D R A F T
FOR DISCUSSION ONLY

REVISION OF UNIFORM COMMERCIAL CODE ARTICLE 1 – GENERAL PROVISIONS

NATIONAL CONFERENCE OF COMMISSIONERS

ON UNIFORM STATE LAWS

Proposed Final Draft
(April 5, 2001)

REVISION OF UNIFORM COMMERCIAL CODE ARTICLE 1 – GENERAL PROVISIONS

WITH PREFATORY NOTE AND REPORTER'S NOTES

The ideas and conclusions set forth in this draft, including the proposed statutory language and any comments or reporter's notes, have not been passed upon by the National Conference of Commissioners on Uniform State Laws, the American Law Institute, or the Drafting Committee. They do not necessarily reflect the views of the Conference and its Commissioners, the Institute and its Members, and the Drafting Committee and its Members and Reporters. Proposed statutory language may not be used to ascertain the intent or meaning of any promulgated final statutory proposal.

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PREFATORY NOTE

I. Introduction

From its inception, the Article 1 Drafting Committee performed two related, but distinct, tasks — revision of the current text of Uniform Commercial Code Article 1 and harmonization of ongoing UCC projects. This draft represents the product of one of those tasks — revision of the provisions of Article 1. The other task entailed the Drafting Committee serving as a harmonization committee for the purpose of seeking to insure that the Uniform Commercial Code speaks with a single voice to the extent appropriate.

After lengthy analysis and discussion, the Drafting Committee decided to recommend a relatively small number of substantive changes to the law as it is currently set forth in Article 1. Those changes, concerning scope of the Article, applicability of supplemental principles of law, the concept of good faith, choice of law, the relevance of course of performance between the parties, and the existence of an independent statute of frauds, are described in some detail in Part II below. The changes with respect to choice of law are probably the most important changes in this draft and were the subject of more extensive Drafting Committee analysis and deliberation than any other topic.

In addition to these substantive changes, the Drafting Committee decided to make some structural changes to Article 1. These structural changes, intended to make this Article more closely fit with the drafting conventions of the more recently addressed Articles and to lessen some difficulties in interpretation, are described in Part III below. Other than these structural changes, the Drafting Committee generally decided to resist the temptation to make non-substantive changes to provisions that have not been a source of serious problems in the nearly four decades since the widespread enactment of the UCC. A few such changes should be noted, however. First, as in all of the other UCC Articles promulgated in the last decade, provisions have been reformulated in a gender-neutral fashion. Second, in a very small number of cases, minor changes in wording have been made when the current wording has proven confusing. Those changes are noted in the Official Comments following each section but are not otherwise described in this Prefatory Note.

II. Substantive Issues

The following are significant substantive issues raised by changes from current Article 1, in the order of their appearance in the draft:

A. Scope

Article 1 contains a relatively small number of substantive rules, but those rules are of fundamental importance. Occasionally courts and commentators have expressed uncertainty as to which transactions are governed by the substantive rules. Section 1-102 expresses a point that is implicit in current Article 1 — namely, that the substantive rules in Article 1 apply only to transactions within the scope of the other Articles.

B. Applicability of Supplemental Principles of Law

This draft merges subsections (1) and (2) of current Section 1-102 (concerning the underlying purposes and policies of the UCC) and current Section 1-103 (concerning the applicability of supplemental principles of law) into a revised Section 1-103. The provisions have been combined in this Section to reflect the interrelationship between the Code's purposes and policies and the extent to which other law is available to supplement it. Except for changing the form of reference to the Uniform Commercial Code, subsection (b) of this Section is identical to current Section 1-103. The revised Official Comments to this Section, though, give more helpful guidance as to the distinction between situations in which Code provisions preempt the application of other law and those in which such supplementation is permissible.

C. Good Faith

Section 1-201(19) replaces the current definition of "good faith" ("honesty in fact in the conduct or transaction concerned") with the definition adopted by all but one of the recently revised UCC Articles as well as drafts of Revised Articles 2 and 2A – "honesty in fact *and the observance of reasonable commercial standards of fair dealing.*" The Section explicitly provides, however, that its definition of "good faith" is subordinate to the narrower definition in UCC Article 5. In addition to centralizing the developments already taking place in other Articles, the new definition resolves any ambiguity as to the proper definition to apply to the general duty of good faith imposed by Article 1.

D. Choice of Law

Section 1-301 represents a significant rethinking of choice of law issues addressed in current UCC Section 1-105. The new section reexamines both the power of parties to select the jurisdiction whose law will govern their transaction and the determination of the governing law in the absence of such selection by the parties. With respect to the power to select governing law, the draft affords greater party autonomy, but with important safeguards protecting consumer interests and fundamental policies. While the Drafting Committee considered also addressing the related topic of forum selection clauses, it ultimately decided that there was no need for uniform commercial law to govern such clauses.

1. Contractual Designation of Governing Law

Revised UCC section 1-301 addresses contractual designation of governing law somewhat differently than does current section 1-105. Current law allows the parties to any transaction to designate a jurisdiction whose law governs if the transaction bears a "reasonable relation" to that jurisdiction. Revised Article 1 deviates from this unified approach by providing different rules for consumer transactions than for "business to business" transactions.

In the context of consumer transactions, revised Article 1, unlike current law, protects consumers against the possibility of losing the protection of consumer protection laws of their home jurisdiction.

In the context of business-to-business transactions, revised Article 1 generally provides the parties with greater autonomy to designate a jurisdiction whose law will govern than does current Article 1, but also provides some safeguards against abuse that do not appear in current Article 1. Following emerging international norms, greater autonomy is provided in subsections (b) and (c) by deleting the requirement that the transaction bear a "reasonable relation" to the jurisdiction designated in this non-consumer context. It should be noted in this regard that in the case of wholly domestic transactions the jurisdiction designated must be a State. An important safeguard not present in current law is provided in subsection (e). Subsection (e) indicates that the designation of a jurisdiction's law is not effective (even if the transaction bears a reasonable relation to that jurisdiction) to the extent that application of that law would be contrary to a fundamental policy of the jurisdiction whose law would govern in the absence of contractual designation. Application of the law designated may be contrary to a fundamental policy of the State or country whose law would otherwise govern either because of the nature of the law designated or because of the "mandatory" nature of the law that would otherwise apply.

2. Choice of Law in the Absence of Contractual Designation of Governing Law

In the absence of an effective contractual designation of governing law, current UCC section 1-105(1) directs the forum to apply its own law if the transaction bears "an appropriate relation to this state." This provision, however, is frequently ignored by courts. Revised UCC section 1-301(b) provides simply that, in the absence of contractual designation, the court should apply the forum's choice of law principles.

Course of Performance

Section 1-304 adds the concept of "course of performance," currently utilized only in Articles 2 and 2A, to course of dealing and usage of trade as the contextual clues that a court may use to interpret a contract.

F. Statute of Frauds

The Statute of Frauds "for kinds of personal property not otherwise covered" that appears in current Section 1-206 has been deleted. The Drafting Committee noted that the other Articles of the Uniform Commercial Code make individual determinations as to writing requirements for transactions within their scope, so that the only effect of Section 1-206 was to impose a writing requirement on transactions not otherwise governed by the UCC. The Drafting Committee decided that it is inappropriate for Article 1 to impose such writing requirements.

III. Structural Issues

A. General Organization

Current Article 1 is divided into two parts. Part 1 is entitled "Short Title, Construction, Application and Subject Matter of Act." Part 2 is entitled "General Definitions and Principles of Interpretation." The rationale for placement of particular sections in one part or the other is occasionally obscure. This draft reorganizes Article 1 into three parts. Part 1 — "General Provisions" — contains general rules about the UCC as a whole. Part 2 — "General Definitions and Principles of Interpretation" — contains the Code's major definitional section as well as additional rules of interpretation. Part 3 — "Territorial Applicability and General Rules" — contains substantive rules that apply to all transactions that are within the scope of the Code.

B. Relocation of Substantive Rules Embedded in Definitions

The Drafting Committee identified four cases in which definitions in Section 1-201 were made unnecessarily complicated by substantive rules embedded within them. Extracting those substantive rules and placing them in their own sections enables those rules to be presented more effectively and is more consistent with current drafting principles in many states.

1. Notice and knowledge

The rules concerning notice and knowledge have been moved from their current location in three subsections of Section 1-201 to a separate substantive section. The Drafting Committee believes that the concepts are more clearly articulated in this fashion.

2. Distinguishing leases from security interests

In current Article 1, the definition of "security interest" consists of a short paragraph elucidating a basic principle that resolves almost every issue, followed by over 50 lines of clarification and qualification that serve only one function — distinguishing "true leases" from transactions that are leases in form but security interests in substance. This extended rule even contains a nested definition of the term "present value," which it uses as part of drawing the distinction between true leases and security interests. The portion of the definition of "security interest" that distinguishes true leases from security interests has been moved to a separate substantive section. As a result, the remaining portion of the definition of "security interest" is shorter and clearer. The definition of "present value" is moved to its own definitional subsection.

3. Value

Whether a person acquires rights "for value" is at present the subject of a definitional provision in current Section 1-201(44). Yet, as the NCCUSL Committee on Style correctly noted to the Drafting Committee, the provision is more appropriately articulated as a free-standing rule. It has been moved to Section 1-204.

PART 1

GENERAL PROVISIONS

SECTION 1–101. SHORT TITLES.

(a) This [Act] may be cited as the Uniform Commercial Code.

(b) This article may be cited as Uniform Commercial Code — General Provisions.

Official Comment

Source: Former Section 1-101.

Changes from former law: Subsection (b) is new. It is added in order to make the structure of Article 1 parallel with that of the other Articles of the Uniform Commercial Code.

1. Each other Article of the Uniform Commercial Code (except Articles 10 and 11) may also be cited by its own short title. See Sections 2–101, 2A-101, 3–101, 4–101, 4A-101, 5–101, 6–101, 7–101, 8–101 and 9–101.

SECTION 1-102. SCOPE OF ARTICLE. This article applies to a transaction to the extent that it is governed by any other article of the [Uniform Commercial Code].

Official Comment

Source: New.

1. This section is intended to resolve confusion that has occasionally arisen as to the applicability of the substantive rules in this article. As this section makes clear, the rules in article 1 apply to transactions to the extent that those transactions are governed by one of the other articles of the Uniform Commercial Code. This article does not apply to transactions to the extent that they are governed by other law. See Official Comment 1 to Section 1-301.

SECTION 1–103. CONSTRUCTION OF ACT TO PROMOTE ITS PURPOSES AND POLICIES; APPLICABILITY OF SUPPLEMENTAL PRINCIPLES OF LAW.

(a) [The Uniform Commercial Code] must be liberally construed and applied to promote its underlying purposes and policies, which are:

(1) to simplify, clarify, and modernize the law governing commercial transactions;

(2) to permit the continued expansion of commercial practices through custom, usage, and agreement of the parties; and

(3) to make uniform the law among the various jurisdictions.

(b) Unless displaced by the particular provisions of [the Uniform Commercial Code], the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.

Official Comment

Source: Former Section 1-102 (1)-(2); Former Section 1-103.

Changes from former law: This Section is derived from subsections (1) and (2) of former Section 1-102 and from former Section 1-103. Subsection (a) of this Section combines subsections (1) and (2) of former Section 1-102. Except for changing the form of reference to the Uniform Commercial Code and minor stylistic changes, its language is the same as subsections (1) and (2) of former Section 1-102. Except for changing the form of reference to the Uniform Commercial Code, subsection (b) of this Section is identical to former Section 1-103. The provisions have been combined in this Section to reflect the interrelationship between them.

1. The Uniform Commercial Code is drawn to provide flexibility so that, since it is intended to be a semi-permanent piece of legislation, it will provide its own machinery for expansion of commercial practices. It is intended to make it possible for the law embodied in the Uniform

Commercial Code to be developed by the courts in the light of unforeseen and new circumstances and practices. However, the proper construction of the Uniform Commercial Code requires that its interpretation and application be limited to its reason.

Even prior to the enactment of the Uniform Commercial Code, courts were careful to keep broad acts from being hampered in their effects by later acts of limited scope. [Pacific Wool Growers v. Draper & Co., 158 Or. 1, 73 P.2d 1391 (1937), and] compare Section 1–104. The courts recognized the policies embodied in an act as applicable in reason to subject-matter that was not expressly included in the language of the act, [Commercial Nat. Bank of New Orleans v. Canal-Louisiana Bank & Trust Co., 239 U.S. 520, 36 S.Ct. 194, 60 L.Ed. 417 (1916) (bona fide purchase policy of Uniform Warehouse Receipts Act extended to case not covered but of equivalent nature)] and did the same where reason and policy so required, even where the subject-matter had been intentionally excluded from the act in general. [Agar v. Orda, 264 N.Y. 248, 190 N.E. 479 (1934) (Uniform Sales Act change in seller's remedies applied to contract for sale of choses in action even though the general coverage of that Act was intentionally limited to goods "other than things in action.")] They implemented a statutory policy with liberal and useful remedies not provided in the statutory text. They disregarded a statutory limitation of remedy where the reason of the limitation did not apply. [Fiterman v. J. N. Johnson & Co., 156 Minn. 201, 194 N.W. 399 (1923) (requirement of return of the goods as a condition to rescission for breach of warranty; also, partial rescission allowed).] Nothing in the Uniform Commercial Code stands in the way of the continuance of such action by the courts.

The Uniform Commercial Code should be construed in accordance with its underlying purposes and policies. The text of each section should be read in the light of the purpose and policy of the rule or principle in question, as also of the Uniform Commercial Code as a whole, and the application of the language should be construed narrowly or broadly, as the case may be, in conformity with the purposes and policies involved.

2. *Applicability of supplemental principles of law.* Subsection (b) states the basic relationship of the Uniform Commercial Code to supplemental bodies of law. The Uniform Commercial Code was drafted against the backdrop of existing bodies of law, including the common law and equity, and relies on those bodies of law to supplement it provisions in many important ways. At the same time, the Uniform Commercial Code is the primary source of commercial law rules in areas that it governs, and its rules represent choices made by its drafters and the enacting legislatures about the appropriate policies to be furthered in the transactions it covers. Therefore, while principles of common law and equity may *supplement* provisions of the Uniform Commercial Code, they may not be used to *supplant* its provisions, including the purposes and policies those provisions reflect, unless a specific provision of the Code provides otherwise. In the absence of such a provision, the Uniform Commercial Code preempts principles of common law and equity that are inconsistent with either its provisions, or its purposes and policies.

The language of subsection (b) is intended to reflect both the concept of supplementation and the concept of preemption. Some courts, however, had difficulty in applying the identical language of former Section 1-103 to determine when other law appropriately may be applied to supplement the Code, and when that law has been displaced by the Code. Some decisions applied other law in situations in which that application, while not inconsistent with the text of any particular provision of the Code, clearly was inconsistent with the underlying purposes and policies reflected in the relevant Code provisions. *See, e.g.,* Sheerbonnet, Ltd. v. American Express Bank, Ltd., 951 F. Supp. 403 (S.D.N.Y. 1995). In part, this difficulty arose from comment 1 to former Section 1-103, which stated that "this section indicates the continued applicability to commercial contracts of all supplemental bodies of law except insofar as they are explicitly displaced by this Act." The "explicitly displaced" language of that comment does not accurately reflect the proper scope of Code preemption, which extends to displacement of other law that is inconsistent with its purposes and policies as well as its text.

3. *Application of subsection (b) to statutes.* The primary focus of Section 1-103 is on the relationship between the Uniform Commercial Code and principles of common law and equity as developed by the courts. State law, however, increasingly is statutory. Not only are there a growing number of state statutes addressing specific issues that come within the scope of the Uniform Commercial Code, but in some states many general principles of common law and equity have been codified. When the other law relating to a matter within the scope of the Uniform Commercial Code is a statute, the principles of subsection (b) remain relevant to the court's analysis of the relationship between that statute and the Uniform Commercial Code, but will be supplemented by other principles of statutory interpretation that specifically address the interrelationship between statutes. In some situations, the principles of subsection (b) still will be determinative. For example, the mere fact that an equitable principle is stated in statutory form rather than in judicial decisions should not change the court's analysis of whether the principle can be used to supplement the Uniform Commercial Code – under subsection (b), equitable principles may supplement provisions of the Uniform Commercial Code only if they are consistent with the purposes and policies of the Uniform Commercial Code as well as its text. In other situations, however, other interpretive principles addressing the interrelationship between statutes may lead the court to conclude that the other statute is controlling, even though it conflicts with the Uniform Commercial Code. This, for example, would be the result in a situation where the other statute was specifically intended to provide additional protection to a class of individuals engaging in transactions covered by the Uniform Commercial Code.

4. Listing not exclusive. The list of sources of supplemental law in subsection (b) is intended to be merely illustrative of the other law that may supplement the Uniform Commercial Code, and is not exclusive. No listing could be exhaustive. Further, the fact that a particular section of the Uniform Commercial Code makes express reference to other law is not intended to suggest the negation of the general application of the principles of subsection (b). Note also that the word "bankruptcy" in subsection (b), continuing the use of that word from former Section 1-103, should be understood not as a specific reference to federal bankruptcy law but, rather as a reference to general principles of insolvency, whether under federal or state law.

SECTION 1–104. CONSTRUCTION AGAINST IMPLIED REPEAL. [The Uniform Commercial Code] being a general act intended as a unified coverage of its subject matter, no part of it shall be deemed to be impliedly repealed by subsequent legislation if such construction can reasonably be avoided.

Official Comment

Source: Former Section 1-104.

Changes from former law: Except for changing the form of reference to the Uniform Commercial Code, this Section is identical to former UCC Section 1-104.

1. This section embodies the policy that an act that bears evidence of carefully considered permanent regulative intention should not lightly be regarded as impliedly repealed by subsequent legislation. The Uniform Commercial Code, carefully integrated and intended as a uniform codification of permanent character covering an entire "field" of law, is to be regarded as particularly resistant to implied repeal.

SECTION 1–105. SEVERABILITY. If any provision or clause of [the Uniform Commercial Code] or application thereof to any person or circumstances is held invalid, such invalidity does not affect other provisions or applications of [the Uniform Commercial Code] which can be given effect without the invalid provision or application, and to this end the provisions of [the Uniform Commercial Code] are declared to be severable.

Official Comment

Source: Former Section 1-108.

Changes from former law: Except for changing the form of reference to the Uniform Commercial Code, this Section is identical to former UCC Section 1-108.

1. This is the model severability section recommended by the National Conference of Commissioners on Uniform State Laws for inclusion in all acts of extensive scope.

SECTION 1-106. USE OF SINGULAR AND PLURAL; GENDER In [the Uniform Commercial Code], unless the statutory context otherwise requires:

(1) words in the singular number include the plural, and those in the plural include the singular; and

(2) words of any gender also refer to any other gender.

Official Comment

Source: Former Section 1-102(5). See also 1 U.S.C. § 1.

Changes from former law: Other than minor stylistic changes, this Section is identical to former UCC section 1-102(5).

1. This section makes it clear that the use of singular or plural in the text of the Uniform Commercial Code is generally only a matter of drafting style – singular words may be applied in the plural, and plural words may be applied in the singular. Only when it is clear from the statutory context that the use of the singular or plural does not include the other is this rule inapplicable. See, e.g., Section 9-322.

SECTION 1-107. SECTION CAPTIONS. Section captions are part of [the Uniform Commercial Code].

Official Comment

Source: Former Section 1-109.

Changes from former law: None.

1. Section captions are a part of the text of the Uniform Commercial Code, and not mere surplusage. This is not the case, however, with respect to subsection headings appearing in Article 9. See Official Comment 3 to Section 9-101 ("subsection headings are not a part of the official text itself and have not been approved by the sponsors.").

PART 2

GENERAL DEFINITIONS AND PRINCIPLES OF INTERPRETATION

SECTION 1–201. GENERAL DEFINITIONS.

(a) Unless the context otherwise requires, words or phrases defined in this section, or in the additional definitions contained in other articles of [the Uniform Commercial Code] that apply to particular articles or parts thereof, have the meanings stated.

(b) Subject to definitions contained in other articles of [the Uniform Commercial Code] that apply to particular articles or parts thereof:

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

(2) "Aggrieved party" means a party entitled to pursue a remedy.

(3) "Agreement" means the bargain of the parties in fact, as found in their language or inferred from other circumstances, including course of performance, course of dealing, or usage of trade as provided in Section 1-303. (Compare "Contract.")

(3a) "Authenticate" *[The standard NCCUSL definition will be inserted.]*

(4) "Bank" means a person engaged in the business of banking and includes a savings bank, savings and loan association, credit union, and trust company.

(5) "Bearer" means a person in possession of a negotiable instrument, document of title, or certificated security that is payable to bearer or indorsed in blank.

(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.

(7) “Branch” includes a separately incorporated foreign branch of a bank.

(8) “Burden of establishing” a fact means the burden of persuading the trier of fact that the existence of the fact is more probable than its nonexistence.

(9) “Buyer in ordinary course of business” means a person that buys goods in good faith, without knowledge that the sale violates the rights of another person in the goods, and in the ordinary course from a person, other than a pawnbroker, in the business of selling goods of that kind. A person buys goods in the ordinary course if the sale to the person comports with the usual or customary practices in the kind of business in which the seller is engaged or with the seller’s own usual or customary practices. A person that sells oil, gas, or other minerals at the wellhead or minehead is a person in the business of selling goods of that kind. A buyer in ordinary course of business may buy for cash, by exchange of other property, or on secured or unsecured credit, and may acquire goods or documents of title under a pre-existing contract for sale. Only a buyer that takes possession of the goods or has a right to recover the goods from the seller under Article 2 may be a buyer in ordinary course of business. A person that acquires goods in a transfer in bulk or as security for or in total or partial satisfaction of a money debt is not a buyer in ordinary course of business.

(10) “Conspicuous”, with reference to a term, means so written, displayed, or presented that a reasonable person against which it is to operate ought to have noticed it. Whether a term is “conspicuous” or not is a decision for the court. Conspicuous terms include the following:

(A) a heading in capitals equal to or greater in size than the surrounding text, or in contrasting type, font, or color to the surrounding text of the same or lesser size; and

(B) language in the body of a record or display in larger type than the surrounding text, or in contrasting type, font, or color to the surrounding text of the same size, or set off from surrounding text of the same size by symbols or other marks that call attention to the language.

(10a) "Consumer" means an individual who enters into a transaction primarily for personal, family, or household purposes

(11) "Contract" means the total legal obligation that results from the parties' agreement as determined by [the Uniform Commercial Code] as supplemented by any other applicable laws. (Compare "Agreement.")

(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.

(13) "Defendant" includes a person in the position of defendant in a counterclaim or third party claim.

(14) "Delivery", with respect to an instrument, document of title, or chattel paper, means voluntary transfer of possession.

(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.

(16) "Fault" means a wrongful act, omission, breach, or default.

(17) "Fungible goods" means either:

(A) goods of which any unit, by nature or usage of trade, is the equivalent of any other like unit; or

(B) goods which by agreement are treated as equivalent.

(18) "Genuine" means free of forgery or counterfeiting.

(19) "Good faith," except as provided in Article 5, means honesty in fact and the observance of reasonable commercial standards of fair dealing.

(20) "Holder" means:

(A) with respect to a negotiable instrument, the person in possession of the negotiable instrument if it is payable either to bearer or to an identified person that is the person in possession; or

(B) with respect to a document of title, the person in possession of it if the goods are deliverable either to bearer or to the order of the person in possession.

(22) "Insolvency proceeding" includes an assignment for the benefit of creditors or other proceeding intended to liquidate or rehabilitate the estate of the person involved.

(23) An "insolvent" person is a person that

(A) has generally ceased to pay debts in the ordinary course of business other than as a result of bona fide dispute as to them;

(B) is unable to pay debts as they become due; or

(C) is insolvent within the meaning of federal bankruptcy law.

(24) "Money" means a medium of exchange currently authorized or adopted by a domestic or foreign government. The term includes a monetary unit of account established by an intergovernmental organization or by agreement between two or more countries.

(28) "Organization" means a person other than an individual.

(29) "Party", as distinct from a "third party", means a person that has engaged in a transaction or made an agreement subject to [the Uniform Commercial Code].

(30) "Person" means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, government, government subdivision or agency or instrumentality, or any other legal or commercial entity.

(30a) "Present value" means the amount as of a date certain of one or more sums payable in the future, discounted to the date certain by use of either an interest rate specified by the parties if that rate is not manifestly unreasonable at the time the transaction is entered into or, if an interest rate is not so specified, a commercially reasonable rate that takes into account the facts and circumstances at the time the transaction is entered into.

(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.

(32) "Purchase" means taking by sale, lease, discount, negotiation, mortgage, pledge, lien, security interest, issue or re-issue, gift, or any other voluntary transaction creating an interest in property.

(33) "Purchaser" means a person that takes by purchase.

(33a) “Record” means information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.

(34) “Remedy” means any remedial right to which an aggrieved party is entitled with or without resort to a tribunal.

(35) “Representative” means any person empowered to act for another, including an agent, an officer of a corporation or association, and a trustee, executor, or administrator of an estate.

(36) “Right” includes remedy.

(37) “Security interest” means an interest in personal property or fixtures which secures payment or performance of an obligation. The term also includes any interest of a consignor and a buyer of accounts, chattel paper, a payment intangible, or a promissory note in a transaction that is subject to Article 9. The special property interest of a buyer of goods on identification of those goods to a contract for sale under Section 2- 401 is not a “security interest”, but a buyer may also acquire a “security interest” by complying with Article 9. Except as otherwise provided in Section 2-505, the right of a seller or lessor of goods under Article 2 or 2A to retain or acquire possession of the goods is not a “security interest”, but a seller or lessor may also acquire a “security interest” by complying with Article 9. 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 interest.” Whether a transaction in the form of a lease creates a “security interest” is determined pursuant to Section 1-203.

(38) “Send” in connection with a writing, record, or notice means to:

(A) deposit in the mail or deliver for transmission by any other usual means of communication with postage or cost of transmission provided for and properly addressed and, in the case of an instrument, to an address specified thereon or otherwise agreed, or if there be none to any address reasonable under the circumstances; or

(B) in any other way cause to be received any record or notice within the time it would have arrived if properly sent.

(39) "Signed" includes any symbol executed or adopted with present intention to adopt or accept a writing.

(39a) "State" means a State of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any territory or insular possession subject to the jurisdiction of the United States.

(40) "Surety" includes a guarantor or other secondary obligor.

(42) "Term" means a portion of an agreement that relates to a particular matter.

(43) "Unauthorized signature" means a signature made without actual, implied, or apparent authority. The term includes a forgery.

(45) "Warehouse receipt" means a receipt issued by a person engaged in the business of storing goods for hire.

(46) "Writing" includes printing, typewriting, or any other intentional reduction to tangible form. "Written" has a corresponding meaning.

Official Comment

Source: Former Section 1-201.

Changes from former law: In order to make it clear that all definitions in the Uniform Commercial Code — not just those in Article 1 — do not apply if the context otherwise requires, a new subsection (a) to that effect has been added. The reference to the "context" is intended to refer to the context in which the defined term is used in the UCC. In other words, the definition applies whenever the defined term is used unless the context in which the defined term is used in the statute indicates that the term was not used in its defined sense. Consider, for example, UCC §§ 3-103(a)(9) (defining "promise," in relevant part, as "a written undertaking to pay money signed by the person undertaking to pay") and 3-303(a)(1) (indicating that an instrument is issued or transferred for value if "the instrument is issued or transferred for a promise of performance, to the extent that the promise has been performed." It is clear from the statutory context of the use of the word "promise" in § 3-303(a)(1) that the term was not used in the sense of its definition in § 3-103(a)(9). Thus, the § 3-103(a)(9) definition should not be used to give meaning to the word "promise" in § 3-303(a). The remainder of former Section 1-201, as revised, now appears as subsection (b).

Other than minor stylistic changes, the definitions in this draft are as in former Article 1 (as amended, most recently, in conjunction with revisions to Article 9) except as noted below. It should be noted that numbering of existing definitions has been left constant even though some new definitions have been added to this section and some others have been moved to other sections.

1. "Action." Unchanged from former Section 1-201, which was derived from similar definitions in Section 191, Uniform Negotiable Instruments Law; Section 76, Uniform Sales Act; Section 58, Uniform Warehouse Receipts Act; Section 53, Uniform Bills of Lading Act.

2. "Aggrieved party." Unchanged from former Section 1-201.

3. "Agreement." Derived from former Section 1-201. As used in the Uniform Commercial Code the word is intended to include full recognition of usage of trade, course of dealing, course of performance and the surrounding circumstances as effective parts thereof, and of any agreement permitted under the provisions of the Uniform Commercial Code to displace a stated rule of law. Whether an agreement has legal consequences is determined by applicable provisions of the Uniform Commercial Code and, to the extent provided in Section 1-103, by the law of contracts.

3a. "Authenticate." This is the standard definition of the term used in acts prepared by the National Conference of Commissioners on Uniform State Laws.

4. "Bank." Derived from Section 4A-104.

5. "Bearer." Unchanged from former Section 1-201, which was derived from Section 191, Uniform Negotiable Instruments Law.

6. "Bill of Lading." Derived from former Section 1-201. The reference to airbills has been deleted as no longer necessary.

7. "Branch." Unchanged from former Section 1-201.

8. "Burden of establishing a fact." Unchanged from former Section 1-201.

9. "Buyer in ordinary course of business." Unchanged from former Section 1-201 (as amended in conjunction with the 1999 revisions to Article 9). The major significance of the phrase lies in Section 2–403 and in the Article on Secured Transactions (Article 9).

The first sentence of paragraph (9) makes clear that a buyer from a pawnbroker cannot be a buyer in ordinary course of business. The second sentence tracks Section 6-102(1)(m). It explains what it means to buy "in the ordinary course." The penultimate sentence prevents a buyer that does not have the right to possession as against the seller from being a buyer in ordinary course of business. Concerning when a buyer obtains possessory rights, see Sections 2-502 and 2-716. However, the penultimate sentence is not intended to affect a buyer's status as a buyer in ordinary course of business in cases (such as a "drop shipment") involving delivery by the seller to a person buying from the buyer or a donee from the buyer. The requirement relates to whether *as against the seller* the buyer or one taking through the buyer has possessory rights.

10. "Conspicuous." Derived from Section 2-103(a)(10). It states the general standard that to be conspicuous a term ought to be noticed by a reasonable person. Whether a term is conspicuous is an issue for the court. Subparagraphs (A) and (B) set out several methods for making a term conspicuous. Requiring that a term be conspicuous blends a notice function (the term ought to be noticed) and a planning function (giving guidance to the party relying on the term regarding how that result can be achieved). Although these paragraphs indicate some of the methods for making a term attention-calling, the test is whether attention can reasonably be expected to be called to it. The statutory language should not be construed to permit a result that is inconsistent with that test.

11. "Contract." Unchanged from former Section 1-201.

11a. "Consumer." Derived from Section 9-102(a)(25).

12. "Creditor." Unchanged from former Section 1-201.

13. "Defendant." Unchanged from former Section 1-201, which was derived from Section 76, Uniform Sales Act.

14. "Delivery." Derived from former Section 1-201. The reference to certificated securities has been deleted in light of the more specific treatment of the matter in Section 8-301.

15. "Document of title." Unchanged from former Section 1-201, which was derived from Section 76, Uniform Sales Act. By making it explicit that the obligation or designation of a third party as "bailee" is essential to a document of title, this definition clearly rejects any such result as obtained in Hixson v. Ward, 254 Ill.App. 505 (1929), which treated a conditional sales contract as a document of title. Also the definition is left open so that new types of documents may be included. It is unforeseeable what documents may one day serve the essential purpose now filled by warehouse receipts and bills of lading. Truck transport has already opened up problems which do not fit the patterns of practice resting upon the assumption that a draft can move through banking channels faster than the goods themselves can reach their destination. There lie ahead air transport and such probabilities as teletype transmission of what may some day be regarded commercially as "Documents of Title." The definition is stated in terms of the function of the documents with the intention that any document which gains commercial recognition as accomplishing the desired result shall be included within its scope. Fungible goods are adequately identified within the language of the definition by identification of the mass of which they are a part.

Dock warrants were within the Sales Act definition of document of title apparently for the purpose of recognizing a valid tender by means of such paper. In current commercial practice a dock warrant or receipt is a kind of interim certificate issued by steamship companies upon delivery of the goods at the dock, entitling a designated person to have issued to him at the company's office a bill of lading. The receipt itself is invariably nonnegotiable in form although it may indicate that a negotiable bill is to be forthcoming. Such a document is not within the general compass of the definition, although trade usage may in some cases entitle such paper to be treated as a document of title. If the dock receipt actually represents a storage obligation undertaken by the shipping company, then it is a warehouse receipt within this Section regardless of the name given to the instrument.

The goods must be "described," but the description may be by marks or labels and may be qualified in such a way as to disclaim personal knowledge of the issuer regarding contents or condition. However, baggage and parcel checks and similar "tokens" of storage which identify stored goods only as those received in exchange for the token are not covered by this Article.

The definition is broad enough to include an airway bill.

16. "Fault." Derived from former Section 1-201. "Default" has been added to the list events constituting fault.

17. "Fungible." Derived from former Section 1-201. The definition has been reorganized and references to securities have been deleted because Article 8 no longer uses the term "fungible" to describe securities.

18. "Genuine." Unchanged from former Section 1-201.

19. "Good faith." Former Section 1-201(19) defined "good faith" simply as honesty in fact; the definition contained no element of commercial reasonableness. Initially, that definition applied throughout the Code with only one exception. Former Section 2-103(1)(b) provided that "*in this Article* . . . good faith in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." This alternative definition was limited in applicability in three ways. First, it applied only to transactions within the scope of Article 2. Second, it applied only to merchants. Third, strictly construed it applied only to uses of the phrase "good faith" *in Article 2;* thus, so construed it would not define "good faith" for its most important use — the obligation of good faith imposed by former UCC Section 1-203.

Over time, however, amendments to the UCC brought the Article 2 merchant concept of good faith (subjective honesty and objective reasonableness) into other Articles. First, Article 2A explicitly incorporated the Article 2 standard. See current UCC Section 2A-103(7). Then, other Articles broadened the applicability of that standard by adopting it for all parties rather than just for merchants. See, e.g., UCC Sections 3-103(a)(4), 4A-105(a)(6), 8-102(a)(10), and 9-102(a)(43). See also Draft of Revised Article 2. All of these definitions are comprised of two elements — honesty in fact *and* the observance of reasonable commercial standards of fair dealing. Only revised Article 5 defines "good faith" solely in terms of subjective honesty, and only Article 6 and Article 7 are without definitions of good faith. (It should be noted that, while revised Article 6 did not define good faith, Comment 2 to revised UCC section 6-102 states that "this Article adopts the definition of 'good faith' in Article 1 in all cases, even when the buyer is a merchant.") Given this near unanimity, it is appropriate to move the broader definition of "good faith" to Article 1. Of course, this definition is subject to the applicability of the narrower definition in revised Article 5.

20. "Holder." Derived from former Section 1-201. The definition has been reorganized for clarity.

22. "Insolvency proceedings." Unchanged from former Section 1-201.

23. "Insolvent." Derived from former Section 1-201. The three tests of insolvency — "generally ceased to pay debts in the ordinary course of business other than as a result of a bona fide dispute as to them," "unable to pay debts as they become due," and "insolvent within the meaning of the federal bankruptcy law" — are expressly set up as alternative tests and must be approached from a commercial standpoint.

24. "Money." Unchanged from former Section 1-201. The test is that of sanction of government, whether by authorization before issue or adoption afterward, which recognizes the circulating medium as a part of the official currency of that government. The narrow view that money is limited to legal tender is rejected.

28. "Organization." The former definition of this word has been replaced with the standard definition used in acts prepared by the National Conference of Commissioners on Uniform State Laws.

29. “Party.” Substantively identical to former Section 1-201. Mention of a party includes, of course, a person acting through an agent. However, where an agent comes into opposition or contrast to the principal, particular account is taken of that situation.

30. “Person.” The former definition of this word has been replaced with the standard definition used in acts prepared by the National Conference of Commissioners on Uniform State Laws.

30a. “Present value.” This definition was formerly contained within the definition of “security interest” in former Section 1-201(37).

31. “Presumption.” Unchanged from former Section 1-201.

32. “Purchase.” Derived from former UCC Section 1-201. The form of definition has been changed from “includes” to “means.”

33. “Purchaser.” Unchanged from former Section 1-201.

33a. “Record.” Derived from Section 9-102(a)(69).

34. “Remedy.” Unchanged from former Section 1-201. The purpose is to make it clear that both remedy and right (as defined) include those remedial rights of “self help” which are among the most important bodies of rights under the Uniform Commercial Code, remedial rights being those to which an aggrieved party can resort on its own motion.

35. “Representative.” Derived from former Section 1-201. Reorganized, and form changed from “includes” to “means.”

36. “Right.” Unchanged from former Section 1-201.

37. “Security Interest.” The definition is the first paragraph of the definition of “security interest” in former Section 1-201. The remaining portion has been moved to Section 1-203. Notice that in view of Article 9 the term includes the interest of certain outright buyers of certain kinds of property.

38. “Send.” New. Compare "notifies".

39. “Signed.” Derived from former Section 1-201. Former Section 1-201 referred to “intention to authenticate”; because authenticate is now a defined term, the language has been changed to “intention to adopt or accept.” The latter formulation is derived from the definition of “authenticate,” The definition of “signed” is to make clear that, as the term is used in the Uniform Commercial Code, a complete signature is not necessary. The symbol may be printed, stamped or written; it may be by initials or by thumbprint. It may be on any part of the document and in appropriate cases may be

found in a billhead or letterhead. No catalog of possible situations can be complete and the court must use common sense and commercial experience in passing upon these matters. The question always is whether the symbol was executed or adopted by the party with present intention to adopt or accept the writing.

39a. "State." This is the standard definition of the term used in acts prepared by the National Conference of Commissioners on Uniform State Laws.

40. "Surety." This definition makes it clear that "surety" includes all secondary obligors, not just those whose obligation refers to them person obligated as a surety. As to the nature of secondary obligations generally, see Restatement of Suretyship and Guaranty § 1.

42. "Term." Unchanged from former Section 1-201.

43. "Unauthorized signature." Unchanged from former Section 1-201.

45. "Warehouse receipt." Unchanged from former Section 1-201, which was derived from Section 76(1), Uniform Sales Act; Section 1, Uniform Warehouse Receipts Act. Receipts issued by a field warehouse are included, provided the warehouseman and the depositor of the goods are different persons.

46. "Written" or "writing." Unchanged from former Section 1-201.

SECTION 1-202. NOTICE; KNOWLEDGE

(a) Subject to subsection (f), a person has "notice" of a fact if the person:

(1) has actual knowledge of it;

(2) has received a notice or notification of it; or

(3) from all the facts and circumstances known to the person at the time in question, has reason to know that it exists.

(b) "Knowledge" means actual knowledge.

(c) "Discover", "learn", or words of similar import refer to knowledge rather than to notice.

(d) 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 the other person actually comes to know of it.

(e) Subject to subsection (f), a person "receives" a notice or notification when:

(1) it comes to that person's attention; or

(2) it is duly delivered in a form reasonable under the circumstances at the place of business through which the contract was made or at another location held out by that person as the place for receipt of such communications.

(f) Notice, knowledge, or a notice or notification received by an organization is effective for a particular transaction from the time it is brought to the attention of the individual conducting that transaction and, in any event, from the time it would have been brought to the individual's 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 the communication is part of the individual's regular duties or the individual has reason to know of the transaction and that the transaction would be materially affected by the information.

Official Comment

Source: Derived from former Sections 1-201(25)-(27).

Changes from former law: These provisions are substantive rather than purely definitional. Accordingly, they have been relocated from Section 1-201 to this Section.

1. Under subsection (a), a person has notice when, *inter alia*, the person has received a notification of the fact in question. The subsection leaves open the time and circumstances under which notice or notification may cease to be effective. Therefore such cases as Graham v. White-Phillips Co., 296 U.S. 27, 56 S.Ct. 21, 80 L.Ed. 20 (1935), are not overruled.

2. As shown in subsection (d), the word "notifies" used when the essential fact is the proper dispatch of the notice, not its receipt. Compare "Send." When the essential fact is the other party's receipt of the notice, that is stated. Subsection (e) states when a notification is received.

3. Subsection (f) makes clear that reason to know, knowledge, or a notification, although "received" for instance by a clerk in Department A of an organization, is effective for a transaction conducted in Department B only from the time when it was or should have been communicated to the individual conducting that transaction.

SECTION 1-203. LEASE DISTINGUISHED FROM SECURITY INTEREST.

(a) Whether a transaction in the form of a lease creates a lease or security interest is determined by the facts of each case.

(b) A transaction in the form of a lease creates a security interest if the consideration that the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease and is not subject to termination by the lessee, and:

(1) the original term of the lease is equal to or greater than the remaining economic life of the goods;

(2) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods;

(3) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement; or

(4) the lessee has an option to become the owner of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement.

(c) A transaction in the form of a lease does not create a security interest merely because:

(1) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than the fair market value of the goods at the time the lease is entered into;

(2) the lessee assumes risk of loss of the goods;

(3) the lessee agrees to pay taxes, insurance, filing, recording, or registration fees, or service or maintenance costs with respect to the goods;

(4) the lessee has an option to renew the lease or to become the owner of the goods;

(5) the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed; or

(6) the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.

(d) Additional consideration is nominal if it is less than the lessee's reasonably predictable cost of performing under the lease agreement if the option is not exercised. Additional consideration is not nominal if:

(1) when the option to renew the lease is granted to the lessee, the rent is stated to be the fair market rent for the use of the goods for the term of the renewal determined at the time the option is to be performed; or

(2) when the option to become the owner of the goods is granted to the lessee, the price is stated to be the fair market value of the goods determined at the time the option is to be performed.

(e) The "remaining economic life of the goods" and "reasonably predictable" fair market rent, fair market value, or cost of performing under the lease agreement must be determined with reference to the facts and circumstances at the time the transaction is entered into.

Official Comment

Source: Former Section 1-201(37).

Changes from former law: This Section is substantively identical to those portions of former UCC Section 1-201(37) that distinguished "true" leases from security interests, except that the definition of "present value" formerly embedded in Section 1-201(37) has been placed in UCC Section 1-201(30a).

1. An interest in personal property or fixtures which secures payment or performance of an obligation is a "security interest." See Section 1-201(37). Security interests are sometimes created by transactions in the form of leases. Because it can be difficult to distinguish leases that create security interests from those that do not, this section provides rules that govern the determination of whether a transaction in the form of a lease creates a security interest.

2. One of the reasons it was decided to codify the law with respect to leases was to resolve an issue that created considerable confusion in the courts: what is a lease? The confusion existed, in part, due to the last two sentences of the definition of security interest in the 1978 Official Text of the Act, Section 1–201(37). The confusion was compounded by the rather considerable change in the federal, state and local tax laws and accounting rules as they relate to leases of goods. The answer is important because the definition of lease determines not only the rights and remedies of the parties to the lease but also those of third parties. If a transaction creates a lease and not a security

interest, the lessee's interest in the goods is limited to its leasehold estate; the residual interest in the goods belongs to the lessor. This has significant implications to the lessee's creditors. "On common law theory, the lessor, since he has not parted with title, is entitled to full protection against the lessee's creditors and trustee in bankruptcy ...." 1 G. Gilmore, *Security Interests in Personal Property* § 3.6, at 76 (1965).

Under pre-UCC chattel security law there was generally no requirement that the lessor file the lease, a financing statement, or the like, to enforce the lease agreement against the lessee or any third party; the Article on Secured Transactions (Article 9) did not change the common law in that respect. Coogan, Leasing and the Uniform Commercial Code, in *Equipment Leasing—Leveraged Leasing* 681, 700 n.25, 729 n.80 (2d ed.1980). The Article on Leases (Article 2A) did not change the law in that respect, except for leases of fixtures. Section 2A–309. An examination of the common law will not provide an adequate answer to the question of what is a lease. The definition of security interest in Section 1–201(37) of the 1978 Official Text of the Act provided that the Article on Secured Transactions (Article 9) governs security interests disguised as leases, *i.e.*, leases intended as security; however, the definition became vague and outmoded.

Lease is defined in Article 2A as a transfer of the right to possession and use of goods for a term, in return for consideration. Section 2A–103(1)(j). The definition continues by stating that the retention or creation of a security interest is not a lease. Thus, the task of sharpening the line between true leases and security interests disguised as leases continues to be a function of this Article.

This section begins where Section 1-201(37) leaves off. It draws a sharper line between leases and security interests disguised as leases to create greater certainty in commercial transactions.

Prior to enactment of the rules in this Section, the 1978 text of Section 1–201(37) provided that whether a lease was intended as security (*i.e.*, a security interest disguised as a lease) was to be determined from the facts of each case; however, (a) the inclusion of an option to purchase did not itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee would become, or had the option to become, the owner of the property for no additional consideration, or for a nominal consideration, did make the lease one intended for security.

Reference to the intent of the parties to create a lease or security interest led to unfortunate results. In discovering intent, courts relied upon factors that were thought to be more consistent with sales or loans than leases. Most of these criteria, however, were as applicable to true leases as to security interests. Examples include the typical net lease provisions, a purported lessor's lack of storage facilities or its character as a financing party rather than a dealer in goods. Accordingly, this section contains no reference to the parties' intent.

Subsections (a) and (b) are taken from Section 1(2) of the Uniform Conditional Sales Act (act withdrawn 1943), modified to reflect current leasing practice. Thus, reference to the case law prior to this Act will provide a useful source of precedent. Gilmore, *Security Law, Formalism and Article 9*, 47 Neb.L.Rev. 659, 671 (1968). Whether a transaction creates a lease or a security interest continues to be determined by the facts of each case. Subsection (b) further provides that a transaction creates a security interest if the lessee has an obligation to continue paying consideration for the term of the lease, if the obligation is not terminable by the lessee (thus correcting early statutory gloss, *e.g.*, *In re Royer's Bakery, Inc.*, 1 U.C.C. Rep.Serv. (Callaghan) 342

(Bankr.E.D.Pa.1963)) and if one of four additional tests is met. The first of these four tests, subparagraph (1), is that the original lease term is equal to or greater than the remaining economic life of the goods. The second of these tests, subparagraph (2), is that the lessee is either bound to renew the lease for the remaining economic life of the goods or to become the owner of the goods. *In re Gehrke Enters.*, 1 Bankr. 647, 651–52 (Bankr.W.D.Wis.1979). The third of these tests, subparagraph (3), is whether the lessee has an option to renew the lease for the remaining economic life or the goods for no additional consideration or for nominal additional consideration, which is defined later in this section. *In re Celeryvale Transp.*, 44 Bankr. 1007, 1014–15 (Bankr.E.D.Tenn.1984). The fourth of these tests, subparagraph (4), is whether the lessee has an option to become the owner of the goods for no additional consideration or for nominal additional consideration. All of these tests focus on economics, not the intent of the parties. *In re Berge*, 32 Bankr. 370, 371–73 (Bankr.W.D.Wis.1983).

The focus on economics is reinforced by subsection (c). It states that a transaction does not create a security interest merely because the transaction has certain characteristics listed therein. Subparagraph (1) has no statutory derivative; it states that a full payout lease does not *per se* create a security interest. *Rushton v. Shea*, 419 F.Supp. 1349, 1365 (D.Del.1976). Subparagraph (2) provides the same regarding the provisions of the typical net lease. *Compare All-States Leasing Co. v. Ochs*, 42 Or.App. 319, 600 P.2d 899 (Ct.App.1979) *with In re Tillery*, 571 F.2d 1361 (5th Cir.1978). Subparagraph (3) restates and expands the provisions of former Section 1–201(37) to make clear that the option can be to buy or renew. Subparagraphs (4) and (5) treat fixed price options and provide that fair market value must be determined at the time the transaction is entered into. *Compare Arnold Mach. Co. v. Balls*, 624 P.2d 678 (Utah 1981) *with Aoki v. Shepherd Mach. Co.*, 665 F.2d 941 (9th Cir.1982).

The relationship of subsection (b) to subsection (c) deserves to be explored. The fixed price purchase option provides a useful example. A fixed price purchase option in a lease does not of itself create a security interest. This is particularly true if the fixed price is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed. A security interest is created only if the option price is nominal and the conditions stated in the introduction to the second paragraph of this subsection are met. There is a set of purchase options whose fixed price is less than fair market value but greater than nominal that must be determined on the facts of each case to ascertain whether the transaction in which the option is included creates a lease or a security interest.

It was possible to provide for various other permutations and combinations with respect to options to purchase and renew. For example, this section could have stated a rule to govern the facts of *In re Marhoefer Packing Co.*, 674 F.2d 1139 (7th Cir.1982). This was not done because it would unnecessarily complicate the definition. Further development of this rule is left to the courts.

Subsections (d) and (e) provide definitions and rules of construction.

SECTION 1-204. VALUE. Except as otherwise provided in articles 3, 4, 5, [and 6], a person gives value for rights if the person acquires them:

(1) in return for a binding commitment to extend credit or for the extension of immediately available credit, whether or not drawn upon and whether or not a charge-back is provided for in the event of difficulties in collection;

(2) as security for, or in total or partial satisfaction of, a preexisting claim;

(3) by accepting delivery under a preexisting contract for purchase; or

(4) in return for any consideration sufficient to support a simple contract.

Official Comment

Source: Former Section 1-201(44).

Changes from former law: Unchanged from former Section 1-201, which was derived from Sections 25, 26, 27, 191, Uniform Negotiable Instruments Law; Section 76, Uniform Sales Act; Section 53, Uniform Bills of Lading Act; Section 58, Uniform Warehouse Receipts Act; Section 22(1), Uniform Stock Transfer Act; Section 1, Uniform Trust Receipts Act. These provisions are substantive rather than purely definitional. Accordingly, they have been relocated from former Section 1-201 to this Section.

1. All the Uniform Acts in the commercial law field (except the Uniform Conditional Sales Act) have carried definitions of "value." All those definitions provided that value was any consideration sufficient to support a simple contract, including the taking of property in satisfaction of or as security for a pre-existing claim. Subsections (1), (2) and (4) in substance continue the definitions of "value" in the earlier acts. Subsection (3) makes explicit that "value" is also given in a third situation: where a buyer by taking delivery under a pre-existing contract converts a contingent into a fixed obligation.

This definition is not applicable to Articles 3 and 4, but the express inclusion of immediately available credit as value follows the separate definitions in those Articles. See Sections 4–208, 4–209, 3–303. A bank or other financing agency which in good faith makes advances against property held as collateral becomes a bona fide purchaser of that property even though provision may be made for charge-back in case of trouble. Checking credit is "immediately available" within the meaning of this section if the bank would be subject to an action for slander of credit in case checks drawn against the credit were dishonored, and when a charge-back is not discretionary with the bank, but may only be made when difficulties in collection arise in connection with the specific transaction involved.

SECTION 1-205. REASONABLE TIME; SEASONABLENESS.

(a) Whether a time for taking an action required by [the Uniform Commercial Code] is reasonable depends on the nature, purpose, and circumstances of the action.

(b) An action is taken seasonably if it is taken at or within the time agreed or, if no time is agreed, at or within a reasonable time.

Official Comment

Source: Former Section 1-204(2)-(3).

Changes from former law: This Section is derived from subsections (2) and (3) of former Section 1-204. Subsection (1) of that Section is now incorporated in Section 1-302(b).

1. Subsection (a) makes it clear that requirements that actions be taken within a "resonable" time are to be applied in the transactional context of the particular action.

2. Under subsection (b), the agreement that fixes the time need not be part of the main agreement, but may occur separately. Notice also that under the definition of "agreement" (Section 1–201) the circumstances of the transaction, including course of dealing or usages of trade or course of performance may be material. On the question what is a reasonable time these matters will often be important.

PART 3

TERRITORIAL APPLICABILITY AND GENERAL RULES

SECTION 1-301. TERRITORIAL APPLICABILITY; PARTIES' POWER TO CHOOSE APPLICABLE LAW.

(a) For purposes of this section:

(1) a transaction is a "domestic transaction" if it is not an international transaction; and

(2) a transaction is an "international transaction" if it bears a reasonable relation to a country other than the United States.

(b) Except as provided in this section:

(1) an agreement by parties to a domestic transaction that any or all of their rights and obligations are to be determined by the law of this State or of another State is effective, whether or not the transaction bears a relation to the State designated; and

(2) an agreement by parties to an international transaction that any or all of their rights and obligations are to be determined by the law of this State or of another State or country is effective, whether or not the transaction bears a relation to the State or country designated.

(c) In the absence of an agreement effective under subsection (b), the rights and obligations of the parties are determined, except as provided in subsections (d) and (f), by the law that would be selected by application of this State's conflict of laws principles.

(d) If one of the parties to a transaction is a consumer, the following rules apply:

(1) An agreement referred to in subsection (b) is not effective unless the transaction bears a reasonable relation to the State or country designated.

(2) Application of the law of the State or country determined pursuant to subsection (b) or (c) may not deprive the consumer of the protection of any rule of law, which both (i) is protective of consumers and (ii) may not be varied by agreement, of the State or country:

(A) in which the consumer habitually resides, unless subparagraph (B) applies; or

(B) if the transaction is a sale of goods, in which the consumer makes the contract and takes delivery of those goods, if such State or country is not the State or country in which the consumer habitually resides.

(e) An agreement otherwise effective under subsection (b) is not effective to the extent that application of the law of the State or country designated would be contrary to a fundamental policy of the State or country whose law would govern in the absence of agreement pursuant to subsection (c).

(f) To the extent that the [Uniform Commercial Code] governs a transaction, where one of the following provisions of the [Uniform Commercial Code] specifies the applicable law, that provision governs and a contrary agreement is effective only to the extent permitted by the law (including the conflict of law rules) so specified:

(1) Section 2-402

(2) Sections 2A-105 and 2A-106

(3) Section 4-102

(4) Section 4A-507

(5) Section 5-116

(6) Section 6-103

(7) Section 8-110

(8) Sections 9-301 through 9-307.

Official Comment

Source: Former Section 1-105.

Summary of changes from former law: Section 1-301,which replaces former UCC Section 1-105, represents a significant rethinking of choice of law issues addressed in that section. The new section reexamines both the power of parties to select the jurisdiction whose law will govern their transaction and the determination of the governing law in the absence of such selection by the parties. With respect to the power to select governing law, the draft affords greater party autonomy than former section 1-105, but with important safeguards protecting consumer interests and fundamental policies. While the Drafting Committee considered addressing the related topic of forum selection clauses, it ultimately decided that Article 1 of the Uniform Commercial Code is not an appropriate vehicle for addressing this issue.

Revised UCC section 1-301 addresses contractual designation of governing law somewhat differently than does former section 1-105. Former law allows the parties to any transaction to designate a jurisdiction whose law governs if the transaction bears a "reasonable relation" to that jurisdiction. Revised Article 1 deviates from this unified approach by providing different rules for consumer transactions than for "business to business" transactions.

In the context of consumer transactions, revised Article 1, unlike former law, generally protects consumers against the possibility of losing the protection of consumer protection laws of their home jurisdiction.

In the context of business-to-business transactions, revised Article 1 generally provides the parties with greater autonomy to designate a jurisdiction whose law will govern than does former Article 1, but also provides some safeguards against abuse that do not appear in former Article 1. Following emerging international norms, greater autonomy is provided in subsections (b) and (c) by deleting the requirement that the transaction bear a "reasonable relation" to the jurisdiction designated in this non-consumer context. It should be noted in this regard that in the case of wholly domestic transactions the jurisdiction designated must be a State. An important safeguard not present in former law is provided in subsection (e). Subsection (e) indicates that the designation of a jurisdiction's law is not effective (even if the transaction bears a reasonable relation to that jurisdiction) to the extent that application of that law would be contrary to a fundamental policy of the jurisdiction whose law would govern in the absence of contractual designation. Application of the law designated may be contrary to a fundamental policy of the State or country whose law would otherwise govern either because of the nature of the law designated or because of the "mandatory" nature of the law that would otherwise apply.

In the absence of an effective contractual designation of governing law, former UCC section 1-105(1) directs the forum to apply its own law if the transaction bears "an appropriate relation to this state." This provision, however, is frequently ignored by courts. Revised UCC section 1-301(c) provides simply that, in the absence of contractual designation, the court should apply the forum's choice of law principles.

1. *Applicability of section.* This section is neither a full Restatement of choice of law principles nor a free-standing choice of law statute. Rather, it is a provision of Article 1 of the Uniform Commercial Code. As such, it is subject to Section 1-102, which states the scope of Article 1. As that section indicates, Article 1, and the rules contained therein, apply to transactions to the extent that they are governed by one of the other Articles of the Uniform Commercial Code. Thus, this section does not apply to a transaction outside the scope of the Uniform Commercial Code such as a services contract or a contract for the sale of real estate. On the other hand, if the transaction is within the scope of a substantive Article of the Uniform Commercial Code, such as in the case of a sale or lease of goods, this section does apply.

In some cases, a transaction is neither completely within the scope of the Uniform Commercial Code (as in the case of a sale or lease of goods) nor completely outside the scope of the Uniform Commercial Code (as in the case of a contract for the sale of real estate). Rather, some aspects of the transaction are within the substantive scope of the Uniform Commercial Code while other aspects are not. One example of this phenomenon is an agreement to loan money in which the borrower's obligation to repay the loan is secured by a security interest in personal property. The security agreement, and the security interest created thereby, are clearly within the scope of Article 9. The loan agreement, on the other hand, is governed not by the Uniform Commercial Code but by the general law of contracts. Another example is provided by a real estate lease in which the lessee's obligation to pay the stated rent is backed by a standby letter of credit issued by a bank. The lease is governed by realty law outside the Uniform Commercial Code, while the letter of credit is governed by Article 5. While this section, by its terms, only applies to the UCC aspect of such a "mixed transaction," it is within a court's discretion to decide in a particular case that bifurcation of the choice of law principles applicable to the transaction is inadvisable and, accordingly, to apply principles of this section to the non-UCC aspects of the transaction in order to have the law of the same State or country apply to the entire transaction. When the UCC aspects of such a "mixed transaction" predominate, such a decision may be particularly appropriate.

2. *Contractual choice of law.* This section allows parties broad autonomy, with several important limitations, to select the law governing their transaction, even if the transaction does not bear a relation to the State or country whose law is selected. This recognition of party autonomy with respect to governing law has already been established in several Articles of the Uniform Commercial Code (see UCC Sections 4A-507, 5-116, and 8-110) and is consistent with international norms. See, e.g., Inter-American Convention on the Law Applicable to International Contracts, Article 7 (Mexico City 1994); Convention on the Law Applicable to Contracts for the International Sale of Goods, Article 7(1) (The Hague 1986); EC Convention on the Law Applicable to Contractual Obligations, Article 3(1) (Rome 1980).

There are three important limitations on this party autonomy to select governing law. First, a different, and more protective, rule applies in the context of consumer transactions (see note *c*). Second, in an entirely domestic transaction, this section does not validate the selection of foreign law. (See note *d*.) Third, contractual choice of law will not be given effect to the extent that application of the law designated would be contrary to a fundamental policy of the State or country whose law would be applied in the absence of such contractual designation (see Comment 5).

The Drafting Committee considered whether this Section should expressly provide for the ability of parties to designate non-legal codes such as trade codes as the set of rules governing their transaction, but decided that the principles of Section 1-302 allowing parties broad freedom of contract to structure their relation are adequate for this purpose. A similar decision was made with respect to the ability of the parties to designate recognized bodies of rules or principles applicable to commercial transactions that are promulgated by intergovernmental authorities such as UNCITRAL or UNIDROIT. See, e.g., UNIDROIT Principles of International Commercial Contracts.

3. *Consumer transactions.* If one of the parties is a consumer (as defined in section 1-201(11a)), subsection (d) provides the parties less autonomy to designate the State or country whose law will govern. First, in a consumer transaction subsection (d)(1) provides that the transaction must bear a reasonable relation to the State or country designated. Second, except as noted below, subsection (d)(2) provides that a designation of the law of a State or country other than that of the consumer's habitual residence, even if the transaction bears a reasonable relation to that State or country, will not deprive the consumer of the protection of any rules of law of the consumer's habitual residence which are protective of consumers and are not variable by agreement. (It should be noted that the phrase "rule of law" is intended to refer to case law as well as statutes and administrative regulations.) Thus, for example, in the case of a sale of goods by a seller in Indiana to a consumer buyer in New York, in which transaction the contract designates Indiana law as governing, the New York buyer will retain the protection of nonwaivable New York rules of law that are protective of consumers.

There is one exception to this principle. In the case of a sale of goods to a consumer in which the consumer makes the contract and takes possession of the goods in a State or country other than the consumer's habitual residence, subsection (d)(2)(B) provides that it is the consumer protection rules of law of that State or country that cannot be eliminated by choice of law. Thus, for example, if a New York consumer, while on vacation in Indiana, buys goods and takes delivery of them at an Indiana branch of an Ohio retailer, and the contract designates Ohio law as governing, this choice of law may not deprive the New York consumer buyer of nonwaivable Indiana rules of law that are protective of consumers, but may deprive that buyer of analogous New York rules. This exception, adapted from UCC section 2A-106 and Article 5 of the EC Convention on the Law Applicable to Contractual Obligations, enables a seller that engages in only face-to-face transactions to ascertain in advance which consumer protection law it is subject to. The reference in subsection (d)(2)(B) to the State or country in which the consumer makes the contract should not be read to incorporate formalistic concepts of where the last event necessary to conclude the contract took place; rather, the intent is to identify the state in which all material steps were taken by the consumer to enter into the contract.

In the absence of a contractual designation of governing law, application of the choice of law rules of the forum, as mandated by subsection (c), could lead to application of the laws of a State or country other than that of the consumer's habitual residence. In such a case, subsection (d)(2) still applies to preserve consumer protection rules for the benefit of the consumer as described in the preceding paragraph.

4. *Wholly domestic transactions.* While this Section provides parties broad autonomy to select governing law, that autonomy is limited in the case of wholly domestic transactions. In a "domestic transaction," subsection (b)(1) validates only the designation of the law of a State. A "domestic transaction" is a transaction that does not bear a reasonable relation to a country other than the United States. See subsection (a). Thus, in a wholly domestic non-consumer transaction, parties may (subject to the limitations set out in subsections (e) and (f)) designate the law of any State but not the law of a foreign country.

5. *International transactions.* This section provides greater autonomy in the context of international transactions. As defined in subsection (a)(2), a transaction is an "international transaction" if it bears a reasonable relation to a country other than the United States. In a non-consumer international transaction, subsection (b)(2) provides that a designation of the law of any State or country is effective (subject, of course, to the limitations set out in subsections (e) and (f)). It is important to note that the transaction need not bear a relation to the State or country designated so long as the transaction is international. Thus, for example, in a non-consumer lease of goods in which the lessor is located in Mexico and the lessee is located in Louisiana, a designation of the law of Ireland to govern the transaction would be given effect under this section even though the transaction may bear no relation to Ireland. The ability to designate the law of any country in non-consumer international transactions is important in light of the common practice in many commercial contexts of designating the law of a "neutral" jurisdiction whose law is well-developed.

6. *Fundamental policy.* Subsection (e) provides that an agreement designating the governing law will not be given effect to the extent that application of the designated law would be contrary to a fundamental policy of the State or country whose law would otherwise govern. This rule provides a narrow exception to the broad autonomy afforded to parties in subsection (b). One of the prime objectives of contract law is to protect the justified expectations of the parties and to make it possible for them to foretell with accuracy what will be their rights and liabilities under the contract. In this way, certainty and predictability of result are most likely to be secured. See Restatement (Second) Conflict of Laws, § 187, comment *e*.

Under the fundamental policy doctrine, a court should not refrain from applying the designated law merely because this would lead to a result different than would be obtained under the local law of the State or country whose law would otherwise govern. Rather, the difference must be contrary to a public policy that is so substantial that it justifies overriding the concerns for certainty and predictability underlying modern commercial law as well as concerns for judicial economy generally. Thus, application of the designated law will rarely be found to be contrary to a fundamental policy of the State or country whose law would otherwise govern when the difference between the two concerns a requirement, such as a statute of frauds, that relates to formalities, or general rules of contract law, such as those concerned with the need for consideration.

The opinion of Judge Cardozo in *Loucks v. Standard Oil Co. of New York*, 120 N.E. 198 (1918), regarding the related issue of when a state court may decline to apply the law of another state, is a helpful touchstone here:

> Our own scheme of legislation may be different. We may even have no legislation on the subject. That is not enough to show that public policy forbids us to enforce the foreign right. A right of action is property. If a foreign statute gives the right, the mere fact that we do not give a like right is no reason for refusing to help the plaintiff in getting what belongs to him. We are not so provincial as to say that every solution of a problem is wrong because we deal with it otherwise at home. Similarity of legislation has indeed this importance; its presence shows beyond question that the foreign statute does not offend the local policy. But its absence does not prove the contrary. It is not to be exalted into an indispensable condition. The misleading word 'comity' has been responsible for much of the trouble. It has been fertile in suggesting a discretion unregulated by general principles.
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> * * *
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> The courts are not free to refuse to enforce a foreign right at the pleasure of the judges, to suit the individual notion of expediency or fairness. They do not close their doors, unless help would violate some fundamental principle of justice, some prevalent conception of good morals, some deep-rooted tradition of the common weal.

120 N.E. at 201-02 (citations to authorities omitted).

Analytically, one might conclude that application of the designated law is contrary to a fundamental policy of the State or country whose law would otherwise govern either (i) because the substance of the designated law violates a fundamental principle of justice of that State or country or (ii) because it differs from a rule of that State or country that is "mandatory" in that it *must* be applied in the courts of that State or country without regard to otherwise-applicable choice of law rules of that State or country and without regard to whether the designated law is otherwise offensive. This distinction, which may have more theoretical than practical significance, has been suggested in some international conventions in this area, although in some cases the concept is applied to authorize the *forum* state to apply *its* mandatory rules, rather than those of the State or country whose law would otherwise govern. The latter situation is not addressed by this section. See comment 9.

In any event, it is obvious that a rule that is freely changeable by agreement of the parties under the law of the State or country whose law would otherwise govern can hardly be construed as a mandatory rule of that State or country. This does not mean, however, that rules that cannot be changed by agreement under that law are, for that reason alone, mandatory rules. Otherwise, contractual choice of law in the UCC context would be illusory and redundant; the parties would be able to accomplish by choice of law no more than can be accomplished under Section 1-302 (by agreeing to vary the rules that would otherwise govern their transaction by substituting for those rules the rules that would apply if the transaction were governed by the designated State or country) without designation of governing law. Indeed, other than cases in which a mandatory choice of law rule is established by statute (see, e.g., UCC sections 9-301 through 9-307, explicitly preserved in subsection (f)), cases in which courts have declined to follow the designated law solely because a rule of the State or country whose law would otherwise govern is mandatory are rare.

7. *Choice of law in the absence of contractual designation.* Subsection (c), which replaces the second sentence of former UCC Section 1-105(1), determines which jurisdiction's law governs a transaction in the absence of an effective contractual choice by the parties. Former Section 1-105(1), provided that the law of the forum (*i.e.*, the Uniform Commercial Code) applies if the transaction bears "an appropriate relation to this state." By using an "appropriate relation" test, rather than, say, requiring that the forum be the location of the "most significant" contact, Section 1-105(1) expressed a bias in favor of applying the forum's law. This bias, while not universally respected by the courts, was justifiable in light of the uncertainty that existed at the time of drafting as to whether the Uniform Commercial Code would be adopted by all the states; the pro-forum bias would assure that the Uniform Commercial Code would be applied so long as the transaction bore an "appropriate" relation to the forum. Inasmuch as the Uniform Commercial Code has been adopted, at least in part, in all U.S. jurisdictions, the vitality of this point is minimal in the domestic context, and international comity concerns militate against continuing the pro-forum, pro-UCC bias in transnational transactions. When the choice is between the law of two jurisdictions that have adopted the Uniform Commercial Code, but whose law differs (whether because of differences in enacted language or differing judicial interpretations), there is no strong justification for directing a court to apply different choice of law rules to its determination than it would apply if the matter were not governed by the Uniform Commercial Code. Similarly, given the wide variety of choice of law principles applied by the states, it would not be prudent to designate only one such principle as the proper one for transactions governed by the Uniform Commercial Code. Accordingly, in cases in which the parties have not made an effective choice of law, Section 1-301(a) simply directs the forum to apply its ordinary choice of law principles to determine which jurisdiction's law governs.

8. *Primacy of other UCC choice of law rules.* Subsection (f), which is essentially identical to former UCC Section 1-105(2), indicates that choice of law rules provided in the other Articles govern when applicable.

9. *Matters not addressed by this section.* As noted in comment 1, this section is not a complete statement of conflict of laws doctrines applicable in commercial cases. In particular, this section does not address, and leaves to other law, two issues that relate to the forum and its law. First, a forum will occasionally decline to apply the law of a different jurisdiction selected by the parties when application of that law would be contrary to a fundamental policy of the forum jurisdiction, even if it would not be contrary to a fundamental policy of the State or country whose law would govern in the absence of contractual designation. Standards for application of this doctrine relate primarily to concepts of sovereignty rather than commercial law and are thus left to the courts. Second, in determining whether to give effect to the parties' agreement that the law of a particular State or country will govern their relationship, courts must, of necessity, address some issues as to the basic validity of that agreement. These issues might relate, for example, to capacity to contract and absence of duress. This section does not address these issues.

SECTION 1-302. VARIATION BY AGREEMENT

(a) Except as otherwise provided in subsection (b) or elsewhere in [the Uniform Commercial Code], the effect of provisions of [the Uniform Commercial Code] may be varied by agreement.

(b) The obligations of good faith, diligence, reasonableness and care prescribed by [the Uniform Commercial Code] may not be disclaimed by agreement. The parties, by agreement, may determine the standards by which the performance of those obligations is to be measured if those standards are not manifestly unreasonable. Whenever the [Uniform Commercial Code] requires any action to be taken within a reasonable time, any time which is not manifestly unreasonable may be fixed by agreement.

(c) The presence in certain provisions of [the Uniform Commercial Code] of the phrase "unless otherwise agreed", or words of similar import, does not imply that the effect of other provisions may not be varied by agreement under this section.

Official Comment

Source: Former Sections 1-102(3)-(4) and 1-204(1).

Changes: This section combines the rules from subsections (3) and (4) of former Section 1-102 and subsection (1) of former Section 1-204. No substantive changes are made.

1. Subsection (a) states affirmatively at the outset that freedom of contract is a principle of the Uniform Commercial Code: "the effect" of its provisions may be varied by "agreement." The meaning of the statute itself must be found in its text, including its definitions, and in appropriate extrinsic aids; it cannot be varied by agreement. But the Uniform Commercial Code seeks to avoid the type of interference with evolutionary growth found in pre-Code cases such as Manhattan Co. v. Morgan, 242 N.Y. 38, 150 N.E. 594 (1926). Thus private parties cannot make an instrument negotiable within the meaning of Article 3 except as provided in Section 3–104; nor can they change the meaning of such terms as "bona fide purchaser," "holder in due course," or "due negotiation," as used in the Uniform Commercial Code. But an agreement can change the legal consequences that

would otherwise flow from the provisions of the Uniform Commercial Code. "Agreement" here includes the effect given to course of dealing, usage of trade and course of performance by Sections 1–201 and 1–303; the effect of an agreement on the rights of third parties is left to specific provisions of the Uniform Commercial Code and to supplementary principles applicable under Section 1-103. The rights of third parties under Section 9–317 when a security interest is unperfected, for example, cannot be destroyed by a clause in the security agreement.

This principle of freedom of contract is subject to specific exceptions found elsewhere in the Uniform Commercial Code and to the general exception stated here. The specific exceptions vary in explicitness: the statute of frauds found in Section 2–201, for example, does not explicitly preclude oral waiver of the requirement of a writing, but a fair reading denies enforcement to such a waiver as part of the "contract" made unenforceable; Section 9–602, on the other hand, is a quite explicit limitation on freedom of contract. Under the exception for "the obligations of good faith, diligence, reasonableness and care prescribed by [the Uniform Commercial Code]," provisions of the Uniform Commercial Code prescribing such obligations are not to be disclaimed. However, the section also recognizes the prevailing practice of having agreements set forth standards by which due diligence is measured and explicitly provides that, in the absence of a showing that the standards manifestly are unreasonable, the agreement controls. In this connection, Section 1–303 incorporating into the agreement prior course of dealing and usages of trade is of particular importance.

Subsection (b) also recognizes that nothing is stronger evidence of a reasonable time than the fixing of such time by a fair agreement between the parties. However, provision is made for disregarding a clause which whether by inadvertence or overreaching fixes a time so unreasonable that it amounts to eliminating all remedy under the contract. The parties are not required to fix the most reasonable time but may fix any time which is not obviously unfair as judged by the time of contracting.

2. An agreement that varies the effect of provisions of the Uniform Commercial Code may do so by stating the rules that will govern in lieu of the provisions varied. Alternatively, the parties may vary the effect of such provisions by stating that their relationship will be governed by recognized bodies of rules or principles applicable to commercial transactions. Such bodies of rules or principles may include, for example, those that are promulgated by intergovernmental authorities such as UNCITRAL or UNIDROIT (see, e.g., UNIDROIT Principles of International Commercial Contracts), or non-legal codes such as trade codes.

3. Subsection (c) is intended to make it clear that, as a matter of drafting, phrases such as "unless otherwise agreed" have been used to avoid controversy as to whether the subject matter of a particular section does or does not fall within the exceptions to subsection (b), but absence of such words contains no negative implication since under subsection (b) the general and residual rule is that the effect of all provisions of the Uniform Commercial Code may be varied by agreement.

SECTION 1-303. COURSE OF PERFORMANCE, COURSE OF DEALING, AND USAGE OF TRADE.

(a) A "course of performance" is a sequence of conduct between the parties to a particular transaction that exists if:

(1) the agreement of the parties with respect to the transaction involves repeated occasions for performance by a party; and

(2) the other party, with knowledge of the nature of the performance and opportunity for objection to it, accepts the performance or acquiesces in it without objection.

(b) A "course of dealing" is a sequence of conduct concerning previous transactions between the parties to a particular transaction that is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct.

(c) A "usage of trade" is any practice or method of dealing having such regularity of observance in a place, vocation or trade as to justify an expectation that it will be observed with respect to the transaction in question. The existence and scope of such a usage are to be proved as facts. If it is established that such a usage is embodied in a trade code or similar record, the interpretation of the record is a question of law.

(d) A course of performance or course of dealing between the parties or usage of trade in the vocation or trade in which they are engaged or of which they are or should be aware is relevant in ascertaining the meaning of the parties' agreement, may give particular meaning to specific terms of the agreement, and may supplement or qualify the terms of the agreement. A usage of trade applicable in the place in which part of the performance under the agreement is to occur may be so utilized as to that part of the performance.

(e) Except as otherwise provided in subsection (f), the express terms of an agreement and any applicable course of performance, course of dealing, or usage of trade must be construed whenever reasonable as consistent with each other. If such a construction is unreasonable:

(1) express terms prevail over course of performance, course of dealing, and usage of trade;

(2) course of performance prevails over course of dealing and usage of trade; and

(3) course of dealing prevails over usage of trade.

(f) Subject to Section [2-209], a course of performance is relevant to show a waiver or modification of any term inconsistent with the course of performance.

(g) Evidence of a relevant usage of trade offered by one party is not admissible unless that party has given the other party notice that the court finds sufficient to prevent unfair surprise to the other party.

Official Comment

Source: Former Sections 1-205, 2-208, and Section 2A-207.

Changes from former law: This section integrates the "course of performance" concept from Articles 2 and 2A into the principles of former Section 1-205, which deals with course of dealing and usage of trade. In so doing, the section slightly modifies the articulation of the course of performance rules to fit more comfortably with the approach and structure of former UCC Section 1-205. There are also slight modifications to be more consistent with the definition of "agreement" in former section 1-201(3). It should be noted that a course of performance that might otherwise establish a defense to the obligation of a party to a negotiable instrument is not available as a defense against a holder in due course who took the instrument without notice of that course of performance.

1. The Uniform Commercial Code rejects both the “lay-dictionary” and the “conveyancer's” reading of a commercial agreement. Instead the meaning of the agreement of the parties is to be determined by the language used by them and by their action, read and interpreted in the light of commercial practices and other surrounding circumstances. The measure and background for interpretation are set by the commercial context, which may explain and supplement even the language of a formal or final writing.

2. “Course of dealing,” as defined in subsection (b), is restricted, literally, to a sequence of conduct between the parties previous to the agreement. A sequence of conduct after or under the agreement, however, is a “course of performance.” “Course of dealing” may enter the agreement either by explicit provisions of the agreement or by tacit recognition.

3. The Uniform Commercial Code deals with “usage of trade” as a factor in reaching the commercial meaning of the agreement that the parties have made. The language used is to be interpreted as meaning what it may fairly be expected to mean to parties involved in the particular commercial transaction in a given locality or in a given vocation or trade. By adopting in this context the term “usage of trade,” the Uniform Commercial Code expresses its intent to reject those cases which see evidence of “custom” as representing an effort to displace or negate “established rules of law.” A distinction is to be drawn between mandatory rules of law such as the Statute of Frauds provisions of Article 2 on Sales whose very office is to control and restrict the actions of the parties, and which cannot be abrogated by agreement, or by a usage of trade, and those rules of law (such as those in Part 3 of Article 2 on Sales) which fill in points which the parties have not considered and in fact agreed upon. The latter rules hold “unless otherwise agreed” but yield to the contrary agreement of the parties. Part of the agreement of the parties to which such rules yield is to be sought for in the usages of trade which furnish the background and give particular meaning to the language used, and are the framework of common understanding controlling any general rules of law which hold only when there is no such understanding.

4. A usage of trade under subsection (c) must have the “regularity of observance” specified. The ancient English tests for “custom” are abandoned in this connection. Therefore, it is not required that a usage of trade be “ancient or immemorial.” “universal,” or the like. Under the requirement of subsection (c) full recognition is thus available for new usages and for usages currently observed by the great majority of decent dealers, even though dissidents ready to cut corners do not agree. There is room also for proper recognition of usage agreed upon by merchants in trade codes.

5. The policies of the Uniform Commercial Code controlling explicit unconscionable contracts and clauses (Sections 1–304, 2–302) apply to implicit clauses that rest on usage of trade and carry forward the policy underlying the ancient requirement that a custom or usage must be “reasonable.” However, the emphasis is shifted. The very fact of commercial acceptance makes out a *prima facie* case that the usage is reasonable, and the burden is no longer on the usage to establish itself as being reasonable. But the anciently established policing of usage by the courts is continued to the extent

necessary to cope with the situation arising if an unconscionable or dishonest practice should become standard.

6. Subsection (d), giving the prescribed effect to usages of which the parties "are or should be aware," reinforces the provision of subsection (c) requiring not universality but only the described "regularity of observance" of the practice or method. This subsection also reinforces the point of subsection (c) that such usages may be either general to trade or particular to a special branch of trade.

7. Although the definition of "agreement" in Section 1-201 includes the elements of course of performance, course of dealing, and usage of trade, the fact that express reference is made in some sections to those elements is not to be construed as carrying a contrary intent or implication elsewhere. Compare Section 1–302(c).

8. In cases of a well established line of usage varying from the general rules of the Uniform Commercial Code where the precise amount of the variation has not been worked out into a single standard, the party relying on the usage is entitled, in any event, to the minimum variation demonstrated. The whole is not to be disregarded because no particular line of detail has been established. In case a dominant pattern has been fairly evidenced, the party relying on the usage is entitled under this section to go to the trier of fact on the question of whether such dominant pattern has been incorporated into the agreement.

9. Subsection (g) is intended to insure that this Act's liberal recognition of the needs of commerce in regard to usage of trade shall not be made into an instrument of abuse.

SECTION 1–304. OBLIGATION OF GOOD FAITH. Every contract or duty within [the Uniform Commercial Code] imposes an obligation of good faith in its performance and enforcement.

Official Comment

Source: Former Section 1-203.

Changes from former law: Except for changing the form of reference to the Uniform Commercial Code, this Section is identical to former UCC Section 1-203. A comment will make it clear that this section applies to the exercise of rights granted by the Uniform Commercial Code.

1. This section sets forth a basic principle running throughout the Uniform Commercial Code. The principle is that in commercial transactions good faith is required in the performance and

enforcement of all agreements or duties. While this duty is explicitly stated in some provisions of the Uniform Commercial Code, the applicability of the duty is broader than merely these situations and applies generally, as stated in this section, to the performance or enforcement of every contract or duty within this Act. It is further implemented by Section 1–303 on course of dealing, course of performance, and usage of trade. This section does not support an independent cause of action for failure to perform or enforce in good faith. Rather, this section means that a failure to perform or enforce, in good faith, a specific duty or obligation under the contract, constitutes a breach of that contract or makes unavailable, under the particular circumstances, a remedial right or power. This distinction makes it clear that the doctrine of good faith merely directs a court towards interpreting contracts within the commercial context in which they are created, performed, and enforced, and does not create a separate duty of fairness and reasonableness which can be independently breached.

2. "Performance and enforcement" of contracts and duties within the Uniform Commercial Code include the exercise of rights created by the Uniform Commercial Code.

SECTION 1–305. REMEDIES TO BE LIBERALLY ADMINISTERED.

(a) The remedies provided by [the Uniform Commercial Code] must be liberally administered to the end that the aggrieved party may be put in as good a position as if the other party had fully performed but neither consequential or special damages nor penal damages may be had except as specifically provided in [the Uniform Commercial Code] or by other rule of law.

(b) Any right or obligation declared by [the Uniform Commercial Code] is enforceable by action unless the provision declaring it specifies a different and limited effect.

Official Comment

Source: Former Section 1-106.

Changes from former law: Other than changes in the form of reference to the Uniform Commercial Code, this section is identical to former UCC Section 1-106.

1. Subsection (a) is intended to effect three propositions. The first is to negate the possibility of unduly narrow or technical interpretation of remedial provisions by providing that the remedies in the Uniform Commercial Code are to be liberally administered to the end stated in this section. The

second is to make it clear that compensatory damages are limited to compensation. They do not include consequential or special damages, or penal damages; and the Uniform Commercial Code elsewhere makes it clear that damages must be minimized. Cf. Sections 1–203, 2–706(1), and 2–712(2). The third purpose of subsection (a) is to reject any doctrine that damages must be calculable with mathematical accuracy. Compensatory damages are often at best approximate: they have to be proved with whatever definiteness and accuracy the facts permit, but no more. Cf. Section 2–204(3).

2. Under subsection (b), any right or obligation described in the Uniform Commercial Code is enforceable by action, even though no remedy may be expressly provided, unless a particular provision specifies a different and limited effect. Whether specific performance or other equitable relief is available is determined not by this section but by specific provisions and by supplementary principles. Cf. Sections 1–103, 2–716.

3. "Consequential" or "special" damages and "penal" damages are not defined in the Uniform Commercial Code; rather, these terms are used in the sense in which they are used outside the Uniform Commercial Code.

SECTION 1–306. WAIVER OR RENUNCIATION OF CLAIM OR RIGHT AFTER BREACH. A claim or right arising out of an alleged breach may be discharged in whole or in part without consideration by agreement of the aggrieved party in an authenticated record.

Official Comment

Source: Former Section 1-107.

Changes from former law: This section changes former law in two respects. First, former Section 1-107, requiring the "delivery" of a "written waiver or renunciation" merges the separate concepts of the aggrieved party's agreement to forego rights and the manifestation of that agreement. This section separates those concepts, and explicitly requires *agreement* of the aggrieved party. Second, the revised section reflects developments in electronic commerce by providing for memorialization in an authenticated record.

1. This section makes consideration unnecessary to the effective renunciation or waiver of rights or claims arising out of an alleged breach of a commercial contract where the agreement effecting such renunciation is memorialized in a record authenticated by the aggrieved party. Its provisions, however, must be read in conjunction with the section imposing an obligation of good faith. (Section 1–304).

SECTION 1–307. PRIMA FACIE EVIDENCE BY THIRD PARTY DOCUMENTS. A document in due form purporting to be a bill of lading, policy or certificate of insurance, official weigher's or inspector's certificate, consular invoice, or any other document authorized or required by the contract to be issued by a third party shall be prima facie evidence of its own authenticity and genuineness and of the facts stated in the document by the third party.

Official Comment

Source: Former Section 1-202.

Changes from former law: No changes.

1. This section supplies judicial recognition for documents that are relied upon as trustworthy by commercial parties.

2. This section is concerned only with documents that have been given a preferred status by the parties themselves who have required their procurement in the agreement, and for this reason the applicability of the section is limited to actions arising out of the contract that authorized or required the document. The list of documents is intended to be illustrative and not exclusive.

3. The provisions of this section go no further than establishing the documents in question as prima facie evidence and leave to the court the ultimate determination of the facts where the accuracy or authenticity of the documents is questioned. In this connection the section calls for a commercially reasonable interpretation.

4. Documents governed by this section need not be writings if records in another medium are generally relied upon in the context.

SECTION 1–308. PERFORMANCE OR ACCEPTANCE UNDER RESERVATION OF RIGHTS.

(a) A party that with explicit reservation of rights performs or promises performance or assents to performance in a manner demanded or offered by the other party does not thereby prejudice the rights reserved. Such words as "without prejudice," "under protest" or the like are sufficient.

(b) Subsection (a) does not apply to an accord and satisfaction.

Official Comment

Source: Former Section 1-207.

Changes from former law: This section is identical to former UCC Section 1-207.

1. This section provides machinery for the continuation of performance along the lines contemplated by the contract despite a pending dispute, by adopting the mercantile device of going ahead with delivery, acceptance, or payment "without prejudice," "under protest," "under reserve," "with reservation of all our rights," and the like. All of these phrases completely reserve all rights within the meaning of this section. The section therefore contemplates that limited as well as general reservations and acceptance by a party may be made "subject to satisfaction of our purchaser," "subject to acceptance by our customers," or the like.

2. This section does not add any new requirement of language of reservation where not already required by law, but merely provides a specific measure on which a party can rely as that party makes or concurs in any interim adjustment in the course of performance. It does not affect or impair the provisions of this Act such as those under which the buyer's remedies for defect survive acceptance without being expressly claimed if notice of the defects is given within a reasonable time. Nor does it disturb the policy of those cases which restrict the effect of a waiver of a defect to reasonable limits under the circumstances, even though no such reservation is expressed.

The section is not addressed to the creation or loss of remedies in the ordinary course of performance but rather to a method of procedure where one party is claiming as of right something which the other believes to be unwarranted.

3. Subsection (b) states that this section does not apply to an accord and satisfaction. Section 3–311 governs if an accord and satisfaction is attempted by tender of a negotiable instrument as stated in that section. If Section 3–311 does not apply, the issue of whether an accord and satisfaction has been effected is determined by the law of contract. Whether or not Section 3–311 applies, this section has no application to an accord and satisfaction.

SECTION 1–309. OPTION TO ACCELERATE AT WILL. A term providing that one party or that party's successor in interest may accelerate payment or performance or require collateral or additional collateral "at will" or when the party "deems itself insecure," or words of similar import, means that the party has power to do so only if that party in good faith believes that the prospect of payment or performance is impaired. The burden of establishing lack of good faith is on the party against which the power has been exercised.

Official Comment

Source: Former Section 1-208.

Changes from former law: Except for minor stylistic changes, this section is identical to former UCC Section 1-208.

1. The common use of acceleration clauses in many transactions governed by the Uniform Commercial Code, including sales of goods on credit, notes payable at a definite time, and secured transactions, raises an issue as to the effect to be given to a clause that seemingly grants the power to accelerate at the whim and caprice of one party. This section is intended to make clear that despite language that might be so construed and which further might be held to make the agreement void as against public policy or to make the contract illusory or too indefinite for enforcement, the option is to be exercised only in the good faith belief that the prospect of payment or performance is impaired.

Obviously this section has no application to demand instruments or obligations whose very nature permits call at any time with or without reason. This section applies only to an obligation of payment or performance which in the first instance is due at a future date.

SECTION 1–310. SUBORDINATED OBLIGATIONS. An obligation may be issued as subordinated to performance of another obligation of the person obligated, or a creditor may subordinate its right to performance of an obligation by agreement with either the person obligated or another creditor of the person obligated. Subordination does not create a security interest as against either the common debtor or a subordinated creditor.

Official Comment

Source: Former Section 1-209.

Changes from former law: This section is substantively identical to former Section 1-209. The language in that Section stating that it "shall be construed as declaring the law as it existed prior to the enactment of this Section and not as modifying it" has been deleted.

1. Billions of dollars of subordinated debt are held by the public and by institutional investors. Commonly, the subordinated debt is subordinated on issue or acquisition and is evidenced by an investment security or by a negotiable or non-negotiable note. Debt is also sometimes subordinated after it arises, either by agreement between the subordinating creditor and the debtor, by agreement between two creditors of the same debtor, or by agreement of all three parties. The subordinated creditor may be a stockholder or other "insider" interested in the common debtor; the subordinated debt may consist of accounts or other rights to payment not evidenced by any instrument. All such cases are included in the terms "subordinated obligation," "subordination," and "subordinated creditor."

2. Subordination agreements are enforceable between the parties as contracts; and in the bankruptcy of the common debtor dividends otherwise payable to the subordinated creditor are turned over to the superior creditor. This "turn-over" practice has on occasion been explained in terms of "equitable lien," "equitable assignment," or "constructive trust," but whatever the label the practice is essentially an equitable remedy and does not mean that there is a transaction "that creates a security interest in personal property . . . by contract" or a "sale of accounts, chattel paper, payment intangibles, or promissory notes" within the meaning of Section 9–109. On the other hand, nothing

in this section prevents one creditor from assigning his rights to another creditor of the same debtor in such a way as to create a security interest within Article 9, where the parties so intend.

3. The enforcement of subordination agreements is largely left to supplementary principles under Section 1–103. If the subordinated debt is evidenced by a certificated security, Section 8–202(a) authorizes enforcement against purchasers on terms stated or referred to on the security certificate. If the fact of subordination is noted on a negotiable instrument, a holder under Sections 3–302 and 3–306 is subject to the term because notice precludes him from taking free of the subordination. Sections 3–302(3)(a), 3–306 and 8–317 severely limit the rights of levying creditors of a subordinated creditor in such cases.