completion or tender of the invited performance in accordance with the terms of the offer.

<sup>43</sup> For variations on this theme, see Clarke B. Whittier, *The Restatement of Contracts and Mutual Assent*, 17 Cal. L. Rev. 441, 450 (1928-29).

<sup>44</sup> See FRIEDRICH KESSLER & GRANT GILMORE, *CONTRACTS: CASES AND MATERIALS* 291 (2d ed. 1970) (referring to UCC §2-206).

<sup>45</sup> *Crabb*, 908 F. Supp. at 644.

analysis that both Judges Crabb and Easterbrook finessed by proceeding as if ProCD and Zeidenberg had made a contract. Yet that description seems falsified by the simple observation that “[i]n later 1994, defendant Zeidenberg purchased a copy of Select Phone™ at a local retail store.”<sup>46</sup> (Note how Judge Crabb uses the word “at” rather than “from,” which carries a somewhat different connotation.) But now return to the language of reasonable expectations that dominates the UCC. It is hard to think that Zeidenberg thought he purchased the box from ProCD, and ProCD’s return statement makes it appear as though the retailer is responsible for deciding whether to offer a refund. But if ProCD has not entered into any contract with Zeidenberg, then where does it get the right to enforce any limitations against transfer? The privity limitation states that only parties to a contract can have rights under it. That principle has long bedeviled the law of torts and now comes back with a vengeance.

Recall a famous observation of Judge Cardozo in *MacPherson v. Buick Motor Co.*: “The dealer was indeed the one person of whom it might be said with some approach to certainty that by him the car would not be used. Yet the defendant would have us say that he was the one person whom it was under a legal duty to protect. The law does not lead us to so inconsequent a conclusion.”<sup>47</sup> So here, the party that has the real stake in the reuse of this program is ProCD, so it would be odd to say that the only contractual action belongs to the retailer, who has neither the expertise nor interest to sue. One could try to think of ProCD as having received some assignment of the seller’s interest, which would be very odd if the additional terms were not part of the retail contract.

In fact, we should all be relieved that no one sought to open this can of worms, because it allowed the real confrontation to emerge. But there is an important object lesson here, in which some network of contracts (at least three) is needed to link the three parties of this transaction together: retailer–customer, customer–manufacturer, and manufacturer–retailer. It may well be that the best solution is for ProCD to promise its buyers that they can make returns of the unused application to the retailer from whom the purchase was made. It also seems appropriate for ProCD to guarantee its retailers that they will receive their money back for any returns as well. The web of contracts is not easy to develop explicitly on a piecemeal basis, so it makes sense for everyone to drop the retailer out of the picture. Ironically this is easier

<sup>46</sup> *Id.* at 645.

<sup>47</sup> 111 N.E. 1050, 1051 (N.Y. 1916).

under the Roman Law, which places the emphasis on agreement, and less on offer and acceptance.<sup>48</sup> But somehow the law has to find a way to allow the real party in interest to seek its injunctive relief precisely because the privity limitation does a bad job in getting matters right.<sup>49</sup> No one said that the contract law of offer and acceptance had to be easy. It isn’t.

### Copyright Preemption

The second of the two contract issues in *ProCD* is at a conceptual level far removed from the nitty-gritty of offer and acceptance. Now the field of combat changes. Here it is assumed that the parties have entered into a transaction that meets all the requirements for a valid contract under state law on the terms that ProCD sought, including the prohibition against the use of its files for commercial purposes. Now the question is whether the copyright law trumps the contract law under the doctrine of preemption. The basic doctrine of preemption stems from the Supremacy Clause of the United States Constitution, which provides that “[t]his Constitution, and the Law of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or the Laws of Any State to the Contrary notwithstanding.”<sup>50</sup> The substantive message from this clause is that any lowly federal law trumps any state law that operates to the contrary. State judges are expressly bound to follow the federal law. It is assumed that the federal judges are not exempt from this provision, but that they would do so in any event, given that their natural loyalties lie within the federal system.

<sup>48</sup> See James Gordley, *Enforcing Promises*, 83 Cal. L. Rev. 547, 562 (1995).

<sup>49</sup> A similar solution was adopted in the early law of product liability with goods sold in sealed containers, where the action for any dangerous condition placed in the product (slivers of tin in the tuna can) was brought against the manufacturer, and not the retailer. See, e.g., *Richenbacher v. California Packing Corp.*, 145 N.E. 281 (Mass. 1924) (heavy gray glass in spinach can). The modern law that allows the action against the retailer who acts as a mere conduit, see *Vandermark v. Ford Motor Co.*, 391 P.2d 168 (Cal. 1964), creates additional problems by bringing in a third party that complicates the litigation (in ways that are of direct relevance to civil procedure classes, given that an out-of-state manufacturer cannot remove to federal court if the plaintiff joins in an in-state retailer).

<sup>50</sup> U.S. CONST. art. VI, cl. 2.

ies a trade secret requires by contract the buyer not to reverse engineer that product. The contract provision here encourages the voluntary dissemination of useful products and should be enforced, as it usually is.<sup>74</sup> In all these cases, the key function of property rights is to create the baseline from which voluntary transactions can take place. It is not, as Judge Crabb assumed, to block further voluntary transactions.

In the end, a broad intellectual gulf separates Judge Crabb from Judge Easterbrook. She looks at these voluntary transactions with deep suspicion, as if they were a deviation from some grand copyright scheme. Contract is thus a dubious end run around property. Judge Easterbrook follows the economic model and sees voluntary contracts as improving social welfare by voluntary exchange. He rightly understands that the Copyright Act prevents the states from creating new or different property rights among strangers. He is equally correct to deny that copyright law prevents the creation of new and different property right by contracts. Once again his sure sense of the economic function of property and contract rights leads him to a result that is easy to miss on a traditional doctrinal approach.

### Epilogue

*ProCD* has both its personal and institutional significance. As to the immediate parties, *ProCD* was acquired by a firm called Acxiom in April 1996 for about \$47 million in stock.<sup>75</sup> One month later, the decision in *ProCD* came down, and ironically Acxiom's stock dropped two points, from 34 to 32, on the news.<sup>76</sup> The impact on Matthew Zeidenberg is captured by his own assessment of the overall situation, which encapsulated his view of law and economics generally:

[C]oming into this as a sort of a naïve person who'd never been involved in a lawsuit before, I really expected a lot more consistency in the law. . . I researched what the law was, and I went into court and I expected to get what I got from Barbara Crabb. And then when I got to Judge Easterbrook, I had no idea about, you know, the Olin Foundation and "law and economics" and the Chicago School and Judges Easterbrook and Posner and this whole thing; you know I had no idea that this kind of thing could happen. I was just totally blown away.<sup>77</sup>

<sup>74</sup> See, e.g., *Davidson & Associates v. Jung*, 422 F.3d 630 (8th Cir. 2005).

<sup>75</sup> *Acxiom Stock Up on Deal*, N.Y. Times, Apr. 10, 1996, at D4.

<sup>76</sup> Eric Convey, *Danvers Firm Wins Court Battle*, Boston Herald, June 25, 1996.

<sup>77</sup> *Freedom from Contract*, *supra* note 7, at 835–36.