UNDERSTANDING THE UNIFORM COMMERCIAL CODE

by David Lloyd

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PREFACE

This short work on the three most used provisions of the Uniform Commercial Code is not designed to be a scholarly treatise on the commercial law of the United States. Nor is it designed to be the final word on the current law. Businessmen and lawyers should not rely upon the discussions in this book, but should consult the Code itself, although the explanations of various provisions should be useful in understanding what the Code means.

The best way to use this book is to approach each problem by use of the subject index or the Table of Contents. It is not written to be conducive to leisurely reading about the broad problems of the commercial law, but is better used as a reference tool since it attempts to answer specific problems. Thus, a student or businessman who desires to know the meaning of terms used in a contract, or what the effect of certain language may be, or what options are available to protect their rights when a sales contract breaks down, can find the proper discussion by using the Index.

While this book is an effort to simplify the complexities of the Uniform Commercial Code (which is the law in all states except Louisiana), I have purposely included a good deal of the language of the Code to illustrate the difficulty and technical nature of the Code. In transactions where large sums of money, important performance, and expectations are involved, a word of advice to the busy businessman who may have consulted various sections of this book: it should be obvious to you that a competent attorney should be a part of your planning team. While it is assumed in commercial transactions that everyone will act in good faith, sometimes conditions require breakdowns in the deals that are made. In such events, the rights, obligations, and liabilities of each of the parties should have been fully understood before the deals were entered into and proper risk allocation made.

In using this book, the four chapters are not really related to each other, except that chapter 1 must be consulted to understand the meaning of particular "words of art" used in the

other three chapters. Chapter 2 on the law of sales is the most comprehensive since it has codified much of the earlier contract law involving the sale of goods on credit or for cash. Chapter 3 deals with negotiable instruments, but does not include bank collections and transactions which may be involved in various negotiable instrument transactions. The bank collection law is contained in Article 4 of the Code. Chapter 4 covers secured transactions (formerly called chattel mortgages), but is merely cursory in treatment, since Article 9 is an extremely complicated and difficult law to work with.

There is included in an appendix an extensive bibliography that should be useful to students and lawyers. It is arranged by topic.

I would like to thank Miss Linda Harries and Lana Sumsion for their diligent typing efforts, as well as Dr. Randall T. Peterson for reading the manuscript. I am especially grateful to Professor Lionell Frankel who taught me commercial law at law school, although any errors in this work are my own. And finally I am grateful for my wife Janice who stuck with me through this book. I would like to dedicate this book to my son, Travis, who passed away during its preparation.

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Chapter 1

BACKGROUND

1.1 Laws governing the commercial transactions of a market place should be as similar in nature as is feasible. Similarity or uniformity of commercial rules is necessary to promote commercial trade. Stabilization of applicable laws enables businessmen and traders to predict the outcome of their negotiations, transactions and commitments. One of the difficulties in the United States' early commercial history was the attempt of local state legislatures to enact favorable laws for its citizens and discriminate against foreign merchants. The Supreme Court of the United States resolved such problems through pre-empting state commercial law by a federal common law. The divergence in state laws became more critical as interstate commerce became increasingly more important.

1.2 The necessity of having the laws regulating commercial transactions relatively uniform in each state so as to promote interstate commerce prompted the promulgation of a number of uniform acts at the turn of the century. These early attempts at creating a national uniform commercial legal system were only partially successful. Part of the difficulty in the early uniform acts was that not all of the states adopted each separate act, so there was not uniformity in the law governing all phases of a commercial transaction. Thus, the separate uniform laws governing negotiable instruments, warehousing, sales, bills of lading, stock transfer, conditional sales, and trust receipts were not wholly integrated into the legal system of each state. As time passed, nonuniform amendments to these acts and the passage of time rendered parts of each of them unacceptable.

1.3 In a great effort to standardize all of the state laws governing commercial transactions, from the negotiation stage to the final performance and payment stage, the National Conference of Commissioners on Uniform State Laws and the American Law Institute succeeded in drafting a complete revision of previous uniform laws and improved upon various common law or judge-made law rules. The final product, the Uniform Commercial Code, consisting of 9 Articles and a repealing section, has been enacted in each of the states, with the exception of

Louisana, and in the District of Columbia and Puerto Rico. The drafting of the Uniform Commercial Code was a monumental task performed by numerous law professors, judges, and practicing attorneys. The first edition took ten years to complete, from 1942 to 1952. Two later editions followed in 1958 and 1962. The Official 1962 text is the generally accepted text enacted by the states. Accompanying the Official text are Official Comments by the drafters of the Code. These Comments are not the law and may or may not be accorded due consideration by a particular court in ascertaining the meaning of any section in question. The Comments are, however, very instructive and should be noted in connection with the reading of a particular section.

2.0 ARTICLE 1. GENERAL PROVISIONS

Before examining the topics of this book, sales, negotiable instruments, and secured transactions, a number of general rules contained in the first article of the Uniform Commercial Code (hereinafter Code) should be mentioned and discussed, since they convey the general purpose and direction of the Code.

2.1 Purpose: The Code clearly states that its purpose is to simplify commercial law rules, make the law uniform throughout the United States, and to allow commercial practices to develop through custom, usage, and agreements of the parties. To further these policies, any of the provisions of the Code can be varied by an agreement between the parties. The parties may not, however, avoid another general rule of the Code: that parties act in good faith and are otherwise diligent, reasonable, and careful. The parties may provide in their contract or by oral agreement the standards to measure the performance of their obligations if the standards are not unreasonable. To further these general aims, the Code states that it is to be liberally construed by judges and lawyers and applied to promote its general policies. In some instances the courts have not followed this statement and have narrowly construed the Code, and, instead of looking at the entire Code for an indication of what the law in a particular case should be, they have looked at the previous common law. Thus in an instance where there may be a misunderstanding of a particular rule between two parties, it is wise to state the understanding in the agreement rather than assume that a judge will liberally construe the Code in a later dispute.

2.2 General Business Law: The enactment of the Code changed a good deal of previous contract law and other common law rules developed in connection with commercial transactions.

However, unless existing contract law, principal and agent law, fraud, mistake, bankruptcy, and other principles of law and equity are displaced by the particular provision in the Code, these rules of law supplement the Code.

2.3 Conflicts of Law Problems: Any agreement made that involves parties, goods, or transactions in different states may have different meanings depending upon whether the law of one state applies or the law of another state applies. The parties may agree which state or nation's laws shall govern various stages of a transaction, but the transaction must bear some "reasonable relation" to the state (often called "forum") or nation in order for that state's law to apply. Failure of the parties to agree as to which state's law will apply in case of a dispute results in an arbitrary assignment by the Code of the laws of the state to which the transactions bear an appropriate relation. On the surface this does not appear to present any difficulties. However, just what does the specific language "transactions bearing an appropriate relation to this state" mean? What kinds of minimum contacts does the transaction have to have in order for the law of a particular state to apply? There are a number of such minimum contacts in conflicts of law cases: (1) the contract was made in the state, or (2) the offer was made in the state, or (3) the acceptance was made in the state, or (4) the contract was performed in the state, or (5) there was partial performance in the state, or (6) the goods were delivered, shipped, or received in the state, or (7) the documents of title were issued, delivered, sent or received in the state, or (8) credit was extended in the state, or (9) other transactions occured in the state.

As is quite apparent, a typical transaction in which the agreement fails to specify which state law will govern may subject either of the parties to a law suit in any number of states where the transaction crosses state lines. If the Uniform Commercial Code were actually uniform in all states, and if other laws were uniform, there would be no difficulty. However, there are a number of non-uniform amendments to the Uniform Commercial Code and there are numerous differences in various state rules governing commercial transactions. Thus, a contract made by a seller in Michigan and a buyer in Illinois for goods in Indiana may be valid in Michigan and Illinois but invalid in Indiana. If the seller wants to avoid the contract, he brings an action in Indiana where the contract is then voided. There are a few limitations to the freedom of parties to choose which state's

laws shall govern their transactions. As mentioned earlier, the transaction must bear a reasonable relation to the state. The parties cannot subvert the rights of third parties. The agreement must be specific, as choice of law will not be implied. The agreement on choice of law cannot violate the unconscionable clause notion (discussed in detail in Chapter 2). And finally, the agreement cannot violate the public policy of the forum state. Specific provisions in the Code prescribe choice of law rules in particular instances but these occur only in very technical circumstances.

2.4 Remedies and Waivers of Breach: The remedies provided by the Code are specifically enumerated in each Article. However, it is important to point out that the Code generally disallows any consequential, special or penal damages. In other words, breach of an agreement does not result in liability for unforseeable harm as a result of the breach nor does breach result in a heavy fine as a penalty. To discharge a claim or right arising out of a purported breach the aggrieved party need only sign and deliver a written waiver; the waiver need not be supported by consideration.

3.0 GENERAL DEFINITIONS AND PRINCIPLES OF INTERPRETATIONS

The drafters of the Code attempted to avoid the various legal meanings of certain terms as they existed at common law and so used different words with new meanings to avoid being tied to the previous common law rules. For example, a security interest in a typewriter was formerly called a chattel mortgage; the term "chattel mortgage" had certain connotations depending upon the circumstances. The Code now refers to the typewriter as "collateral" and the mortgage as a "security interest." The owner of the typewriter is a "debtor" and the person holding the mortgage to the typewriter is a "secured party." Each of these terms has an independent meaning in the Code and is separately defined. The Code sets out in Section 1-201 forty-six separate definitions. Because of the importance of these definitions and the precise meaning attached to each word or phrase defined, the entire section is set out below. Whenever one of these defined words or phrases is used in any agreement governed by the Code, the specific meaning given by the Code will probably govern the words in the agreement unless there is sufficient extrinsic evidence available to show a mistake or lack of mutuality of agreement. A non-lawyer should be alerted to investigate further the precise meaning of words appearing in a contract governing a commercial transaction to insure that the

meaning attributed to those words are in fact the legal definition.

3.1 "Action" in the sense of a judicial proceeding includes recoupment, counterclaim, set-off, suit in equity and any other proceedings in which rights are determined.

The word "action" refers to what laymen call a lawsuit. A "right of action" refers to a legal right to bring a lawsuit to obtain a remedy enforceable by the sheriff, such as the right of action to force the return of goods not paid for by the debtor.

3.2 "Aggrieved party" means a party entitled to resort to a remedy.

3.3 "Agreement" means the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance as provided in this Act. Whether an agreement has legal consequences is determined by the provisions of this Act, if applicable; otherwise by the law of contracts.

An agreement under the Code can be found much more easily than a "contract" under traditional rules of contract law. This problem is dealt with in detail in Chapter 2.

3.4 "Bank" means any person engaged in the business of banking.

3.5 "Bearer" means the person in possession of an instrument, document of title, or security payable to bearer or indorsed in blank.

The key word to understanding this definition is "possession." The Code seems to make little distinction between the former doctrines of "title" and the simple fact of possession.

3.6 "Bill of lading" means a document evidencing the receipt of goods for shipment issued by a person engaged in the business of transporting or forwarding goods, and includes an airbill. "Airbill" means a document serving for air transportation as a bill of lading does for marine or rail transportation, and includes an air consignment note or air waybill.

3.7 "Branch" includes a separately incorporated foreign branch of a bank.

3.8 "Burden of establishing" a fact means the burden of persuading the triers of fact that the existence of the fact is more probable than its non-existence.

This term is strictly a legal term relating to the fact that

the party trying to prove something must convince the judge or jury that something actually exists or did happen.

> 3.9 "Buyer in ordinary course of business" means a person who in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods buys in ordinary course from a person in the business of selling goods of that kind but does not include a pawnbroker. "Buying" may be for cash or by exchange of other property or on secured or unsecured credit and includes receiving goods or documents of title under a preexisting contract for sale but does not include a transfer in bulk or as security for or in total or partial satisfaction of a money debt.

A "buyer in ordinary course of business" receives certain protections, as will be explained in later chapters. However, the requirements for being a buyer in ordinary course of business must be fully met to take advantage of the protections: (1) the buyer must act in good faith (honest in fact), (2) without knowledge that he violates another's rights or interests, and (3) the buyer must buy from a seller who ordinarily sells goods of that type. Thus, a sale of a personal automobile by a businessman who sells insurance does not render the buyer a "buyer in ordinary course of business" since the seller does not ordinarily sell automobiles.

> 3.10 "Conspicuous": A term or clause is conspicuous when it is so written that a reasonable person against whom it is to operate ought to have noticed it. A printed heading in capitals (as: NON-NEGOTIABLE BILL OF LADING) is conspicuous. Language in the body of a form is "conspicuous" if it is in larger or other contrasting type or color. But in a telegram any stated term is "conspicuous". Whether a term or clause is "conspicuous" or not is for decision by the court.

Difficulties arise over the meaning of "conspicuous" where a contract attempts to exclude or modify the implied warranty of merchantability (for example). In such a case, if the exclusion or modification is not conspicuous, it will not be effective. The key words in this definition are what constitutes a "reasonable person" and "noticing" the term or clause. The best procedure in such circumstances is to print the exclusion or waiver or other clause in large, different-color type, and then ask the

other party to initial each such clause. If the other party does not see the clause or his attention is not called to the clause, it becomes difficult to escape under the old rule that one is supposed to read what one signs, especially where the parties are not in substantially the same bargaining position. The contract is supposed to represent the agreement of the parties, and it is difficult to prove the existence of an agreement where the terms of the purported agreement are too small to read and contain endless "boiler plate" clauses which few reasonable persons would be expected to read and assent to.

3.11 "Contract" means the total legal obligation which results from the parties' agreement as affected by this Act and any other applicable rules of law.

3.12 "Creditor" includes a general creditor, a secured creditor, a lien creditor and any representative of creditors, including an assignee for the benefit of creditors, a trustee in bankruptcy, a receiver in equity and an executor or administrator of an insolvent debtor's or assignor's estate.

3.13 "Defendant" includes a person in the position of defendant in a cross-action or counterclaim.

This is merely a technical term meaning anyone who has to answer a complaint made in a lawsuit.

3.14 "Delivery" with respect to instruments, documents of title, chattel paper or securities means voluntary transfer of possession.

Since the possession of an "instrument" or written document may indicate certain rights or value in and of itself, turning such a piece of paper over to another person (called delivery) can have serious consequences and affect a number of rights.

3.15 "Document of title" includes bill of lading, dock warrant, dock receipt, warehouse receipt or order for the delivery of goods, and also any other document which in the regular course of business or financing is treated as adequately evidencing that the person in possession of it is entitled to receive, hold and dispose of the document and the goods it covers. To be a document of title a document must purport to be issued by or addressed to a bailee and purport to cover goods in the bailee's possession which are either identified or are fungible portions of an identified mass.

It is clear that there must be a third party designated on the face of the instrument indicating that the third party is in

fact a bailee. The instrument must also specifically identify the goods. "Fungible" goods are those such as wheat or corn, etc., that are sold as lots. The document of title is generally negotiable -- that is, it can be transferred to another party who then may surrender the document of title to the bailee (person holding the goods) for possession of the goods.

3.16 "Fault" means wrongful act, omission or breach.

3.17 "Fungible" with respect to goods or securities means goods or securities of which any unit is, by nature or usage of trade, the equivalent of any other like unit. Goods which are not fungible shall be deemed fungible for the purpose of this Act to the extent that under a particular agreement or document unlike units are treated as equivalents.

Normally this definition would cover such items as a bushel of corn is the same as any other bushel of corn (assuming the same grade of corn). Goods under this definition may be made fungible by agreement.

3.18 "Genuine" means free of forgery or counterfeiting.

3.19 "Good faith" means honesty in fact in the conduct or transaction concerned.

This term has a great deal of meaning in the Code. Normal business relations are carried on in good faith or with honesty, and the Code makes this fact a legal requirement. In the case of a merchant, he must observe reasonable commercial standards of fair dealing in the trade -- a question of fact, but not impossible to prove.

3.20 "Holder" means a person who is in possession of a document of title or an instrument or an investment security drawn, issued or indorsed to him or to his order or to bearer or in blank.

This term, with nothing more, is simply referring to possession. A "holder" may have certain rights incident to possession as is explained in Chapter 3. If the "holder" takes the instrument "for value;" and in "good faith;" and "without notice" that is "overdue" or has been "dishonored" or of any defense against or claim to it on the part of any person, the "holder" is a "holder in due course." As is illustrated, being a mere "holder" is not the same as being a "holder in due course," and the two terms must not be confused, since the "holder in due course" has a number of privileged rights that

protect him from certain claims arising out of the transaction.

3.21 To "honor" is to pay or to accept any pay, or where a credit so engages to purchase or discount a draft complying with the terms of the credit.

3.22 "Insolvency proceedings" includes any assignment for the benefit of creditors or other proceedings intended to liquidate or rehabilitate the estate of the person involved.

3.23 A person is "insolvent" who either has ceased to pay his debts in the ordinary course of business or cannot pay his debts as they become due or is insolvent within the meaning of the federal bankruptcy law.

The test for determining when a person or business has become insolvent is based upon commercial approaches. In the context of sales, it is important to determine when a buyer or seller has become insolvent in order to obtain certain protective priorities and rights over goods in the possession of the insolvent party. A person is insolvent within the meaning of the federal bankruptcy law when his liabilities are greater than his assets.

3.24 "Money" means a medium of exchange authorized or adopted by a domestic or foreign government as a part of its currency.

The Comments point out that the test in this section is that of sanction of government which recognizes the circulating medium as a part of the government's official currency, thus rejecting the narrower view that money is limited to legal tender.

3.25 A person has "notice" of a fact when

(a) he has actual knowledge of it; or

(b) he has received a notice or notification of it; or

(c) from all the facts and circumstances known to him at the time in question he has reason to know that it exists.

A person "knows" or has "knowledge" of a fact when he has actual knowledge of it. "Discover" or "learn" or a word or phrase of similar import refers to knowledge rather than to reason to know. The time and circumstances under which a notice or notification may cease to be effective are not determined by this Act.

Knowledge of the existence of a fact in question can thus be implied by showing that the person had reason to know that the fact existed. Compare this definition with the next definition.

3.26 A person "notifies" or "gives" a notice or

notification to another by taking such steps as may be reasonably required to inform the other in ordinary course whether or not such other actually comes to know of it. A person "receives" a notice or notification when

(a) it comes to his attention; or

(b) it is duly delivered at the place of business through which the contract was made or at any other place held out by him as the place for receipt of such communications.

It can only be assumed that occasionally a notification is made and has legal consequences of great significance to a business but the actual knowledge of the notified fact never reaches the proper office in the business. It is important that incoming mail receive proper attention by competent staff personnel in order to avoid the careless loss of a letter or note having the effect of legally binding a business or person. The problem of avoiding the misfortunate careless handling of incoming mail is also raised in the "battle of forms" discussion in Chapter 2.

3.27 Notice, knowledge or a notice or notification received by an organization is effective for a particular transaction from the time when it is brought to the attention of the individual conducting that transaction, and in any event from the time when it would have been brought to his attention if the organization had exercised due diligence. An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routines. Due diligence does not require an individual acting for the organization to communicate information unless such communication is part of his regular duties or unless he has reason to know of the transaction and that the transaction would be materially affected by the information.

3.28 "Organization" includes a corporation, government or governmental subdivision or agency, business trust, estate, trust, partnership or association, two or more persons having a joint or common interest, or any other legal or commercial entity.

3.29 "Party", as distinct from "third party", means a person who has engaged in a transaction or

made an agreement within this Act.

3.30 "Person" includes an individual or an organization.

3.31 "Presumption" or "Presumed" means that the trier of fact must find the existence of the fact presumed unless and until evidence is introduced which would support a finding of its nonexistence.

This is a technical term of evidence that refers to a legal fiction: because of X we shall assume that Y is also the case; but it you prove that Y is not the case, Y is no longer assumed to be true, but must also be proved.

3.32 "Purchase" includes taking by sale, discount, negotiation, mortgage, pledge, lien, issue or re-issue, gift or any other voluntary transaction creating an interest in property.

Note the numerous methods in which a "purchase" can be made: by actual sale, by a credit sale, by a promise to sell, or by a gift.

3.33 "Purchaser" means a person who takes by purchase.

3.34 "Remedy" means any remedial right to which an aggrieved party is entitled with or without resort to a tribunal.

A "remedy" under the Code may be more than the relief given to the aggrieved party by a judge and enforced by the sheriff. There are important rights given to parties in several of the major Code provisions allowing limited "self-help" as immediate rights, rather than making the parties go to court to seek relief. The immediate right to self-help is of great value where the court system is clogged and inefficient, or may have great commercial value where the goods may be repossessed immediately before they depreciate or the market falls.

3.35 "Representative" includes an agent, an officer of a corporation or association, and a trustee, executor or administrator of an estate, or any other person empowered to act for another.

3.36 "Rights" include remedies.

3.37 "Security Interest" means an interest in personal property or fixtures which secures payment or performance of an obligation. The retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer (Section 2-401) is limited in effect to a reservation of a "security in-