*Hill v. Gateway 2000, Inc.**

As more and more consumer transactions are conducted via mail and telephone,[1] courts begin to face difficult issues of contract formation. Vendors cannot reasonably be expected to tirelessly read cumbersome boilerplate language over the phone just as consumers cannot be expected to suffer through such a monotonous recitation. Consequently, consumers agree to purchase products without knowing all of the contract terms, with the understanding that they will be able to "back out" of the contract if they later encounter provisions, such as arbitration clauses, that they find unacceptable. Although courts usually allow such an understanding, the consumer's ability to be released from the contract obligations depends on when and if a contract was actually formed. Even if a court finds contract formation, it may strike various provisions which are unfair or unlawful.[2]

Rich and Enza Hill initiated a consumer transaction with Gateway in September of 1995.[3] After reading about an offer for a computer system in a magazine, they called Gateway and ordered the computer for $4,009 plus tax and shipping. After receiving the computer, the Hills discovered numerous defects and inadequacies in the system based in part on Gateway's misrepresentations of the system in the magazine advertisement.[4]

Accompanying the system was a "Standard Terms and Conditions Agreement," which contained, among other items, a three-year limited warranty,[5] a liability limitations clause[6] and an arbitration clause.[7] The

---

*105 F.3d 1147 (7th Cir. 1997).

[1] In 1989, the mail order industry reached $183.3 billion in sales, up 75-fold from 1967. Moreover, more than 54% of Americans made at least one mail order purchase in 1990. *See* State *ex rel.* Heitkamp v. Quill Corp., 470 N.W.2d 203, 209 (N.D. 1991).

[2] E.g., unconscionability, or in some situations, arbitration clauses. *See infra* note 12.

[3] *See* Hill v. Gateway 2000, Inc., No. 96-C4086, 1996 WL 650631, at *1 (N.D. Ill. Nov. 7, 1996).

[4] *See id.* at *1–2. The CD-ROM that the Hills received was allegedly a slower model than the one described in the ad, a model which performed poorly due to "sub-par materials" used by Gateway. Moreover, the "surround sound" speakers promised by Gateway allegedly did not produce surround sound but instead emitted a "static or hiss." Gateway admitted that it did not offer surround sound speakers, and that there had been a misprint in its advertising. In addition, Gateway allegedly substituted an inferior graphics accelerator without informing its customers. Overall, the Hills would have had to pay an additional $1000 to get the system they thought they had ordered. *See id.*

[5] The district court did not reproduce the warranty clause, stating only that it contained "various exclusions and limitations." *Id.*

[6] The liability limitations clause stated:

> Any liability of Gateway under this Agreement is expressly limited to the price by Buyer for the Products that are the subject of a dispute or controversy. Buyer's sole remedy

Hills had not seen this agreement before receiving the computer and had no prior notice that an arbitration clause would be included in the materials.[8] They claimed that Gateway provided these clauses because it intended to engage in fraudulent conduct and did not want its customers to be able to seek judicial redress for their resulting losses.[9] The Hills brought a class action suit against Gateway, alleging breach of contract and seeking a declaratory judgment that the clauses described above were not enforceable.[10] In addition, they sued Gateway for violations of the Uniform Commercial Code ("U.C.C."), the Magnuson-Moss Consumer Warranty Act, the Racketeer Influenced and Corrupt Organization Act ("RICO"), the Illinois Consumer Fraud Act and the South Dakota Consumer Fraud Act.[11] The district court's refusal to honor the arbitration clause was immediately appealed by Gateway, which led to this Seventh Circuit opinion.[12]

> against Gateway in any dispute or controversy concerning this Agreement shall be to seek recovery of the foregoing amount, upon the payment of which Gateway shall be released from and discharged of all further obligations and liability to Buyer. IN NO EVENT SHALL EITHER PARTY BE LIABLE TO THE OTHER FOR SPECIAL, EXEMPLARY, CONSEQUENTIAL, INCIDENTAL OR INDIRECT DAMAGES, INCLUDING BUT NOT LIMITED TO, LOSS OF ANTICIPATED PROFITS OR ECONOMIC LOSS, EVEN IF THE OTHER PARTY HAS BEEN ADVISED OF THE POSSIBILITY OF SUCH LOSS OR DAMAGE.

Id. at *2. (emphasis in original) Gateway did in fact offer to replace certain parts of the computer system or refund the Hills' purchase price. *See id.*

[7] The arbitration clause stated:

> Any dispute or controversy arising out of or relating to the Agreement or its interpretation shall be settled exclusively and finally by arbitration. The arbitration shall be conducted in accordance with the Rules of Conciliation and Arbitration of the International Chamber of Commerce. The arbitration shall be conducted in Chicago, Illinois, U.S.A. before a sole arbitrator. Any award rendered in any such arbitration proceeding shall be final and binding on each of the parties, and judgment may be entered thereon in a court of competent jurisdiction.

Id.

[8] In *Hill v. Gateway 2000, Inc.*, 105 F.3d 1147 (7th Cir. 1997), the Seventh Circuit pointed out that under the agreement, the Hills had 30 days to examine the agreement and return the computer for a full refund. Instead, the Hills waited more than 30 days before complaining about the computer's faulty performance and components. *See id.* at 1150.

[9] *See Hill*, 1996 WL 650631, at *2.

[10] *See id.* at *1.

[11] *See id.*

[12] The portion of the district court opinion that is published discusses only class certification standards. The Seventh Circuit cites the relevant portion of the unpublished

While the Seventh Circuit's common sense approach initially seems logical, a closer examination of the decision reveals the court's misapplication of the U.C.C. and the court's failure to consider applicable provisions of a relevant federal statute, the Magnuson-Moss Consumer Warranty Protection Act. Judge Easterbrook's terse opinion dealt only with the arbitration clause in the agreement between the Hills and Gateway, ultimately finding it valid.[13] The court began by addressing the Hills' claim that the arbitration clause did not "stand out." Relying on the recent Supreme Court opinion in *Doctor's Associates, Inc. v. Casarotto, Inc.*,[14] the court stated that generally there is no requirement that an arbitration clause be prominent to be enforceable. The Hills, reasoned the court, did not need to read the contract provisions for them to be effective. Taking an all-or-nothing approach, the court stated that "[t]erms inside Gateway's box stand or fall together," so that if the Hills did not contact Gateway within 30 days of receipt of the computer, then all of the contract provisions must be enforced.[15]

The court next spoke generally about "commercial transactions in which people pay for products with terms to follow,"[16] referring to a case in which the Supreme Court enforced a forum-selection clause within three pages of terms that accompanied a cruise ship ticket.[17] More significantly, the court introduced another Seventh Circuit case, *ProCD, Inc. v.*

opinion pertaining to the arbitration clause: "[t]he present record is insufficient to support a finding of a valid arbitration agreement between the parties or that the plaintiffs were given adequate notice of the arbitration clause." *Hill*, 105 F.3d at 1148.

[13] *See id.* at 1151. The Seventh Circuit remanded the case with instructions to compel the Hills to submit their claim to arbitration. The Hills filed a petition for rehearing en banc on January 21, 1997. The petition was unanimously denied. Hill v. Gateway 2000, Inc., No. 96-3294, 1997 U.S. App. LEXIS 1877 (7th Cir. Feb. 3, 1997).

[14] 116 S. Ct. 1652 (1996). In *Doctor's Associates*, a Montana statute required that "Notice that a contract is subject to arbitration . . . shall be typed in underlined capital letters on the first page of the contract; and unless such notice is displayed thereon, the contract may not be subject to arbitration." *Id.* at 1654. The Court held that Section 2 of the Federal Arbitration Act preempted the statute by providing that "A written provision . . . to settle by arbitration . . . shall be valid, irrevocable, and enforceable, save upon grounds that exist at law or in equity for the revocation of any contract." *Id.* at 1656–1657.

[15] *Hill*, 105 F.3d at 1148.

[16] *Id.*

[17] *See* Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585 (1991). The case is not precisely analogous, however, since, unlike the Hills, the plaintiffs in *Carnival* conceded that they had notice of the forum selection provision. The Court explicitly reserved the question of notice: "[W]e do not address the question whether respondents had sufficient notice of the forum clause before entering the contract for passage." *Id.* at 590.

Zeidenberg,[18] upon which it based the remainder of the *Hill v. Gateway* analysis.[19] In *ProCD*, the Seventh Circuit held that one who buys a box of software is bound by the terms inside the box after having had an opportunity to read the terms and reject them by returning the product.[20] The court in *ProCD* framed the issue as one of contract formation: "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."[21] Thus, according to *ProCD*, the vendor makes an offer by making available a product at a certain price, with the contract provisions in the box. The buyer accepts not simply by purchasing, but also by not returning the item within a certain period of time, to be determined by the vendor, the "master of the offer." If the buyer returns the item within the set period of time, then the offer is rejected. The court concluded that *ProCD* applied to the Hills' case,[22] so that the Hills accepted the contract with all of its terms by not returning the computer system within thirty days.[23]

The court then discussed the widespread use[24] and practical advantages of the approve-or-return method of contract formation in routine commercial transactions. Commerce would be considerably frustrated if, for example, a cashier had to read legal documents to customers before having the customers pay for the items. Similarly, as in the present case, it would be unduly burdensome to require a company salesperson to read pages of documentation over the phone before taking a customer's credit card number.[25] Although the observations here are insightful, the court seems to be answering an argument that the Hills did not make. Surely they did not suggest that *all* contract terms be recited before purchase; rather certain

---

[18] 86 F.3d 1447 (7th Cir. 1996).

[19] *See Hill*, 105 F.3d at 1148.

[20] *See id.* (citing *ProCD*, 86 F.3d at 1447).

[21] *Id.* at 1452.

[22] The Seventh Circuit used the following reasoning to conclude that *ProCD* applied to *Hill*: Gateway and ProCD used the same sort of accept-or-return offer; the court in *ProCD* relied on the U.C.C. instead of peculiarities of Wisconsin law; both states in the present case have adopted the U.C.C.; neither party has pointed to any other atypical doctrines in those states that might apply; therefore, *ProCD* applies to the present case. *See Hill*, 105 F.3d at 1149.

[23] *See id.* at 1150.

[24] The court noted that "[p]ayment preceding the revelation of full terms is common for air transportation, insurance, and many other endeavors." *Id.* at 1149.

[25] The court in *Hill* noted, "[T]he droning voice would anesthetize rather than enlighten many potential buyers." *Id.*

important, unusual terms, such as arbitration or liability limitation clauses, should be disclosed prior to purchase or displayed prominently on written materials accompanying the purchase.

The Hills attempted to distinguish *ProCD*, which dealt with a software license, on the ground that it should apply only to executory contracts, or licenses in particular.[26] *ProCD* would therefore not apply, because both parties' performance of the agreement was complete when the Hills received the computer system in their home.[27] Not only were the parties' performance not complete at this time,[28] opined the Seventh Circuit, but *ProCD* and this case were not about performance at all, they were about contract *formation*.[29] The court seemed to be saying that the contract was formed when the Hills' received the computer system and allowed thirty days to elapse without contacting Gateway.

The court then summarily addressed the Hills' argument that *ProCD* is irrelevant because the buyer in that case was a merchant, as opposed to consumers, like the Hills.[30] The Hills pointed to Section 2-207(2) of the U.C.C., the battle-of-the-forms provision, which states that "additional terms [following acceptance of an offer] are to be construed as proposals for addition to a contract. Between merchants, such proposals become part of the contract unless . . . they materially alter it . . . ."[31] Distinguishing *ProCD*, the Hills argued that the terms inside the software box were not excluded by the "unless" clause. The court first disagreed with the Hills' characterization of the ProCD buyer, Zeidenberg, as a merchant, because he purchased the software at a retail store.[32] Even if he was a merchant, the

---

[26] *See id.*

[27] *See id.*

[28] The Seventh Circuit stated that performance was not complete because Gateway had promised future performance in the form of future service and warranty obligations. *See id.* at 1149-1150. The U.C.C., however, treats performance of a contract and contract warranties as two mutually exclusive events. The U.C.C. refers to performance in terms of the seller's basic obligation to tender conforming goods and the buyer's obligation to pay for them. *See* U.C.C. §§ 2-301, 2-507, 2-511 (1977). Warranties of quality, on the other hand, are governed separately in the code, independent of performance. *See* U.C.C. §§ 2-314 to 2-318 (1977). It would be anomalous if a buyer had to wait for the expiration of a warranty or service agreement, here Gateway's "lifetime service," to determine whether or not the basic obligations of the contract had been performed.

[29] *See Hill*, 105 F.3d at 1149-1150.

[30] *See id.* at 1150.

[31] *Id.* (quoting U.C.C. § 2-207). Courts have found that arbitration clauses are material alterations. *See, e.g.*, Bergquist Co. v. Sunroc Corp., 777 F. Supp. 1236, 1243-1247 (E.D. Pa. 1991).

[32] *See Hill*, 105 F.3d at 1150. While the court correctly *quoted* the U.C.C. § 2-104(1)

court stated, Section 2-207(2) would not apply because there was only one form involved.[33] Again, the court seemed to misunderstand that U.C.C. Section 2-207 does not apply only to the situation when two forms are exchanged. On the contrary, Official Comment 1 to Section 2-207 provides:

> This section is intended to deal with two typical situations. The one is the written confirmation, where an agreement has been reached either *orally* or by informal correspondence between the parties and followed by *one* or both of the parties sending formal memoranda embodying the terms as far as agreed upon and adding terms not discussed. [The other situation is the typical exchange of offer and acceptance forms referred to by the Seventh Circuit.][34]

The Hill/Gateway agreement falls precisely into the first described situation. The Hills' oral agreement to purchase the computer system over the phone was followed by Gateway's written embodiment of the agreement, including terms not discussed. At the very least, the Hills' U.C.C. arguments merit more comprehensive consideration than that dispensed by the Seventh Circuit.[35]

The court next dismissed a final *ProCD* distinction made by the Hills. The software box in *ProCD* contained a notice that additional terms to the contract were contained inside the box, while there was no such notice on the box in which the Hills' computer was shipped.[36] Therefore, the Hills argued, *ProCD* should not apply. In response, the court made its own

---

definition of merchant as "a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction," it seemed to misunderstand its proper application. *Id.* Comment 2 to § 2-104 commands courts to construe "merchant" broadly as it appears in, among other provisions, § 2-207: "[f]or purposes of these sections almost every person in business would, therefore, be deemed to be a merchant . . . ." U.C.C. § 2-104, cmt. 2 (1977). Surely, under Judge Easterbrook's own description of him in *ProCD*, Zeidenberg would fall into the category of "every person in business" when Zeidenberg "formed Silken Mountain Web Services, Inc., to resell the information in the . . . database [when] [t]he corporation makes the database available on the internet to anyone willing to pay its price . . . ." *ProCD*, 86 F.3d at 1450. The most talented legal minds would be hard-pressed to construct a persuasive argument that Zeidenberg was not a "person in business" in this situation.

[33] *See Hill*, 105 F.3d at 1150. This was the court's conclusion in *ProCD*. *See id.* (citing *ProCD*, 86 F.3d at 1452).

[34] U.C.C. § 2-207, cmt. 1 (1977) (emphasis added).

[35] The drafters of Article 2 of the U.C.C. may deal with the issue of boxed contract terms in the revision of Article 2, due to be released at the end of 1998.

[36] *See Hill*, 105 F.3d at 1150.

distinction between the boxes. The software box in *ProCD* allowed the consumer to look at the box in determining whether to buy the product notwithstanding the additional terms in the box.[37] Gateway's box, on the other hand, was for shipping only, with the information on the outside of the box intended for handlers rather than potential purchasers.[38] Under this view, the purpose of the notice is to allow the purchaser to avoid potential transaction costs involved in returning the product if the purchaser later finds the terms inside unpalatable.[39] Such a notice would therefore be unnecessary when the product is shipped to the purchaser sight unseen because, at this point, these transaction costs now play no part in the decision whether to purchase the product.

The court's myopic view of the notice's purpose is flawed for two reasons. First, the stated functional purpose is too narrow. Indeed, although a minority of purchasers may consider the costs of returning the product relevant in their decision to purchase, that is neither the only nor the best reason to print such a notice on the outside of the box. The obvious purpose of such a notice is to alert the consumers of additional terms inside the box so they can comply with those terms and be aware of unusual terms. Often a consumer is required to register the product in order to take advantage of a company's warranty. A consumer may need to know when a warranty expires, in order to make a claim or extend the warranty in a timely manner. Most relevant to this case, a consumer may want to be informed of liability or dispute resolution limitations. In these situations, the concern is not so much with the transaction costs of returning the item, but with having notice of the important, relevant contract provisions that might be overlooked by the average consumer not used to reading boilerplate language.

Second, the court's view of the purpose of the notice is incomplete. According to the court, the notice is no longer important after the purchaser decides whether to buy the product. This view ignores the significance of persuading the purchaser to actually read the agreement for warranty, liability and dispute resolution limitations.

Whatever the notice on the box, the Seventh Circuit clearly placed the onus on the consumer to "discover" the terms of the contract in advance, rather than on the vendor to provide notice of the terms.[40] The court described three ways in which a purchaser could access important agreement terms: (1) by asking the vendor to send the terms in advance; (2) by consulting public sources such as the vendor's website; or (3) by inspecting

---

[37] *See id.*

[38] *See id.*

[39] *See id.*

[40] *See id.*

the documents after delivery.[41] According to the court, the Hills accepted the third option. The court concluded that by not contacting Gateway within thirty days, the Hills agreed to all of the terms of the agreement, including the arbitration clause.[42]

Most troubling about this opinion is the absence of any discussion of the Magnuson-Moss Act,[43] which deals squarely with the issue before the court.[44] The Hills had two substantial arguments that the arbitration clause was unenforceable under the Magnuson-Moss Act. First, Section 703.2 contains a list of requirements, in addition to any state law requirements, that a vendor must comply with for an arbitration clause to be valid.[45] Section 703.2(b) provides that the arbitration provision must be clear and conspicuous[46] and on the face of the written warranty.[47] The Act contains various other technical requirements about information that must be included in the clause that Gateway may or may not have complied with.[48]

---

[41] *See id.*

[42] *See id.*

[43] 15 U.S.C. § 2301 (1994). Congress enacted the Act in 1974 "to improve the adequacy of information available to consumers [and] prevent deception . . . ." *Id.* § 2302(a). The Act deals primarily with consumer product warranties, including detailed guidelines for the use of "informal dispute resolution." *See* 15 U.S.C.§ 2310 (1994); 16 C.F.R § 703 (1996).

[44] The court mentions Magnuson-Moss only when discussing Gateway's obligation to distribute warranty forms to potential purchasers on request. *See Hill*, 105 F.3d at 1150. The Hills fall under the definition of "consumer" as required by the Act, and the computer, because it was not purchased for resale, is a "consumer product." *See* 15 U.S.C. §§ 2301(1), 2301(3) (1994).

[45] *See* Magnuson-Moss Warranty Act Regulations, 16 C.F.R. § 703.2 (1996).

[46] *See id.* § 703.2(b). The Seventh Circuit relied on the Supreme Court opinion in *Doctor's Associates, Inc. v. Casarotto*, 116 S. Ct. 1652 (1996), in finding no requirement that Gateway's arbitration clause be "prominent." *See Hill*, 105 F.3d at 1148. *Doctor's Associates*, however, concerned a dispute between two parties to a franchise agreement, neither of whom was a consumer, thus not implicating the Magnuson-Moss Act. This crucial distinction makes *Doctor's Associates* inapposite, and the Seventh Circuit should have decided whether Gateway fulfilled the Act's requirement of conspicuousness. While § 703 of the Magnuson-Moss Act does not define the term "conspicious," the U.C.C. states that "[L]anguage in the body of a form is 'conspicious' if it is larger or other contrasting type or color . . . . Whether a term or clause is 'conspicious' is for decision by the court." U.C.C. § 1-201(10)(1977). The arbitration clause, as reprinted in the unpublished district court opinion, seems to have been printed in regular size, nonbold-faced type. *See supra* note 7.

[47] The Act defines "on the face of the warranty" as on the side of the document where the warranty begins. *See* Magnuson-Moss, 16 C.F.R. § 703.1(h)(1) (1996).

[48] *See* Magnuson-Moss, 16 C.F.R. §§ 703.3-703.8 (1996).

Second, even if Gateway complied with all of the Act's arbitration clause requirements, it faced a steeper obstacle: the Act renders binding arbitration agreements[49] in consumer product agreements unenforceable. The Act provides that if a warrantor "establishes such a[n] [informal dispute resolution] procedure,"[50] and the procedure meets the requirements described above,[51]and if the warrantor "incorporates in a written warranty a requirement that the consumer resort to such procedure *before pursuing any legal remedy*[52] . . . then . . . the consumer may not commence a civil action . . . unless he initially resorts to such a procedure."[53] The Act speaks only of pursuing informal dispute resolution as a prerequisite to, not a substitution for, civil action.[54] The legislative history of the Act explicitly supports this conclusion.[55] Even if the Seventh Circuit somehow found for Gateway on these section 703 issues, it nonetheless erred by not considering the Act at all.

The Seventh Circuit's sloppy consideration of the U.C.C. and the Magnuson-Moss Act aside, the case sends a loud message to consumers. At least in the Seventh Circuit, Magnuson-Moss consumer protections have

---

[49] Gateway's arbitration clause stated that "any dispute or controversy . . . shall be settled exclusively and finally by arbitration . . .[a]ny award rendered in any such arbitration proceeding shall be final and binding on each of the parties . . . ." Hill v. Gateway 2000, Inc., No. 96 C-4086, 1996 WL 650631, at *2 (N.D. Ill. Nov. 7, 1996). Such language could only be construed as mandating binding arbitration.

[50] Magnuson-Moss Act, 15 U.S.C. § 2310(a)(3)(A) (1994).

[51] *See id.* § 2310(a)(3)(B).

[52] *Id.* § 2310(a)(3)(C) (emphasis added).

[53] *Id.*

[54] For a recent illustration of the application of the Magnuson-Moss informal dispute resolution provisions to render a similar arbitration clause unenforceable, see *Wilson v. Waverly Homes*, No. 96-T-1017-N, 1997 U.S. Dist. LEXIS 1361 (M.D. Ala. Feb. 4, 1997).

[55] The statements of Congressman Moss, co-sponsor of the bill, are relevant:

> First, the bill provides the consumer with an economically, [sic] feasible private right of action so that when a warrantor breaches his warranty or service contract obligations, the consumer can have effective redress. Reasonable attorneys fees and expenses are provided for the successful consumer litigant, and the bill is further refined so as to place a minimum extra burden on the courts by requiring as a prerequisite to suit that the purchaser give the [warrantor] reasonable opportunity to settle the dispute out of court, including the use of a fair and formal dispute settlement mechanism . . . .

119 Cong. Rec. 972 (Jan. 12, 1973). Moss's comments in the report on the bill articulate the conclusion even more clearly: "An adverse decision in any formal dispute settlement proceeding would not be a bar to a civil action on the warranty involved in the proceeding . . . ." H.R. REP. No. 93-1107, at 41 (1974), *reprinted in* 1974 U.S.C.C.A.N. 7702, 7723.

eroded considerably and given way to vendor-friendly notions of caveat emptor and duty to read. Consumers must now make the dichotomous, possibly adhesive choice of accepting the terms of the contract completely at their own peril, or wholly rejecting the contract and abandoning the transaction. By eviscerating consumer protections, the Seventh Circuit holds consumers to the same standards as businesses, leaving behind a dangerous precedent depriving unwary consumers of their right to sue.

Mark A. French