JUDICIARY SUBCOMMITTEE ON CIVIL PROCEDURE

Senator Richard Rock, Chairman

March 7, 1991
10:00 a.m.
Room 514-S

SB 352 - family and children trust fund review panel.
Provide travel money for advisers to the Commissioners for Youth Services.

PROPONENTS

Doug Bowman, Children and Youth Advisory Committee (ATTACHMENT 1)

OPPONENTS

none appeared.

Subcommittee recommendation: to recommend favorable for passage and to be placed on the Consent Calendar.

SB 132 - consignments sales and rights of creditors.
Amends UCC dealing with consignment sales to exclude from reach of creditors of sellers any consigned goods in a seller's possession which were bought for personal use by the consignor.

PROPONENTS

John Kisner, Sedgwick County District Attorney's Office
(ATTACHMENT 2)

OPPONENTS

none appeared.

Subcommittee recommendation: to recommend favorable for passage.

SB 336 - enacting the Kansas lease-purchase agreement act.
Lease agreements must contain certain disclosures, including the total number of, amount and timing of all payments necessary for ownership of the articles.

PROPONENTS

Barkley Clark, Shook, Hardy & Bacon, Kansas City, Missouri
(ATTACHMENT 3) balloon amendment providing certain clarifications.
Christopher Korst, Rent-A-Center, Wichita (ATTACHMENT 4)

OPPONENTS

none appeared.

Subcommittee recommendation: to amend as suggested and to recommend favorable as amended.

SB 337 - enacting article 2A of UCC relating to leases.
Would enact article 2A -- Leases as a new article of the Uniform Commercial Code.

PROPONENTS

Barkley Clark, Shook, Hardy & Bacon, Kansas City, Missouri
Debra Perlman, National Conference on Uniform State Laws, Chicago
(ATTACHMENTS 5 through 13)
William Lawrence, University of Kansas School of Law

OPPONENTS

none appeared.

Subcommittee recommendation: to recommend favorable for passage.

SB 359 - concerning the UCC relating to bulk transfers.
Would repeal article 6 of the Uniform Commercial Code.

PROPONENTS

Barkley Clark, Shook, Hardy & Bacon, Kansas City, Missouri
Debra Perlman, National Conference on Uniform State Laws, Chicago
William Lawrence, University of Kansas School of Law

OPPONENTS

none appeared.

Subcommittee recommendation: no action taken.

SB 361 - stylistic amendments to article 4A of the UCC regarding funds transfers.
Makes a number of technical and clarifying amendments to article 4A of the Uniform Commercial Code.

PROPONENTS

Debra Perlman, National Conference on Uniform State Laws, Chicago
(ATTACHMENTs 14 through 24)
William Lawrence, University of Kansas School of Law

OPPONENTS

none appeared.

Subcommittee recommendation: to recommend favorable for passage.

SB 371 - revisions to article 3 and 4 of the UCC.

PROPONENTS

Debra Perlman, National Conference on Uniform State Laws, Chicago
(ATTACHMENTs 25 through 34)
William Lawrence, University of Kansas School of Law

OPPONENTS

none appeared.

Subcommittee recommendation: to recommend favorable for passage.

GUEST LIST

COMMITTEE: Senate Judiciary Subcommittee on CIVIL PROCEDURE

DATE: 3/7/91

NAME (PLEASE PRINT)	ADDRESS	COMPANY/ORGANIZATION
Jan Waide	Topeka	Y.S. - SRS
Jim McHenry	Topeka	KCAPC
JOE KISNER	Wichita	Sedg. Co D.A's office
Lydia Rand Pigelman	Chicago	NCCUSL
William A. Lawrence	Lawrence	University of Kansas
Bartley Clark	KC	Shook, Hardy + Bacon
Chris Korst	Wichita	Rent A Center Inc
Eric Owens	Wichita	West H.S.
Paul J. Cox	Lawrence	intern
Janet Neff	Topeka	KDHE
Kris Gottschalk	Lawrence	intern
Kay Farley	Topeka	OJA
Doug Bowman	"	Children & Youth Advisory
Kathy Taylor	"	Ks Bankers Assn
Jim Maag	"	" " "
Carol Beard	Topeka Secretary of State →	
Stan Lind	Ks. Assn. of Financial Services	K C Ks.

STATE OF KANSAS

CHILDREN AND YOUTH ADVISORY COMMITTEE

SMITH-WILSON BLDG.
300 S.W. OAKLEY
TOPEKA, KANSAS 66606-1898

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KANS-A-N 561-2017

TESTIMONY BEFORE SENATE JUDICIARY SUBCOMMITTEE
SENATOR RICHARD ROCK, CHAIRPERSON
SENATE BILL 352 - March 6, 1991

Mr. Chairman and members of the committee, thank you for the opportunity to testify. My name is Doug Bowman, and I represent the Children and Youth Advisory Committee.

One of our duties established by law is to "advise the Commissioner of Youth Services, in detail, on the expenditures of monies in the family and chidren trust fund." In doing so, we have called upon a review panel to thoroughly read each grant application and make recommendations to the Children and Youth Advisory Committee. This bill would legitimize this review panel and make possible reimbursement payments for their expenses.

The review panel is comprised of four members of the C & Y Committee and five citizens with expertise in matters pertaining to children and families. These individuals spend many hours reading the large number of grant applications. They then travel to Topeka for a one day meeting to discuss them and to make recommendations. The Children and Youth Advisory Committee makes the final determination of grant awards.

The fiscal note on this bill is negligible. Yet the service these people provide is of great value to the Children and Youth Advisory Committee and the children of Kansas. Thank you.

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TO: Chairperson and Senators of the Kansas Senate Committee on Judiciary

BY: John J. (Joe) Kisner, Jr., Assistant District Attorney, Consumer Fraud and Economic Crime Division, District Attorney's Office of the Eighteenth Judicial District, Sedgwick County, Kansas

RE: Senate Bill No. 132 - An Act concerning the uniform commercial code; relating to consignment sales and rights of creditors; amending K.S.A. 84-2-326 and repealing the existing section.

Senate Bill 132 addresses a problem that currently exists under Kansas law involving the rights of an individual to property that has been taken by that individual to a dealer to be sold on consignment. In 1990, citizens of Kansas lost thousands of dollars worth of property merely due to the fact that they had taken this property to a business to sell on their behalf. Under Kansas Law 84-2-326, once the consumer has taken property and left it on consignment with an establishment that sells that type of product in their ordinary course of business, the product becomes immediately attachable by the creditors of that business.

This scenario usually takes place when the business at which the goods are consigned enters into financial problems and all the products in the store are picked up and sold by a creditor who possesses an inventory security agreement pursuant to Article 9 of the Uniform Commercial Code. During 1990, many people lost pianos and organs worth thousands of dollars when Kansas Piano Exchange went bankrupt and the business' creditors picked up and sold all of the consigned pianos and organs. The same problem has occurred with other consumer items such as boats.

Senate Bill 132 would amend our Uniform Commercial Code to provide for an exception in a situation where the individual "delivers goods which the person making delivery used or bought for use for personal, family, or household purposes." The bill also provides that "any payment received by the deliveree or consignee from a buyer of these goods, less any amount which the deliverer expressly agreed could be deducted from the payment for commissions, fees or expenses, is the property

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of the deliverer and shall not be subject to the claims of the deliveree's or consignee's creditors."

Senate Bill 132 would simply provide consumers with basic protection from the consignee's creditors. They could then consign their property to be sold, without the risk of losing everything in the event the consignee ran into financial trouble. The Consumer Fraud and Economic Crime Division of the District Attorney's Office requests this committee vote in favor of Senate Bill 132.

from Barkley Clark

Session of 1991

SENATE BILL No. 336

By Committee on Judiciary

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AN ACT enacting the Kansas consumer lease-purchase agreement act.

Be it enacted by the Legislature of the State of Kansas:

Section 1. This act shall be known and may be cited as the Kansas consumer lease-purchase agreement act.

Sec. 2. As used in this act:

(1) "Advertisement" means a commercial message in any medium that aids, promotes or assists, directly or indirectly, a lease-purchase agreement;

(2) "cash price" means the price at which the lessor would have sold the property to the consumer for cash on the date of the lease-purchase agreement;

(3) "consumer" means a natural person who rents personal property under a lease-purchase agreement to be used primarily for personal, family or household purposes;

(4) "consummation" means the time a consumer becomes contractually obligated on a lease-purchase agreement;

(5) "lessor" means a person who regularly provides the use of property through lease-purchase agreements and to whom lease payments are initially payable on the face of the lease-purchase agreement; and

(6) "lease-purchase agreement" means an agreement for the use of personal property by a natural person primarily for personal, family or household purposes, for an initial period of four months or less that is automatically renewable with each payment after the initial period, but does not obligate or require the consumer to continue leasing or using the property beyond the initial period, and that permits the consumer to become the owner of the property.

Sec. 3. (a) Lease-purchase agreements which comply with this act are not governed by the laws relating to:

(1) ~~A home solicitation sale~~ door-to-door sales as defined in K.S.A. ~~16a-3-403~~ 50-640 and amendments thereto;

(2) a consumer credit transaction as ~~discussed~~ defined in K.S.A. ~~50-624~~ 16a-1-301 and amendments thereto; ~~or a~~

(3) a security interest as defined in K.S.A. 84-1-201 and amendments thereto; or

(4) an instrument as defined in K.S.A. 16-207.

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(b) This act does not apply to the following:

(1) Lease-purchase agreements primarily for business, commercial or agricultural purposes, or those made with governmental agencies or instrumentalities or with organizations;

(2) a lease of a safe deposit box;

(3) a lease or bailment of personal property which is incidental to the lease of real property, and which provides that the consumer has no option to purchase the leased property; or

(4) a lease of an automobile.

Sec. 4. (a) The lessor shall disclose to the consumer the information required by this act. In a transaction involving more than one lessor, only one lessor need make the disclosures, but all lessors shall be bound by such disclosures.

(b) The disclosures shall be made at or before consummation of the lease-purchase agreement.

(c) The disclosures shall be made clearly and conspicuously in writing and a copy of the lease-purchase agreement provided to the consumer. The disclosures required under subsection (a) of section 5 shall be made on the face of the contract above the line for the consumer's signature.

(d) If a disclosure becomes inaccurate as the result of any act, occurrence or agreement by the consumer after delivery of the required disclosures, the resulting inaccuracy is not a violation of this act.

Sec. 5. (a) For each lease-purchase agreement, the lessor shall disclose in the agreement the following items, as applicable:

(1) the total number, total amount and timing of all payments necessary to acquire ownership of the property;

(2) a statement that the consumer will not own the property until the consumer has made the total payment necessary to acquire ownership;

(3) a statement that the consumer is responsible for the fair market value of the property if, and as of the time, it is lost, stolen, damaged or destroyed;

(4) a brief description of the leased property, sufficient to identify the property to the consumer and the lessor, including an identification number, if applicable, and a statement indicating whether the property is new or used, but a statement that indicates new property is used is not a violation of this act;

(5) a brief description of any damages to the leased property;

(6) a statement of the cash price of the property. Where the agreement involves a lease of five or more items as a set, in one agreement, a statement of the aggregate cash price of all items shall

satisfy this requirement;

(7) the total of initial payments paid or required at or before consummation of the agreement or delivery of the property, whichever is later;

(8) a statement that the total of payments does not include other charges, such as late payment, default, pickup and reinstatement fees, which fees shall be separately disclosed in the contract;

(9) a statement clearly summarizing the terms of the consumer's option to purchase, including a statement that the consumer has the right to exercise an early purchase option and the price, formula or method for determining the price at which the property may be so purchased;

(10) a statement identifying the party responsible for maintaining or servicing the property while it is being leased, together with a description of that responsibility, and a statement that/if any part of a manufacturer's express warranty covers the leased property at the time the consumer acquires ownership of the property, it shall be transferred to the consumer, if allowed by the terms of the warranty;

(11) the date of the transaction and the identities of the lessor and consumer;

(12) a statement that the consumer may terminate the agreement without penalty by voluntarily surrendering or returning the property in good repair upon expiration of any lease term along with any past due rental payments; and

(13) notice of the right to reinstate an agreement as herein provided.

(b) With respect to matters specifically governed by the federal consumer credit protection act, compliance with such act satisfies the requirements of this section.

Sec. 6. A lease-purchase agreement may not contain:

(1) A confession of judgment;

(2) a negotiable instrument;

(3) a security interest or any other claim of a property interest in any goods except those goods delivered by the lessor pursuant to the lease-purchase agreement;

(4) a wage assignment;

(5) a waiver by the consumer of claims or defenses; or

(6) a provision authorizing the lessor or a person acting on the lessor's behalf to enter upon the consumer's premises or to commit any breach of the peace in the repossession of goods.

Sec. 7. (a) A consumer who fails to make a timely rental payment may reinstate the agreement, without losing any rights or options which exist under the agreement, by the payment of:

(1) All past due rental charges;

(2) if the property has been picked up, the reasonable costs of pickup and redelivery; and

(3) any applicable late fee within five days of the renewal date if the consumer pays monthly, or within two days of the renewal date if the consumer pays more frequently than monthly.

(b) In the case of a consumer who has paid less than 2/3 of the total of payments necessary to acquire ownership and where the consumer has returned or voluntarily surrendered the property, other than through judicial process, during the applicable reinstatement period set forth in subsection (a) of this section, the consumer may reinstate the agreement during a period of not less than 21 days after the date of the return of the property.

(c) In the case of a consumer who has paid 2/3 or more of the total of payments necessary to acquire ownership, and where the consumer has returned or voluntarily surrendered the property, other than through judicial process, during the applicable period set forth in subsection (a) of this section, the consumer may reinstate the agreement during a period of not less than 45 days after the date of the return of the property.

(d) Nothing in this section shall prevent a lessor from attempting to repossess property during the reinstatement period, but such a repossession shall not affect the consumer's right to reinstate. Upon reinstatement, the lessor shall provide the consumer with the same property or substitute property of comparable quality and condition.

Sec. 8. A lessor shall provide the consumer a written receipt for each payment made by cash or money order.

Sec. 9. (a) A renegotiation shall occur when an existing lease-purchase agreement is satisfied and replaced by a new agreement undertaken by the same lessor and consumer. A renegotiation shall be considered a new agreement requiring new disclosures. However, events such as the following shall not be treated as renegotiations:

(1) The addition or return of property in a multiple-item agreement or the substitution of the lease property, if in either case the average payment allocable to a payment period is not changed by more than 25%;

(2) a deferral or extension of one or more periodic payments, or portions of a periodic payment;

(3) a reduction in charges in the lease or agreement; and

(4) a lease or agreement involved in a court proceeding.

(b) No disclosures are required for any extension of a lease-purchase agreement.

Sec. 10. (a) If an advertisement for a lease-purchase agreement refers to or states the dollar amount of any payment and the right to acquire ownership for any one specific item, the advertisement shall also clearly and conspicuously state the following items, as applicable:

(1) That the transaction advertised is a lease-purchase agreement;

(2) the total of payments necessary to acquire ownership; and

(3) that the consumer acquires no ownership rights if the total amount necessary to acquire ownership is not paid.

(b) Any owner or personnel of any medium in which an advertisement appears or through which it is disseminated shall not be liable under this section.

(c) The provisions of subsection (a) of this section shall not apply to an advertisement which does not refer to or state the amount of any payment, or which is published in the yellow pages of a telephone directory or in any similar directory of business.

Sec. 11. Any violation of this act shall constitute a prohibited practice under the provisions of the Kansas consumer protection act and shall be subject to any and all of the enforcement provisions of the Kansas consumer protection act.

Sec. 12. This act shall take effect and be in force from and after its publication in the statute book.

SUMMARY OF THE KANSAS LEASE-PURCHASE AGREEMENT ACT

Senate Bill 336, titled the Kansas Consumer Lease-Purchase Agreement Act, is designed to regulate the lease-purchase, or "rent-to-own", industry in this state. This consumer transaction is presently not regulated under either Federal or Kansas consumer protection laws, and therefore S.B. 336 would fill an important void in the current law.

* * *

1. The Rent-to-Own Transaction: By way of background, the rent-to-own industry rents durable household consumer goods, such as electronic items (televisions, stereos, VCRs), appliances (washers/dryers, microwave ovens, refrigerators), and furniture (bedroom, living room, dining room furniture), on a week-to-week or month-to-month basis. No down payment or other up front charge is required, and the customer may renew the agreement for an additional week or month at the end of each rental period. Upon the completion of an agreed-to number of weekly or monthly rental periods, the customer will own the property being rented.

   The critical point of distinction between this transaction and the typical consumer credit sale or installment sale is that the rent-to-own customer is never obligated to continue renting or to purchase the property. The credit customer makes a commitment at the beginning of the transaction to pay for the property. By way of contrast, the rent-to-own customer is able to stop the transaction at any time without further obligation. Equally importantly, the customer may start the agreement again at a later point in time and not lose any ground under the original agreement.

   The rent-to-own customer also enjoys a full service package in addition to use and enjoyment of the property. If the property cannot be repaired in the home, loaner property is provided to use until the original unit is repaired. Finally, because the agreement is a rental transaction, no favorable credit history is required.

2. Senate Bill 336: Senate Bill 336 represents comprehensive consumer protection legislation governing the rent-to-own industry in Kansas. The bill is modeled after the Virginia rent-to-own law, which is included in the 1991 Council of State Governments Suggested State Legislation Handbook. The bill is nearly identical to legislation in place in 24 states, including Missouri, Colorado, Oklahoma, Nebraska, Texas, Illinois, Ohio and New York. This legislation has proven to be very effective in these other states in regulating the rent-to-own industry.

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Specifically, S.B. 336 would:

- define the rent-to-own transaction
- require extensive contract disclosures to fully inform the potential customer of all aspects of the transaction
- provide protection for late-paying customers in the form of extended reinstatement and other rights
- require full disclosure of key financial terms in advertising
- prohibit practices deemed to be detrimental to the customers' interests
- provide customers with full remedies in the event of violations of this Act.

The bill enjoys the support of the industry, and has been fully reviewed and found acceptable by the Attorney General's office.

Christopher A. Korst
Legislative Coordinator
RAC
Rent-A-Center, Inc.
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Rhone: (816) 636-7368
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A Few Facts About
The Uniform Commercial Code, Article 2A – Leases

Purpose: To provide states with a legal framework for any transaction, regardless of form, that creates a lease.

Origin: Completed by the Uniform Law Commissioners in 1987 and amended in 1990.

Endorsed by:
American Bar Association
American Law Institute

State Adoptions of 1987 Act:

California
Florida
Kentucky
Minnesota
Nevada
Oklahoma
Oregon
South Dakota
Utah

Adoptions with 1990 Amendments:

1991 Introductions:

Colorado
District of Columbia
Hawaii
Indiana
Maryland
Missouri
Minnesota
Montana
Nevada
New Mexico
North Dakota
Oklahoma
Virginia
Washington
Wyoming

Need a Speaker? These persons are available to provide testimony or give presentations on the Article 2A Amendments:

Marion Benfield, Jr.
Champaign, Illinois
Drafting Committee

Fred H. Miller
Norman, Oklahoma
Drafting Committee

For information on arranging a speaker, please contact John McCabe or Katie Robinson at 312-915-0195.

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WHY STATES SHOULD ADOPT ARTICLE 2A OF THE UNIFORM COMMERCIAL CODE – LEASES

The leasing of large scale items ranging from oil-drilling platforms to automobiles is big business in this country, with an estimated dollar volume reaching $150 billion. Yet the laws governing leasing have not kept pace with the intricacies of today's leasing arrangements, resulting in considerable uncertainty for lessors and lessees alike.

To fill this gap, the Uniform Law Commissioners approved a new amendment to the Uniform Commercial Code: Article 2A – Leases. UCC–2A provides for the fundamentals of the leasing contract, including the formation of the contract, provisions for express and implied warranties, and damages for breach of a leasing contract.

Historically, we have thought of financed purchase transactions as conditional sales. As sales, such transactions fall under the UCC, particularly Articles 2 and 9. But a leasing transaction, even though very similar to a conditional sale in many ways, is not clearly subject to the UCC. The rights and remedies of the lessor and lessee, therefore, are not well defined, and courts have characterized these transactions differently from jurisdiction to jurisdiction. Many troubling issues have been extensively and confusingly litigated.

UCC–2A gives leasing transactions an appropriate underpinning in the law. Because of the broad similarities between lease and sales transactions, that underpinning is largely derived from the sales article of the UCC – Article 2. Hence the new article is 2A, indicating its relationship to Article 2. Article 2 has been adopted in every state except Louisiana.

There are a number of reasons all states should adopt UCC – Article 2A, Leases:

LEASES SHOULD BE A PART OF THE UCC

Since leases are an important part of business and commercial law, they should be governed by the Uniform Commercial Code. Further, the leasing business is interstate in character. Uniformity is as important to the conduct of leasing transactions as it is to sales transactions.

LEASES AS SECURED TRANSACTIONS

Perhaps the most important question answered in UCC–2A is when leases are subject to UCC–Article 9 on "Secured Transactions." Certain lease contracts establish what effectively are conditional sales, in which the lessor is no different from a creditor subject to Article 9.

The prior law has never effectively dealt with the issue, and concrete standards are established in UCC–2A and an accompanying amendment to UCC-1-

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201(37), which is a basic definition section in the UCC. Under these provisions, a secured transaction occurs when the lessor has no meaningful residual rights in goods when the lease expires. In a true lease, the rights to the goods revert to the lessor when the lease term ends. But if the contract terms indicate that the rights to this residue are valueless, then it can be inferred that the lease really amounted to a conditional sale of the goods. Article 9 then should and would apply.

FINANCE LEASES

UCC–2A creates a separate category of leases called "finance leases" to eliminate existing confusion over the rights of parties in such leases. Finance leases are characterized by the unique position of the lessor – as purchaser of goods only for the purpose of delivering them to a lessee pursuant to a lease contract.

Because the lessor is not the real supplier of the goods, and acts merely to finance the goods in the hands of the lessee, certain of lessee's rights are best served by imposing obligations on the real supplier and by limiting some rights against the lessor. UCC–2A does not give a lessee implied warranties against a lessor in a finance lease, but passes the lessor's warranties against the real supplier under Article 2 on the lessee.

UCC–2A also further limits a lessee's already limited rights to reject goods, once accepted under the contract, or to cancel, terminate, modify, excuse or substitute performance under the lease contract. The lessee relies upon warranty rights against the supplier, and the lessor is treated as the financing entity it really is.

REMEDIES

Prior law does not provide clear remedies for leasing transactions. Because the parties to lease contracts share substantial characteristics with the parties to sales contracts, the full panoply of UCC – Article 2 remedies can easily be translated and applied to lease contracts.

UCC–2A not only provides clear measures of damages upon breach of contract, but also provides: clear standards for anticipatory repudiation by a party to a contract when anticipated performance by another party becomes insecure; for rejection of goods that do not conform to the contract; for excused non–performance of the contract; and for specific performance under appropriate circumstances.

UCC–2A remedies carry over the original Article 2 policies of encouraging cure of default without litigation and of mitigation of damages whenever and wherever possible.

WARRANTIES

UCC–2A establishes and standardizes warranties for true leases. It follows closely Article 2 of the UCC, but it does not protect title, since title remains with the lessor. Rather than title, UCC–2A warrants against infringement with lease rights.

There are two kinds of implied warranties: merchantability and fitness for a particular purpose. Both are directly derived from Article 2 of the UCC. The warranty of merchantability assures the resalability of goods between merchants. The fitness warranty presumes a purpose and reliance upon the lessor to supply goods fit for the purpose. These warranties can be excluded or modified by agreement.

UCC–2A implied warranties do not apply to finance leases. In that case the implied warranties under Article 2 of the supplier to the lessor are passed on to the lessee.

CONSUMER LEASES

UCC–2A defines a consumer lease as a lease in which the lessee takes the lease primarily for a personal, family or household purpose, when the total payments do not exceed $25,000. UCC–2A does provide some protection for lessees in a consumer lease. Among other things, there is a burden on the lessor to justify acceleration of rentals in a consumer lease. But most consumer protection is left to other laws.

FIXTURE AND ACCESSION PROBLEM

UCC–2A settles recurring problems of what to do with leased goods that become fixtures and accessions and who has priority in each case.

Fixtures are defined as "goods so related to particular real estate that an interest in them arises under real estate law." Generally, if goods are leased and become fixtures, the lessor with prior interest in them has priority over those with the real estate interests – if the lessor perfects his or her prior interest with a fixture filing under UCC – Article 9.

An accession occurs when leased goods are "installed in or affixed to other goods." Any existing rights in a lease contract are superior to any rights in the whole in which leased goods become accession after the lease contract is entered.

CONCLUSION

The changes in leasing transactions in recent years make it clear that modernization is long overdue. States now depend on the common law to resolve disputes over lease contracts. This creates great uncertainty, particularly for companies that conduct business in more than one state, since case law conflicts from state to state. Additionally, some important issues have never been adequately addressed in the common law, and UCC – 2A answers these immediate needs.

UNIFORM COMMERCIAL CODE, ARTICLE 2A – LEASES

– A Summary –

The Uniform Commercial Code (UCC) Article 2A – Leases, governs true leases of goods. In a true lease, the lessor gives possession and right to use the goods to the lessee for a fixed period of time in return for rent. The title to the property and a meaningful residual interest remain with the lessor.

A "finance lease" is a true lease in which the lessor is not the fundamental supplier of the goods leased, but leases goods to lessees as a means of financing their acquisition. UCC – 2A governs "finance leases" as well as other true leases, but "finance leases" are treated differently from other true leases in certain respects. The principal differences in treatment will be discussed in subsequent paragraphs of this summary.

UCC – 2A is largely derived from the sales article of the UCC – Article 2. It provides basic contract rules, including matters of offer and acceptance, statutes of frauds, warranties, assignment of interests, and remedies upon breach of contract. There are five parts to the UCC – 2A: (1) General Provisions, (2) Formation and Construction of a Lease Contract, (3) Effect of a Lease Contract, (4) Performance of a Lease Contract, and (5) Default.

General Provisions

The General Provisions include the large, general definitions section and general rules pertaining to the construction of leasing contracts, including conflict of law provisions, choice of forum rules, and interpretation of remedies. Most of these provisions are drawn from Article 2 of the UCC.

UCC – 2A creates an entity called the "-lessee in the ordinary course of business." The definition parallels the "buyer in the ordinary course of business" in the UCC. Both take property free of prior encumbrances, under the appropriate conditions, and are essential to commercial enterprise.

UCC – 2A also defines "supplier" as "a person from whom a lessor buys or leases goods to be leased under a finance lease." This definition is important because goods in a "finance lease" must come from another source than a lessor.

Formation and Construction of a Lease Contract

In a sale transaction, the UCC provides warranties of title and against infringement by any claims of another person. There are similar warranties in UCC – 2A, although title is not protected, since title remains in the lessor. But the lessor does warrant the lessee's enjoyment of the leasehold interest against "a claim to or interest in the goods that arose from an act or omission of the lessor. " This warranty applies to all lease contracts. Infringement, however, is not warranted against in finance leases, and this warranty only binds a merchant-lessor, who deals regularly in goods of the kind.

Implied warranties are of two kinds, merchantability and fitness for a particular pur-

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pose. Both kinds of implied warranty are directly derived from the Article 2 of the UCC. The warranty of merchantability operates between merchants, and assures the resalability of goods. The fitness warranty presumes a purpose and reliance upon the lessor to supply goods fit for the purpose. Both kinds of implied warranties can be excluded or modified by agreement.

Implied warranties of quality (and against infringement) by lessors do not similarly apply to finance leases. UCC – 2A instead passes any implied warranties of the supplier-seller to the lessor-buyer under Article 2, to the lessee under a finance lease. The finance lessor does not directly make such warranties.

Effect of a Lease Contract

Generally, a lessee's rights under a lease contract or the residual rights of a lessor are freely transferable, unless the contract prohibits the transfer or unless transfer risks the other party's contract rights. An assignment, so-called, of lease rights is treated as any transfer is, and is presumed to transfer both rights and obligation, unless otherwise specified in the agreement.

If a subsequent lease is entered when there is an existing lease, the subsequent lease is subject to the prior lease. However, a subsequent "lessee in the ordinary course of business," who deals with a lessor who is a merchant dealing in goods of the kind leased and to whom the goods are entrusted under the prior lease, will take goods free of the prior, existing lease contract.

Another third party issue dealt with in Part 3 of UCC – 2A is lien priorities. Here, UCC – 2A becomes analogous to provisions in UCC, Article 9. A statutory materialmen's lien has priority over any interest in a lease contract, unless other law sets a different priority. Otherwise, lessee's creditors take subject to the lease contract. Lessor's creditors with prior interests to those arising under a lease contract, generally, take priority over interests arising under the contract.

However, a "lessee in the ordinary course of business" takes free of any prior perfected security interests, unless the lessee has specific knowledge of their existence. A prior interest of a lessee takes priority over a subsequent interest of a lessor's creditor. But there are special instances in which a creditor of a lessor has priority over a lessee's interest, even though the lease interest is prior in time. Included are instances in which depriving the creditor of possession of the collateral would be fraudulent to the creditor "under any statute or rule of law."

Goods that become fixtures present priority problems when leased. Fixtures are defined as goods "so related to particular real estate that an interest in them arises under real estate law." Who has priority between the lessor and those holding the real estate interests?

Generally, if goods are leased and become fixtures, the lessor with prior interest in them has priority over those with the real estate interests - if the lessor perfects his or her prior interest with a fixture filing under Article 9 of the UCC. A fixture filing is made by placing an appropriate financing statement in the real estate records. There are instances in which a lessor can retain an interest against the real estate holder without filing, but a fixture filing will generally be essential.

"Accessions" also present a special problem. An "accession" occurs when leased goods "are installed in or affixed to other goods." Any existing rights in a lease contract are superior to any rights in the whole in which leased goods become accession after the lease contract is entered. If the lease contract arises at the time goods become accessions or after, earlier interests in the whole have priority, If someone purchases the whole after a lease contract, rights under the lease contract take priority over the purchaser's rights. However, a "buyer in the ordinary course of business," or a prior creditor who makes advances without knowledge of the lease contract, takes priority over a lessor or lessee, even though the lease contract precedes the purchase or advance in time.

Performance of a Lease Contract

Part 4 of UCC – 2A deals with performance and repudiation of a contract, with substituted performance and with excused performance. If performance is to be impaired, however, UCC – 2A gives contracting parties the latitude to minimize losses.

For example, a party to a lease contract who has reasonable grounds for insecurity as to the performance of the other party, may demand written assurance of performance. Until written assurance is provided, the demanding party may suspend his or her performance. If assurance is not given in a reasonable time, the contract may be treated as repudiated.

When performance is impaired without the fault of either party, because of such events as failure of an agreed means of transport, a commercially reasonable substitute must be accepted. There are instances in which performance may be excused: "If performance as agreed has been made impracticable by the occurrence of a contingency the non-occurrence of which was basic assumption on which the lease contract was made." The lessor must notify the lessee (and the supplier if there is a finance lease) of delay or non–delivery. These are examples of the options open to contracting parties.

Default

Upon default, UCC – 2A provides remedies in Part 5, including damages and equitable remedies, such as specific performance. UCC – 2A permits cover. That is, a party may seek goods from another source to limit losses. Mitigation of damages is encouraged. The general measure of any damage is actual loss.

Lease Transactions as Secured Transactions

The last issue of importance addressed in UCC – 2A is an added appendix, consisting of a crucial amendment to Section 1-201(37) of the UCC, which defines the term security interest. If a lease involves a "security interest," it is subject to Article 9 of the UCC. A lease involves a security interest, dependent upon four alternative factors or characteristics.

If the term of the lease is equal or greater than the remaining economic life of the goods; if there is a renewal option for no additional consideration or nominal consideration; if there is mandatory renewal or the lessee becomes owner at the end of the lease term; or if the lessee has the option to purchase at the end of the lease term for no additional consideration, or any combination of these factors, the lease would tend to be treated as creating a security interest and would be subject to Article 9.

Conclusion

UCC – 2A is comprehensive, dealing with every phase of leasing transactions. It draws a great share of its concepts from Article 2 of the UCC, but it is adapted to the peculiarities of the leasing form. It is an important advance in commercial law.

UNIFORM COMMERCIAL CODE ARTICLE 2A AMENDMENTS (1990)

– A Summary –

Article 2A of the Uniform Commercial Code (UCC), when it was promulgated in 1987, marked the first addition to the UCC since its original promulgation in 1951. The subject of this new addition is Leasing, confined to the leasing of personal property. Most of the UCC is comprised of earlier uniform acts that were promulgated by the Uniform Law Commissioners between 1896 and 1947. Each article had a substantial legal and legislative history before it was brought into the UCC.

UCC 2A did not have the advantage of so much history. Leasing as a means of financing the acquisition of capital goods is a phenomenon of roughly the 20 years just preceding the promulgation of UCC 2A. Therefore, the Uniform Law Commissioners (ULC) and the American Law Institute, its partner in the UCC, were moving into new territory, entirely, in the promulgation of this new article. To form an appropriate bridge between the familiar and the new, the drafters of UCC 2A modeled the new article on the tried and familiar principles of UCC Article 2, the Sales article. But inevitably, an effort to move into a new subject is an effort with some risks.

UCC 2A had its initial consideration in the California and Oklahoma legislatures. In California, it was subjected to an extensive study by the California Bar, and the scrutiny of others with interests in the area of leasing law. The result was a series of amendments to the act. Because of the large interest in this new piece of legislation, nationally, the California amendments were circulated throughout the country. There were more bar association studies, a symposium in the Alabama Law Review, and finally, a review by the New York Law Revision Commission. Two things emerged from all this intense scrutiny: *(1)* The initial decision to follow the principles of UCC Article 2 was fundamentally the correct decision and the basic structure of UCC Article 2A is sound; and *(2)* Some issues needed to be readdressed by amendment.

The ULC was gratified by the first conclusion that universally arose from that scrutiny. It was not particularly surprised at the second. This is entirely new legislation. That further scrutiny might find some issues to address is a logical expectation. So the ULC has proceeded to address these very few issues with amendments in 1990.

Most of the amendments proposed in 1990 are meant to clarify specific provisions of the act or to readjust them in fairly minor ways. There are three significant issues that are addressed. The three issues addressed involve the definition of a finance lease, the power to restrict assignments in a lease contract, and the character of remedies in the event a lease contract is breached.

A finance lease is a lease in which the les-

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sor does not supply the goods that are leased. The lessor acts as a financier for the acquisition of those goods. Under the original UCC 2A, a lease was not a finance lease unless the lessee received a copy of the contract between the lessor and the supplier of the goods evidencing the acquisition of the goods, or unless the lease contract conditioned its effectiveness upon the lessee's approval of the purchase contract between the lessor and the supplier of the goods. In many leasing situations, which involve finance leasing, the lessor cannot comply with these requirements, thereby losing the attributes of a finance lease.

It is possible to satisfy the lessee's interest in the contract of supply between lessor and supplier of the goods without the strict requirement of the original definition of finance lease.

In the amendments a lease qualifies as a finance lease if the lessor provides a statement of the terms of the supply contract or notifies the lessee where the information may be obtained from the supplier, as well as by providing the supply contract, itself.

Original UCC 2A followed UCC Article 2 with respect to freedom of contract, including the freedom to contract for restrictions on either party's ability to assign rights or obligations. Freedom of contract is a primary underlying policy of both acts. However, there are some differences between sales and leases that make the pure form notion of freedom of contract an uneasy fit for leases. Finance lessors commonly assign a security interest in the right to receive rents under a lease contract to a lending institution. This security interest is a UCC Article 9 interest. In this aspect of leasing, the transaction more clearly resembles a secured transaction under UCC 9. As a matter of policy in protecting the rights of secured parties, UCC 9 limits the power of parties to certain kinds of contracts in so far as assignment of rights as security interests is concerned.

It was decided, therefore, to amend UCC Article 2A, following UCC Article 9 precedent, to limit the freedom of contract in lease contracts, but only for that narrow purpose of protecting the interests of secured parties. Thus a restriction on assignment rights cannot affect a holder of a security interest in the right to receive rents under a lease contract. Otherwise, freedom of contract is carefully preserved.

The third significant issue addressed in the UCC 2A 1990 amendments appears in the aggregate of amendments to several sections in Part 5. This Part deals with remedies when a lease contract is breached. In the scrutiny to which UCC 2A was subjected, it was pointed out that there is no way in original UCC 2A to distinguish between material breaches of contract that allow the contract to be rescinded, fully, and breaches that are not so material as to call for absolute recision, but may still call for the payment of damages. The amendments eliminate this deficiency.

These are the significant aspects of the 1990 amendments to UCC 2A. They are provided in the spirit of enhanced uniformity, and will make the entire UCC 2A a better act.

Old Wine in New Bottles: UCC Article 2A-Leases

Edwin E. Huddleson, III, Esq.

Introduction

Over the past decade, commentators and practicing lawyers have debated the desirability of a uniform state law on equipment leasing. The "statutory codification" movement was a natural reaction to the explosive growth of equipment leasing after World War II. Beginning in 1980, the American Bar Association undertook serious studies to define the scope and substance of a uniform state law on the leasing of goods.

The Commissioners on Uniform State Laws, acting in 1985 after three years of restudy by a drafting committee of law professors and attorneys, approved a proposed state law on equipment leasing: the Uniform Personal Property Leasing Act (UPPLA). UPPLA was then rewritten stylistically to make it a part of the Uniform Commercial Code (UCC). Today a new UCC Article 2A-Leases has been approved by the commissioners and is awaiting approval by the American Law Institute in May 1987. Thereafter, the new statute will be formally presented for enactment to the state legislatures.

Edwin E. Huddleson, III, is a partner in the law firm of Volpe, Boskey and Lyons, which represented AAEL throughout the drafting committee sessions that created new UCC Article 2A-Leases.

Overview of the Statute

UCC Article 2A-Leases is a uniform state law on equipment leasing, with standardized provisions on warranties and remedies that are variable by agreement between the lessor and lessee. The statute expands the scope of the UCC to cover leases of goods. But it is not a comprehensive code. It leaves several areas of state law to be developed by other law, particularly consumer protection statutes and so-called "products liability" case law. To avoid conflict with state certificate of title statutes (which cover automobiles, trailers, boats and other often-leased goods), the new statute defers to those other statutes. Within its own sphere, however, it addresses several issues that are important for equipment leasing.

The statute is divided into six parts: (1) General provisions. These include definitions ("consumer lease," statutory "finance lease,") as well as provisions governing choice of law in consumer leases, unconscionability, and options to accelerate at will. (2) Formation and construction of lease contract. Warranties, both express and implied, are dealt with here. Other Provisions in Part 2 address statute of frauds, when the lessee obtains an insurable interest, risk of loss and the special status of "finance leases" in the law of warranties. (3) Effect of lease contract. Third party rights are covered here, as are priority disputes between lien creditors or secured parties and lessees, and competing claims in fixtures. (4) Performance of lease contract: repudiated, substituted and excused. One provision here (§2A-404) imposes an automatic "hell or high water" obligation on lessees to pay rent under a statutory "finance lease" that is not a consumer lease. Other sections in Part 4 cover topics such as adequate assurance of performance, anticipatory repudiation, and substituted and excused performance. (5) Default. Outlined in Part 5 are general provisions concerning default (statute of limitations, procedure in event of default), as well as the statutory (not contracted for) remedies of both the lessee and the lessor on the other party's default. (6) "Exhibit A to Article 2A-Leases" contains an amendment to old UCC §1-201(37), clarifying the definition of a true lease.

Within reasonable limits, the new statute preserves the freedom of contract of the lessor and the lessee to write specific lease agreements that vary or differ from UCC Article 2A-Leases.[1] The statute's standardized provisions on warranties and remedies, not affecting the rights of third parties, are variable by agreement between the lessor and the lessee. This is a powerful rebuttal to critics: Lessors and lessees who don't like the standardized provisions in the new statute can write their lease agreement to provide otherwise.

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JCC Article 2A-Leases: Its Central Provisions

The core issues covered by UCC Article 2A-Leases include the definition of a true lease, remedies and measure of damages after default, warranties, the special status of "finance leases," "consumer lease" issues, the rejection of mandatory UCC filing (or public notice) requirements for true leases, and fixtures. These provisions, which are the subject of this article, will largely determine the success or failure of the new statute. Threats of stormy opposition to UCC Article 2A-Leases already have arisen, particularly from some vehicle lessors who are engaged in "open-end" "finance leasing" to consumers.[2] Overall, however, the new statute succeeds remarkably well in capturing the best of earlier commercial law decisions on equipment leasing. To a great extent, UCC Article 2A-Leases simply mirrors the common law on bailments for hire—that classic benchmark of reasonableness and gut equity in the law of equipment leasing.

True Leases of Goods Distinguished from Conditional Sales

One threshold issue confronting the drafters of new UCC Article 2A-Leases was how to define a true lease of goods, as opposed to a conditional sale or disguised security interest. True leases have long been distinguished from sales for many purposes in commercial law, including determining remedies on default, a lessor's rights under §365 of the Bankruptcy Code,[3] and whether a transaction is covered by state usury laws.[4] Moreover, a secured sale, unlike a lease, is subject to UCC Article 9, which sets rules of priority and generally requires the filing of a financing statement for secured interests. True leases henceforth will generally be governed by the provisions of new UCC Article 2A-Leases, while secured sales will be covered by UCC Article 9.

The commissioners on Uniform State Laws, after considering a variety of suggestions, decided to clarify the definition of a true lease with an amendment to old UCC §1-201(37) suggested by AAEL. The thrust of the AAEL proposal was to preserve common law principles and reaffirm the importance of the residual as a source of potential gain or loss in the business of equipment leasing.

The old common law principles, elaborated in the new amendment to UCC §1-201(37), provide significantly more guidance than current law as to what is the essence of a true lease. True leases are still defined by reference to and comparison with "security interests." The structure of the amended statutory definition is to first state the general rule:

> "Whether a transaction creates a lease or security interest is determined by the facts of each case."

Then, several specific factors are identified that will *destroy* true lease status and create a "security interest." Finally, other factors are listed that are consistent with true lease status.

Where the lessee cannot terminate the obligation to pay rents for the lease term, there are two basic factors, either of which will destroy true lease status: (1) where the term of the lease extends for the full economic life of the goods; or (2) where the lessee has an option to become the owner for "nominal" additional consideration. Where either factor exists, the transaction is not a true lease, because the lessor will receive no meaningful residual. The comment emphasizes that "these tests focus on economics, not the intent of the parties."[5]

Other factors are specified, in the final part of amended §1-201(37), which are consistent with true lease status. These include:

- a "full payout" lease (where the present value of the lessee's payments are substantially equal to the fair market value of the goods at the outset of the lease);
- typical "net lease" provisions where the lessee assumes the risk of loss, or agrees to pay taxes, insurance, filing, recording, or registration fees, or service or maintenance costs;
- the mere existence of an option to renew the lease or buy the goods; and
- options to renew or buy at a fixed price equal to or greater than reasonably predictable fair market value (as predicted at the outset of the lease).

Moreover, the amendec [illegible] tory definition deletes all reference to "the parties' intent." The comment explains that most of the criteria that courts have relied upon to show intent—including "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"—are "as relevant to true leases as to security interests." Objective criteria, not a search for subjective intention, is the order of the day.

These are significant clarifications of the law. Yet no attempt was made to answer all questions, since the variety of transactions that parties to a "lease" can produce is almost unlimited. The overall general standard is that whether a transaction is a lease, or a "security interest," will be determined on the basis of all the facts and circumstances.

Options to Renew or Buy

One linchpin in the definition of a true lease is the subject of options. Originally, the drafting committee considered tying the definition of an option in a true lease to artificial percentages and formulas for determining what constitutes "nominal consideration" for options to renew or buy. But AAEL objected to this approach. The commissioners then adopted the functional approach suggested by AAEL, tracking the earlier common law.

Where the option price in a lease is "*stated to be the fair market value of the goods,*" the statute creates a safe harbor validating such options as consistent with true lease status. On the other hand, another part of the new statute repeats old UCC §1-201(37) by stating that, where the lessee cannot terminate the lease (simply walk away from it), a transaction creates a "security interest" (and not a true lease) if:

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

Transactions are *not* true leases where the parties anticipate, when they enter into a transaction, that the option will e irresistible in the sense that the option price is extremely low in comparison to the value of the property.[6] As noted above, another part of the amended true lease definition validates certain *fixed-price options* as clearly consistent with "true lease" status by stating:

> "A transaction does not create a security interest merely because it provides that..."
>
> "(e) 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."

This safe harbor for true leases with fixed-priced purchase options should be helpful to equipment lessors, particularly in bankruptcy and usury cases.

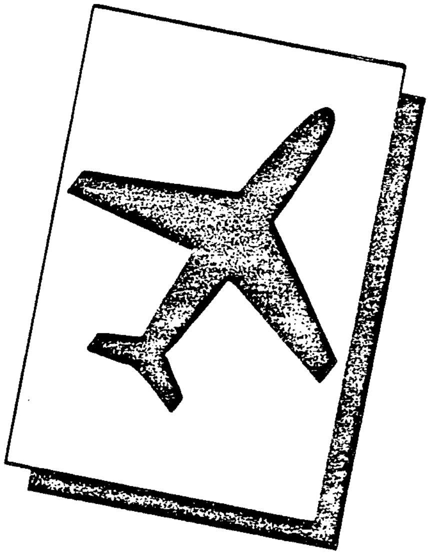
One criticism leveled at the new, amended UCC §1-201(37) is that it fails to validate, as clearly consistent with true lease status, agreements with fixed-price options whenever the fixed-price option

> "approximates reasonably predictable fair marked value."

But this criticism is unsound. The only purpose of substituting "approximates" for "equal to or greater than" would be to attempt to validate, as clearly consistent with true lease status, agreements with fixed-price options at *less* than predictable fair market value. This is unwarranted. When the lessor and the lessee agree at the outset to give the lessee a discount on the option price (so that the option is less than reasonably predictable fair market value), they have written a "bargain" option agreement that "tilts the scales" to encourage exercise of the option. That sort of agreement may not be a true lease.

Moreover, it makes no sense to use a vague word like "approximates" in what is supposed to be a bright-line safe harbor test for valid fixed-price options in a true lease. No business justification exists: The safe harbor validating fixed-price options "equal to or greater than reasonably predictable fair market value" covers a wide range of predicted option values.[7] This should give businessmen all the flexibility they need.

TRAC Leases



"Open-end" leases, with terminal rental adjustment clauses (TRAC), have been widely used in the motor vehicle leasing industry for over 30 years. TRAC motor vehicle leases are specifically recognized as true leases by the federal tax laws. But the case law is divided on whether TRAC leases are true leases under state law. The commissioners decided that amended UCC §1-201(37) would be silent on whether TRAC leases are true leases.

"Open-end" leases also raise the issue of whether TRAC provisions (or some variations of them) are validated by the liberal provisions of new §2A-504 on "liquidation of damages" (see part III b *infra*). Viewed as liquidated damage formulas, some narrowly-drawn TRAC provisions may be reasonable: One common lease provision, according to the comment in new §2A-504, leaves the lessor with potential profits from a residual sale, while essentially making the lessee a guarantor of the estimated residual value set out in the lease. This "one-sided" TRAC provision leaves the lessor with a meaningful interest in the residual. Other kinds of narrowly-drafted TRAC-like provisions, which charge the lessee for excessive use or poor maintenance (as opposed to changes in value due to market trends), also seem consistent with true lease status.

Outspoken critics of new UCC Article 2A-Leases include some motor vehicle lessors who fault the new statute for failing to specifically validate "open-end" TRAC leases as true leases. But the statute mirrors the common law. To this date, the weight of the case law has not recognized broadly-phrased "open-end" TRAC leases as true leases under state law. Moreover, some equipment lessors in the past have opposed according true lease status to "open-end" TRAC leases outside the specific context of motor vehicle leasing. The commissioners acted reasonably in simply preserving the status quo with respect to "open-end" leases.

Remedies

One major impetus for the new statute was dissatisfaction among equipment lessors, and their lawyers, with inconsistent and unpredictable

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court decisions on the *remedies* available under a true lease. UCC Article 2A clarifies the law on lease remedies: Ordinarily, the lessor's remedies available for breach of a true lease will be those specified in the lease agreement. Yet UCC Article 2A provides a minimum safety net set of remedies (including a measure of damages for the lessee's breach), which will apply if the lease agreement is silent (or held invalid) on remedies issues.

Repossession and Disposition

Whether a default has occurred, as well as issues about repossession and other post-default rights and remedies under a true lease, are to be decided in the first instance by reference to the lease agreement. (UCC §2A-501, §2A-503). Both judicial and self-help remedies are available (§2A-501). Within wide limits, the statute allows the parties in a true lease to craft their own set of rights and remedies in the lease agreement.[8]

UCC §2A-525 specifically confirms the lessor's right to repossess the goods on the lessee's default. Advance notice of default or enforcement need not be given to the defaulting party (§2A-502). Ordinarily, the lessor is expected to mitigate damages by re-leasing or selling the repossessed goods. But where it proves impractical for the lessor to dispose of the goods at a reasonable price after repossession, he may hold the goods and recover accelerated rentals as damages (§2A-529(1)(b)).

Two types of provisions exist, in UCC Article 2A, on the lessor's damage remedies for the lessee's default: those that apply to contractual liquidated damage clauses; and those provisions that apply where the lease contract is silent (or invalid) on damages.

Contractually specified damages. UCC §2A-504(1) validates liquidated damages clauses that comply with this basic "reasonableness" test:

> "Damages payable by either party for default, or any other act or omission, including indemnity for loss or diminution of anticipated tax benefits or loss or damage to lessor's residual interest, may be liquidated in the lease agreement but only at an amount or by a formula that is reasonable in light of the then anticipated harm caused by the default or other act or omission."

This validates formulas as well as amounts, and drops some of the limitations on liquidated damage clauses that appeared in the old law of sales.

The comments provide little specific guidance on how the "reasonableness" standard in new UCC §2A-504 should be applied. The courts are left to wrestle with several recurring questions, as best they can, under the general standard of "reasonableness."

Residual risks on lessees. One question concerns the validity of default remedies that essentially push the whole residual risk onto the lessee. This issue may arise particularly for sweeping liquidated damages clauses in short-term consumer leases: especially where the lease runs for only a short time in relation to the expected useful life of the goods, it may not be "reasonable" (§2A-504) to stick the lessee with the risk that the market value of the lessor's residual may drop.

Cumulative remedies. There are some old cases holding that "cumulative remedy" provisions, in and of themselves, may render a liquidated damages clause invalid. But such provisions should pass muster under the new leasing statute so long as the total cumulative remedy sought is simply one satisfaction (not a double recovery) and is "reasonable in light of the then anticipated harm caused by the default or other act or omission" (§2A-504).

Accelerated rentals. Ordinarily, a liquidated damages clause with provision for accelerated rentals is enforceable by the lessor, if coupled with a contractual provision requiring the lessor to mitigate damages by sale or re-lease after repossession.[9] Without strong proof of reasonableness, however, a liquidated damage clause providing for acceleration of future rentals (without mitigation) is likely to be struck down. Moreover, at least in contested cases, the courts are likely to continue past precedent by holding, under the "reasonableness" test in new §2A-504, that the lessor's recovery for future lost rentals must be discounted to present value.[10] UCC §2A-109 specifies that the lessor can invoke an acceleration clause only when he "in good faith believes that the prospect of payment or performance is impaired."[11]

Election of remedies. Where a liquidated damages clause is otherwise valid, the "reasonableness" test in UCC §2A-504 should overrule earlier cases that required a lessor under a true lease to elect between repossessing the equipment, on the one hand, or suing for the accelerated rent and leaving the equipment in place, on the other. These old cases improperly extended the rule against double recovery. But the lessor's repossession and simultaneous recovery of accelerated rents does *not* necessarily result in double recovery or unjust enrichment. No double recovery results, for example, where a defaulting lessee is credited with proceeds from the sale or re-lease of equipment after repossession.[12]

Partial invalidity. Will the invalidity of *part* of a liquidated damage clause invalidate the whole clause, throwing the lessor back onto the statutory (non-contract) remedies in UCC Article 2A? Section 2A-504(2) states:

> "If the lease agreement provides for liquidation of damages, and such provision does not comply with [the "reasonableness" test in] subsection (1), or such provision is an exclusive or limited remedy that circumstances cause to fail of its essential purpose, remedy may be had as provided in this Article."

Equipment lease liquidated damages clauses often set out alternative damage measures, so that no single alternative is "an exclusive or limited remedy" (§2A-504(2)). For such multipart liquidated damages clauses, partial invalidity may not always be fatal to the whole clause, if the invalid part is written to be reasonably segregable from the rest. This result would be consistent with the new statutory section on "unconscionability" (§2A-108): It states where a court finds a clause unconscionable, it has discretion under §2A-108 to refuse to enforce the whole contract or it may simply "blue pencil" out the offending clause and enforce the remainder of the lease contract.

(b) *Where the lease agreement is silent (or held invalid) on damages remedies*

The only time UCC Article 2A will control measure of damages

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medies is when the lease agreement is silent (or held invalid) on damages remedies. Two basic statutory (not contracted for) measure of damages standards are spelled out for the lessor. These apply in different situations: (1) where the lessor repossesses and then sells or re-leases the goods (§2A-527(2), §2A-528)); and (2) where the lessor repossesses and holds the goods for the lessee for the remainder of the lease term (§2A-529).

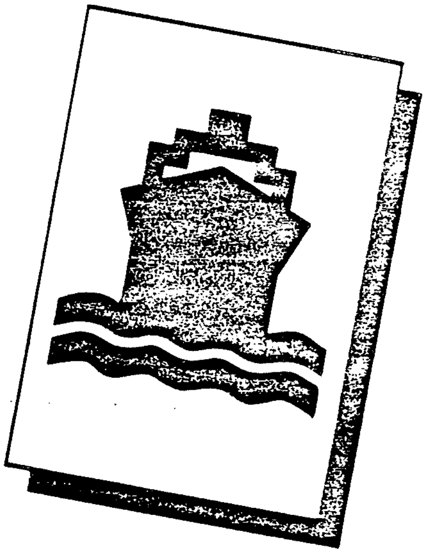
1. Where the lessor repossesses and then sells or re-leases the goods, after the lessee's default, the lessor's satutory (non-contract) damages consist of the sum of (1) past unpaid rentals, plus (2) reasonable lost future rentals (measured by the present value of the difference between total scheduled future rentals and the "market rent" for future use of the goods)[13], plus (3) incidental damages less "expenses saved in consequence of the lessee's default." UCC §2A-507, 52A-528. The concept of "market rent," defined in new 52A-507, is essentially fair market rent as determined "at the time of the default."

One objection to the "rent-to-rent" comparison in this standard is that it makes it difficult to prove damages where the lessor repossesses and then sells the goods. The statutory "rent-to-rent" comparison has been employed in California statutes to measure damages under a lease of goods.[14] Yet the "rent-to-rent" comparison clearly takes a different approach to damages than "finance lease" liquidated damage clauses that define the lessor's measure of damages as the sum of (1) past unpaid rentals, plus (2) the present value of accelerated future rentals, plus (3) the lessor's estimated residual value, minus (4) the net proceeds from a commercially reasonable sale of the goods on the lessor's default, up to the point where such proceeds equal the sum of (2) plus (3). This sort of contract clause puts the risk on the *lessee* (not the lessor) that the value of the goods will drop after one enters into the lease.

True lessors own the residual and, on the lessee's default, the lessor's remedies should include recovery of the residual or its value. UCC Article 2A's statutory (noncontract) damages scheme clearly allows this recovery. And new §2A-527(5) makes it clear that the "lessor is not accountable to the lessee for any profit made on any disposition." But the new statute puts the burden on the lessor to recover the value of the residual through sale or re-lease. And it puts the risk on the *lessor* (not the lessee) that the value of the residual might drop after entering into the lease.

The commissioners decided that this is exactly where the risk belongs for statutory (noncontract) measure of damages. Where goods are leased for only a short time in relation to their useful life, it seems unfair (as not in accord with the common expectancies of the parties, in the absence of any agreement on the point) to stick the *lessee* with the risk that the value of the goods will drop after the lease is transacted. The only situations where it might be fair to saddle the lessee with that risk—*by statutory fiat in the absence of any contractual agreement on the point*—are those involving "long-term" true leases.[15] This category might be difficult to define in a statute. Moreover, the statutory (noncontract) measure of damages in UCC Article 2A applies only where the contract is silent or is struck down (as unconscionable or otherwise unenforceable) on measure of damages. The commissioners decided that there was no warrant to *guarantee* "long-term" true lessors a "home run" measure of damages in the statute, when all lessors could readily protect themselves by writing appropriate liquidated damages clauses in their lease agreements.

UCC §2A-528(2) provides an important alternative measure of damages—lost profits "including reasonable overhead" plus incidental damages—for lessors who repossess and then sell or re-lease the goods, but who (under the statutory rent-to-rent measure of damages) would not wind up "in as good a position as performance would have" put them. Though this measure of damages is phrased as an alternative, it may frequently be available to the merchant lessor.



2. Where the lessor repossesses, and it proves impractical to dispose of the goods at a reasonable price, he has the option of holding the goods for the

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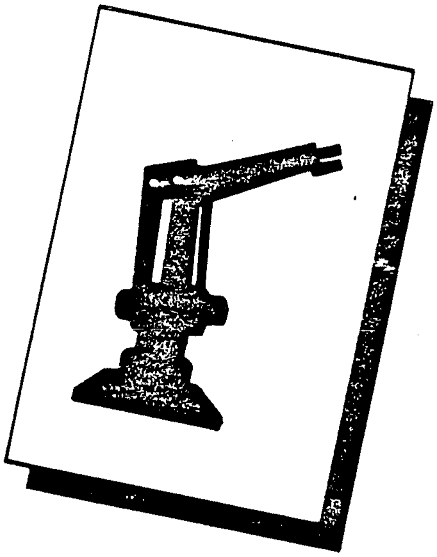
lessee for the remainder of the lease term, and recovering damages equal to the sum of (1) past rents due, plus (2) the present value of accelerated future rentals, plus (3) incidental damages "less expenses saved in consequence of the lessee's default." UCC §2A-529(1)(b).[16] This statutory (noncontract) measure of damages may be particularly important for "merchant lessors" who have more equipment in inventory than customers.



Over several years, commentators have debated whether such "merchant lessors" should be under a duty to mitigate damages by selling or re-leasing the goods after the lessee's default and repossession by the lessor. UCC §2A-529(1)(b) accords the merchant lessor (or any other lessor) the full present value of accelerated rentals, without offset, where it is impractical for the lessor to dispose of repossessed goods at a reasonable price. Yet the statute tracks earlier law by requiring the lessor to mitigate damages, where practical, before recovery will be allowed for accelerated rentals.

The same statutory (noncontract) recovery for accelerated rentals (without offset) is also generally available to statutory "finance lessors," without special efforts at mitigation of damages, for goods accepted by the lessee. §2A-529(1)(a). This seems appropriate. Typically the finance lessee selects the goods, which often are uniquely suited for the finance lessee's business (and no other).

Warranties

The old common law, as well as UCC §2-314 and 2-315, recognized two implied warranties—merchantability and fitness for a particular purpose—for transactions involving goods. These implied warranties impose strict liability, without regard to negligence or fault. The weight of authority is that these implied warranties apply to merchant lessors, under true leases as well as sales. Well-drafted lease agreements, as a consequence, have long been based on the assumption that these warranties would apply at least to merchant lessors (who dealt in goods), if not to "finance lessors" (who advanced money but had no special knowledge of the goods).

One salutary effect of new UCC Article 2A is to clarify and standardize the law of warranties for true leases. There are special statutory provisions dealing with warranties in the case of statutory "finance leases"—where the lessor does not select, manufacture or supply the goods out of inventory (see part III D *infra*). Otherwise, the new statute tracks the old sales article concerning the creation of express warranties (§2A-210), implied warranties of fitness, title and merchantability (§2A-211 through §2A-213), and accumulation of warranties (§2A-215).

The old sales article's requirements for conspicuous disclaimers of warranties are also repeated in the new leasing statute (§2A-214). Waiver of defense clauses—whereby the lessee agrees not to assert certain types of claims or defenses against the lessor's assignee—are approved by the new leasing statute to the same extent as allowed by old UCC Article 9.

With respect to breach of warranty issues, there are again special provisions for statutory "finance leases" (discussed in part III D *infra*). Otherwise, UCC Article 2A essentially tracks the old sales article. This is true, for example, for the lessee's remedies and damages (§2A-508, 2A-518, 2A-519, 2A-520), and the lessee's rights to reject the leased goods (§2A-509 and 2A-517).

UCC Article 2A's provisions do not spell out the relationship between Article 2A and the case law on strict liability in tort.[17] This reflects the commissioners' recognition that products liability is a rapidly developing field, as well as the view that Article 2A is basically a statement of "contract" (rather than "tort") principles. The whole area of products liability of merchant lessors will be left for the courts to develop.

Treatment of Finance Leases

Traditionally, a finance lessor has been thought of as a passive lessor, whose transactions remain functionally the equivalent of an extension of credit. It is typically the lessee (not the lessor) who selects the goods in a "finance lease," without relying upon the lessor. Moreover, a finance lessor often has neither the opportunity nor

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the expertise to inspect the goods to discover any defects in them. Recognizing these special circumstances, the cases and authorities consistently held that finance lessors did not owe implied warranties of fitness and merchantability with respect to the leased goods.

The impact of new UCC Article 2A on "finance leases" is limited. Where a lessor qualifies under UCC Article 2A as a *statutory* finance lessor, the new statute basically provides him with automatic exemptions by statute from implied warranties of fitness and merchantability. But a lessor always can write a lease contract to exclude warranties, making himself a finance lessor *by contract*. Where a lessor writes the lease contract to exclude such warranties, and in addition qualifies as a new UCC Article 2A *statutory* finance lessor, he will have two independent grounds (or double protection) for exempting himself from such warranties. These new statutory provisions, of course, only apply to "finance leases" that are true leases.

Definition of Statutory "Finance Lease."

To create a *statutory* "finance lease," the lessor essentially must have no function in picking the goods for the lessee's use. The statutory definition in new UCC §2A-103(1)(g) is:

> "Finance lease" means a lease in which (i) the lessor does not select, manufacture or supply the goods, (ii) the lessor acquires the goods or the right to possession and use of the goods in connection with the lease, and (iii) either the lessee receives a copy of the contract evidencing the lessor's purchase of the goods on or before signing the lease contract, or the lessee's approval of the contract evidencing the lessor's purchase of the goods is a condition to effectiveness of the lease contract."

There is no limitation that a statutory finance lessor can supply only money, or that he must not perform maintenance.[18] To ensure the lessee's reliance on the supplier, nor the lessor, the lessor must acquire the goods "in connection with the lease." The scope of this phrase, "in connection with," is to be determined by the courts on a case-by-case basis.

One controversial part of UCC Article 2A is the third requirement in the definition of a statutory "finance lease:" the lessee must receive a copy of (or approve) the lessor's purchase contract with the manufacturer or supplier. No earlier authorities contained this requirement. But its purpose is to ensure that the lessee receives specific notice of the supplier's warranties covering the goods. This seems only fair before cutting off the lessee's warranty rights against the lessor and subjecting the lessee to automatic statutory "hell or high water" clause liability under a statutory "finance lease" (§2A-407). The commissioners decided that—particularly in light of a lessor's ability to make himself a "finance lessor" *by contract*—the new statute should be conservative in giving lessors an automatic exemption *by statute* from warranties.

The comments to §2A-103(1)(g) state that the leasebacks in many sales-and-leaseback transactions will qualify as statutory finance leases. Moreover, lessors who are merchants may qualify as statutory finance lessors. The comment to §2A-103(1)(g) also says that "where the lessor is an affiliate of the supplier no special rule applies; whether the transaction qualifies as a finance lease will be determined by the facts of each case." Excluded from *statutory* finance lessor status are manufacturers and individuals who are regular dealers in the leased asset. Also excluded is the lessor who obtains the asset out of inventory, since he did not acquire the asset for a particular lease transaction. Yet an independent automobile dealer/lessor, who obtains a car for a particular lessee, for example, may be able to qualify as a *statutory* finance lessor under new UCC §2A-103(g).

Statutory "Finance Leases:" Special Provisions.

UCC Article 2A makes it clear that a statutory finance lessor does not assume any implied warranties with respect to the lease. He is held only to express warranties (§2A-210) and the warranty of title (§2A-211(1)). Moreover, under a statutory finance lease that is not a consumer lease, the lessee's promises (especially to pay rent) are made irrevocable and independent (§2A-407, §2A-508(6)).

Only *commercial* finance leases (not consumer leases) qualify for the statutory imposition of automatic "hell or high water" obligations on the lessee under new UCC §2A-407. The comments to §2A-407 leave open the possibility that the parties to a "consumer lease" might *agree* to a hell-or-high-water clause in the lease agreement. But the comments also make it clear that other "consumer protection" statutes and evolving case law on consumer rights put severe restraints on the enforceability of such clauses in consumer leases.

The statutory finance lessee is the automatic beneficiary of all warranties under the supply contract (§2A-209(1)). But such a lessee generally cannot revoke acceptance of the goods (§2A-516, §2A-517(1)). To have any rights against the lessor, the finance lessee would have to reject goods immediately. Other special rules dealing with statutory "finance leases" include the provision (§2A-219) that risk of loss passes to the lessee (not the lessor).

These special provisions in the new statute, for statutory "finance leases," mirror the provisions commonly found in most finance lease contracts.

Two separate and independent kinds of "finance leases" will exist in the wake of UCC Article 2A: contractual "finance leases" and statutory "finance leases." One effect of this new regime is to short-circuit the courts' development of a common law definition of "finance lease" in the law of warranties. Where the written lease agreement does not cover warranties, a transaction must fall within the narrow Article 2A definition of a statutory "finance lease" to exempt the lessor from warranty liability. But this seems of minimal practical significance: The nearly universal practice of finance lessors is to "contract out" of warranties in their lease agreements.

Overall, the "finance lease" provisions in new Article 2A will provide certainty, and some additional protections, for lessors able to qualify as statutory finance lessors. Other lessors can protect themselves as finance lessors by contract.

"Consumer Lease" Issues

UCC Article 2A-Leases in general does not deal with consumer protec-

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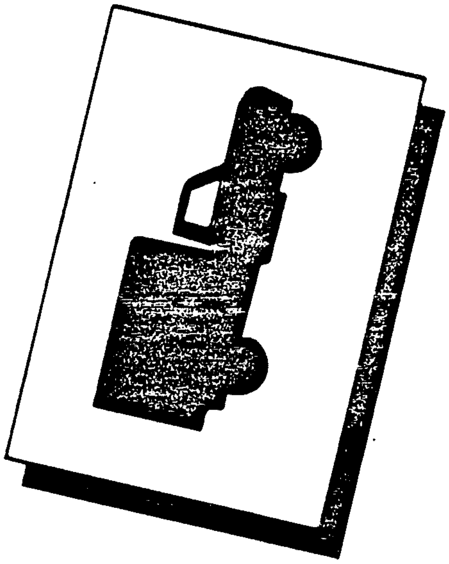

tion. This is left to other laws. But the new statute does contain some protections for lessees in "consumer leases," which are defined in new UCC §2A-103(1)(e):

> "Consumer lease" means a lease that a lessor regularly engaged in the business of leasing or selling makes to a lessee, except an organization, who takes under the lease primarily for a personal, family, or household purpose, if the total payments to be made under the lease contract, excluding payments for options to renew or buy, do not exceed $25,000.

Whereas the federal Consumer Leasing Act of 1976 defines "consumer lease" in terms of leases "for a period of time exceeding four months" (15 U.S.C. §1667)1)), new UCC Article 2A covers even shorter-term "consumer leases." A lease primarily for an agricultural purpose falls outside the "consumer lease" protections of UCC Article 2A.

The major "consumer lease" provisions in the new statute include new UCC §2A-106 (limiting abusive choice-of-law and choice-of-forum clauses in consumer leases); new UCC §2A-108 (2), (4) (where court finds consumer lease contract or claim collection activity under consumer lease to be "unconscionable," it may grant appropriate relief including attorneys' fees); new UCC §2A-109 (burden on lessor to justify acceleration of rentals in a consumer lease). The commissioners and the drafting committee rejected proposals for including other, more sweeping "consumer protection" provisions.

UCC Filings (or Notice) Not Required for Leased Personal Property

Yet another major issue was whether to establish a mandatory system requiring the filing of UCC financing statements for personal property covered by a true lease. UCC Article 2A was made subject to state certificate of title statutes, with the result that goods covered by those statutes generally must comply only with the filing (or notice) requirements in those statutes. The more general question remained whether there should be a general filing (c ıce) requirement for leased goods, with a list of exceptions covering short-term leases and other "special cases" where filing was impractical.

Traditionally, equipment lessors have *not* been required to file UCC financing statements, or to give other public notice of their interests in the goods under a true lease.[19] The drafting committee heard conflicting views on whether current law on filing and notice should be changed. But the majority of businessmen and practicing lawyers in the field of equipment leasing seemed to favor the status quo. Technical faults in filing (misdescription of goods or failing to file in all the right places, for example) should not be controlling on a lessor's rights to multimillion dollar equipment, AAEL argued. To be sure, mandatory UCC filings might cut down on litigation concerning the "true lease" status of questioned transactions. But such litigation would not disappear: Even where a true lease was covered by mandatory UCC filings, the true lease/security interest determination would still have to be made by the courts in a variety of contexts (*e.g.*, bankruptcy law, remedies, usury law). Moreover, additional filings of UCC financing statements might overwhelm an already over-burdened UCC filing system. When the issue of mandatory UCC filings for leased goods was discussed within the American Bar Association, the majority of lawyers polled was opposed to the concept.

Taking these factors into account, the commissioners concluded that existing law on UCC filings (or notice) was working reasonably well. There was no compelling reason to overthrow it. UCC Article 2A therefore generally rejects the concept of mandatory UCC filings (or other required notice) for personal property covered by a true lease. The only exception concerns "fixture filings" (discussed below).

"Vendor in possession" doctrine for sales-and-leasebacks abolished. The new statute also *abolishes* the so-called "vendor in possession doctrine" which has long created state law difficulties for sales-and-leasebacks of equipment. This will be welcome news to lessors. The old "vendor in possession" doctrine (making retention of possession by the vendor fraudulent *per se* or *prima facie* fraudulent) is an ancient anachronism

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that has been recognized in one form or another in many states.[20] New UCC §2A-308(3) abolishes it for transactions in which the buyer "bought for value and in good faith."[21] The statute also expressly provides in §2A-302 that separation of ownership and possession *per se* does not affect the enforceability of a lease contract. The old, unlamented "vendor in possession" doctrine for leases is no more.

Optional UCC filings permitted. Optional filing of UCC financing statements is still permitted under new Article 2A, as under current law, for any true (or doubtful) lease. Incentives remain for lessors to file UCC financing statements: Though new amended UCC §1-201(37) clarifies the definition of a true lease, it does not eliminate all ambiguities. UCC filings for leases provide protection to the person filing if it is later determined that the "lease" was a secured sale. Moreover, the filing of a UCC financing statement may not be considered as a factor in determining whether or not the transaction is a true lease or a secured sale (see UCC §9-408 (1972)).

Fixtures: Modest Reform

Over the years the subject of "fixtures" has triggered many battles between real estate interests and equipment lessors. New UCC Article 2A attempts to resolve some of the recurring problems in this area by imposing new UCC filing requirements for leased fixtures.

Two basic sets of priority rules are set forth in the new statute to determine the priority of competing interests in fixtures: one for unfiled lessors, the other for lessors who have made a "fixture filing." Traditional common law protections for unfiled lessors of fixtures are generally preserved in §2A-309(5).[22] Unfiled lessors obtain the benefit of a very modest reform expanding the category of "readily removable" goods.[23] The statute gives more rights, however, to the fixture lessor who makes a "fixture filing" in the office where a mortgage on the real estate would be recorded. Without such a "fixture filing," the lessor may lose out to real estate interests, since under new UCC §2A-309(7) the priority of the lessor's interest will be determined by real estate priority rules.

This imposes, in effect, a new "fixture filing" requirement for lessors of fixtures. But double filings in both personal property and real estate records have long been industry practice. The statute's new requirement for a "fixture filing" in real estate records implements the views of thoughtful commentators.[24] And new §2A-309(8) makes it clear that, where a lessor of fixtures has priority over conflicting real estate interests, the lessor (or the lessee) may *remove* the goods on the lessee's default (as well as in other circumstances), as long as he pays the cost of repair of any physical injury."[25]

The commissioners may well revisit the subject of "fixtures" again in the future. Though the search continues for the most reasonable balance between competing real estate interests and lessors of fixtures, new UCC Article 2A provides some helpful clarification in this overly-technical area of the law.

Conclusion

The impact of new UCC Article 2A-Leases will underline the importance of careful drafting for leases of motor vehicles and equipment. The statute clarifies the differences between a true lease and a "security interest." Moreover, it provides some helpful clarification and uniformity in the law of warranties and lessors' remedies.

Threatened stormy opposition to the new UCC Article 2A seems overstated and unwarranted. Bernard J. McKenna, chairman of AAEL, went to the heart of the matter: "The new statute rejects a simplistic approach which might have blurred the distinction between a true lease and a financing. The short of the matter is that if you can't write a good solid lease agreement, you're in trouble. That's always been true and it always will be true, with or without the new UCC provisions on leasing."

Footnotes:

[1] Other statutes and case law (particularly in the area of "consumer protection") may limit the unbridled "contractual freedom" of the parties, of course. Yet the main limitations on "contractual freedom" in UCC Article 2A-Leases itself is the injunction against unconscionable lease clauses (2A-108). Other well established limits on "contractual freedom"—such as the requirement that contractual waivers of implied warranties be "conspicuous"—are picked up in the new statute (§2A-214). There are also scattered provisions according protections to lessees in "consumer leases," such as §2A 106 (limiting abusive choice-of-law and choice-of-forum clauses in consumer leases) and §2A-109 (placing burden on the lessor to justify acceleration of rentals in a consumer lease). Moreover, the new statute incorporates the general UCC rules that the obligations of good faith, diligence, reasonableness and care are not disclaimable by agreement.

[2] "THREAT OF NEW UNIFORM PERSONAL PROPERTY LEASING ACT" trumpeted the front-page headline of CAR RENTAL/LEASING INSIDER, Weekly Newsletter (June 9, 1986). "Open-end" vehicle lessors have criticized the new statute's failure to validate "open-end" leases of vehicles as true leases, as well as the provisions in UCC Article 2A-Leases covering "finance leases" and warranties and remedies in leases to consumers. *See* CAR RENTAL/LEASING INSIDER, Weekly Newsletter (June 16, 1986); AUTOMOTIVE FLEET MAGAZINE p. 130 (August 1986). These issues are discussed in parts III A, C, D and E *infra*.

[3] True lessors under §365 of the Bankruptcy Code generally have a better chance than secured lenders of obtaining current payments, as well as repossessing the goods, when the lessee/debtor is in bankruptcy. Under §365 of the Bankruptcy Code, the lessee (or bankruptcy trustee) must assume a true lease or reject it in its entirety, and if assumed, must give "adequate assurances" that prior defaults will be cured and that performance (payment of rentals) will take place in the future. The secured creditor, on the other hand, is covered by §361-§363 (not §365) of the Bankruptcy Code: The buyer-debtor in bankruptcy has the right to continue to use any of the collateral property, with or without the consent of the seller-lender, so long as the secured lender is given "adequate protection" that the *value* of the property will be preserved. Cf. *In re American Mariner Industries*, 734 F.2d 426 (9th Cir. 1984.)

[4] True leases (as opposed to disguised loans or "forebearances" of money) may be exempt from state usury laws.

[5] Throughout this article, references to the comments denote the Official Comments to new UCC Article 2A-Leases in ALI Council Draft No. 1 (December 1, 1986), now being revised.

One theme that runs through the cases and authorities is that the owner/lessor in a true lease must have, at the outset, some legitimate possibility for return or other disposition of the leased property before the end of the economic life of the property. *See, e.g., In re Marhoefer Packing Co.*, 674 F.2d 1139, 1143, 1145 (7th Cir. 1982). With respect to options to renew or buy, under state law, the essence of a true lease may be that the *original agreement* should leave the lessor with a significant economic stake in the residual and should not "tilt the scales" to require or encourage the lessee to exercise the option for the remaining economic life of the property. Cf. *id.* at 1144-1145; Mooney, *True Lease or Lease "Intended as Security"*, in Coogan, Hogan, Vagts & McDonnell, *Secured Transactions Under the* UCC (Matthew Bender 1986).

[7] This is because the economic uncertainties of life (such as changes in the rate of inflation, and technological obsolescence) are such that a wide range of values should qualify as "reasonably predictable" option prices in any given transaction.

[8] One important issue for counsel drafting a lease agreement is raised by new §2A-508(5), which authorizes the lessee to sell the goods, if the lease agreement says nothing to the contrary, where the lessee rightfully rejects the goods, or justifiably revokes acceptance.

[9] DeKoven, *Proceedings After Default By the Lessee Under a True Lease of Equipment* in 1C Coogan, Hogan, Vagts & McDonnell, *Secured Transactions Under the UCC*, §29B.06[5](b) (Matthew Bender 1986).

[10] *See, e.g., Heller Financial* v. *Burry*, 633 F.Supp. 706 (N.D.Ill. 1986) [court reduces accelerated future rentals to present value]; *In re Winston Mills, Inc.*, 6 B.R. 587 (Bkrpt S.D.N.Y. 1980) [same].

[11] With respect to a consumer lease, the burden of establishing good faith is on the party invoking the acceleration clause; otherwise the burden of establishing lack of good faith is on the lessee. UCC §2A-109(2).

[12] DeKoven, *Leases of Equipment: Puritan Leasing Co. v. August, A Dangerous Decision*, 12 U.San Fran.L.Rev.257,277-278 (1978).

[13] Where the goods are re-leased "by lease contract substantially similar to the original lease contract and the lease contract is made in good faith and in a commercially reasonable manner," then the lessor's *lost future rentals* (apart from other damages) are measured by the present value of the the difference between the "total rent for the remaining lease term of the original lease" and the "total rent for the lease term of the new lease contract." UCC §2A-527(2).

[14] California Civil Code §3308 permits liquidated damage clauses in a lease providing that, after the lessee defaults and the lease has been terminated, the lessor may recover the present value of accelerated future rentals minus the "reasonable rental value" of the goods for the remainder of the lease term. Where this measure of damages is selected, it is exclusive.

[15] Of course, if the original term of the lease runs for essentially the entire remaining economic life of the goods, and the lessee is obligated throughout the term so that he cannot simply "walk away" from the lease, then the transaction is not a true lease at all but a security interest covered by UCC Article 9.

[16] This statutory measure of damages applies "for goods identified to the lease contract if the lessor is unable after reasonable effort to dispose of them at a reasonable price or the circumstances reasonably indicate that effort will be unavailing." UCC 2A-529 (1) (b). This statutory remedy is optional. At any time before the collection of the judgment for this statutory remedy (accelerated rents), the lessor may choose to dispose of the goods by sale or re-lease, in which case his remedies are limited by the "rent-to-rent" test discussed above. 2A-529 (3). If the lessee pays the judgment for accelerated rents, then the lessee is entitled to "use and possession of the goods not then disposed of for the remaining lease term of the lease agreement." 2A-529 (4).

[17] One commentator on products liability has explained that the true lease/sale distinction "has no bearing on product liability. Instead, the criterion of superior knowledge of a merchant is the prerequisite to nonconsenual product liability. A merchant-lessor, as one who deals in goods and thus has superior knowledge, should be a target defendant. In contrast, a finance-lessor should remain immune from product liability as one who, in the ordinary course of business, makes advances against goods but is not a merchant." Carlin, *Product Liability for the Equipment Lessor? Merchant-Lessor versus Finance-Lessor* printed in ch 8 of *Equipment Leasing-Leveraged Leasing* (2d ed. Fritch & Reisman 1980) p. 848.

[18] Where the lessor does perform maintenance, or other functions other than the supply of money, the comment to §2A-103 (1) (g) states that "express warranties, covenants and the common law will protect the lessee." This leaves open the possibility that a statutory finance lessor who performs maintenance, under a so-called "operating lease," may be held liable for negligently failing to discover defects during maintenance.

[19] *See, e.g., In re Marhoefer Packing Co.*, 674 F.2d 1139 (7th Cir. 1982); *In re Leasing Consultants, Inc.*, 486 F.2d 367 (2d Cir. 1973); *Allen* v. *Cohen*, 310 F. 2d 312 (2d Cir. 1962).

[20] *See* Coogan, *Leasing and the Uniform Commericial Code* in *Equipment Leasing-Leveraged Leasing* pp. 827-846 (2d ed. Fritch & Reisman 1980).

[21] The statute states in pertinent part: §2A-308. SPECIAL RIGHTS OF CREDITORS * * * (3) A creditor of a seller may treat a sale or an indentification of goods to a contract for sale as void if as against the creditor retention of possession by the seller is fraudulent under any statute or rule of law, *but retention of possession of the goods pursuant to a lease contract entered into by the seller as lessee and the buyer as lessor in connection with the sale or identification of the goods is not fraudulent if the buyer bought for value and in good faith.* [Emphasis added]. The Comment to §2A-308 confirms: "Notwithstanding any statute or rule of law that would treat such retention as fraud, whether *per se*, *prima facie*, or otherwise, the retention is not fraudulent if the buyer bought for value and in good faith. This provision overrides Section 2-402 (2) to the extent it would otherwise apply to a sale-leaseback transaction."

[22] Thus, for example, new UCC §2A-309 (5)(d) reflects the earlier UCC Article 9 and common law provisions allowing removal of trade fixtures. *See* UCC §9-313 (5)(b); *Lemmons* v. *United States*, 496 F.2d 864, 869-872 (Ct.Cl. 1974); *see also* 3 Witkin, Summary of California Law, *Personal Property* §§60-66, *Real Property* §469-470.

[23] New UCC §2A-309 (5)(a) gives an *unfiled* lessor of fixtures priority over competing real estate interests if "the fixtures are readily removable factory or office machines, *readily removable equipment that is not primarily used or leased for use in the operation of the real estate*, or readily removable replacements of domestic appliances that are goods subject to a consumer lease, and before the goods become fixtures the lease contract is enforceable" [new provisions in italics]. The Comment to §2A-309 indicates that, aside from leased equipment that is "integral to the operation of real estate *e.g.*, heating and air conditioning equipment" other "readily removable equipment" constituting fixtures can be repossessed by an unfiled lessor. Owners and encumbrancers of real estate, on the other hand, will be able to rely on the continuing availability of fixtures that are essential to the operation of the land and building itself.

[24] *See* Leary, *The Procrustean Bed of Finance Leasing*, 56 N.Y.U.L. Rev. 1061, 1089-1093 (1981); Gilmore, *Security Interests in Personal Property* §30.5 (1965).

[25] The specific language of new §2A-309(8) gives the lessor or the lessee the right to remove the goods from the real estate, on the other party's default (as well as in other circumstances), but requires that he or she "must reimburse any encumbrancer or owner of the real estate who is not the lessee and who has not otherwise agreed for the cost of repair of any physical injury, but not for any diminution in value of the real estate caused by the absence of the goods removed or by any necessity of replacing them. A person entitled to reimbursement may refuse permission to remove until the party seeking removal gives adequate security for the performance of this obligation."

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UNIFORM COMMERCIAL CODE ARTICLE 2A: COMMERCIAL AND CONSUMER LEASES

Overview of History, Status and Purpose of Article 2A

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Prepared for Amercian Bar Association Program on Article 2A, Section of Business Law 1989 Spring Meeting, Houston, Texas.

I. History and Status of Article 2A

A. Current Law, Types of Leases, Codification Reasons

Article 2A of the Uniform Commercial Code, along with conforming amendments to Articles 1 and 9, represents a major development in commercial law, addressing a type of business transaction, the leasing of goods, that has long existed.

1. Under present law, transactions of this type may be governed partly by scattered statutes dealing with bailments, remedies and contracts in general; partly by common law principles relating to personal property and real estate leases; and partly by reference to Articles 2 and 9 of the Uniform Commercial Code, dealing with sales and secured transactions respectively. The legal rules and concepts derived from these sources imperfectly fit a transaction that involves personal property rather than realty, and a lease rather than either a sale or a security interest as such, and often imperfectly cover the matters in such transactions that the parties may not provide for in the lease itself.

2. A statute directly addressing the wide variety of personal property leases has become especially appropriate with the exponen-

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tial expansion of the number and scale of personal property lease transactions. Article 2A will apply to transactions involving billions of dollars annually. It will apply to a consumer's rental of an automobile or do-it-yourself equipment, on the one hand, and to leases of such items as commercial aircraft (to the extent not preempted by federal law) and industrial machinery, on the other. The provisions of Article 2A recognize the differences between consumer and business leasing, while resting upon concepts that apply generally to any lease of goods.

3. There are several specific reasons for codifying the law with respect to leases of goods. An analysis of the case law as it applies to leases of goods suggests at least three significant issues to be resolved by codification.

First, what is a lease? It is necessary to define a lease to determine whether a transaction creates a lease or a security interest disguised as a lease. If the transaction creates a security interest disguised as a lease, the lessor will be required to file a financing statement or take other action to perfect its interest in the goods against third parties. There is no such requirement with respect to leases. Yet the distinction between a lease and a security interest disguised as a lease is not clear under present law.

Second, will the lessor be deemed to have made warranties to the lessee? If the transaction is a sale, the express and implied warranties of Article 2 of the Uniform Commercial Code apply. However, the warranty law with respect to leases is uncertain.

Third, what remedies are available to the lessor upon the lessee's default? If the transaction is a security interest disguised as a lease, the answer is stated in Part 5 of the Article on Secured Transactions (Article 9). There is no clear answer with respect to leases.

There are reasons to codify the law with respect to leases of goods in addition to those suggested by a review of the reported cases. It is also proper to determine the remedies available to the lessee upon the lessor's default. That issue is not reached through a review of the reported cases. And this is only one of the many issues presented in structuring, negotiating and documenting a lease of goods.

B. History and Status

1. Article 2A represents an important undertaking of the National Conference of Commissioners on Uniform State Laws, an organization of practicing attorneys, judges, law professors and experts on statutory drafting founded in 1892, and the American Law Institute, founded in 1923 to advance the clarification and development of the law. Article 2A proceeded, following recommendations by the National Conference's Study Committee in 1981, through consideration and review of numerous drafts prepared by the Conference's Drafting Committee. These drafts were subjected to suggestions by numerous advisors to the Committee and by American Bar Association Committees. The final product was considered and approved by the Permanent Editorial Board, the Executive Committee of the Conference, the Conference, the Council of the Institute and the Annual Meeting of the members of the Institute. Article 2A also has been approved by the American Bar Association.

2. Since its approval in 1987, Article 2A has been enacted in Oklahoma, California, Minnesota, Nevada, Oregon and South Dakota. As of June 1989, it has been introduced in Alaska, Florida, Illinois, Maine, Massachusetts, Mississippi, Montana, New Hampshire, New York, North Dakota, Rhode Island, Tennessee, Utah, Vermont, Washington, and West Virginia, and is under study in other states, including Colorado, New Jersey, Texas and Virginia.

II. Purpose of Article 2A

A. Overview

The purpose of Article 2A is to codify the better law presently governing leases of goods and to clarify or provide law applicable to various aspects of leasing practice where that law presently is absent, ambiguous or inappropriate for modern leasing practice. As in the case of a sale of goods, the parties to a lease of goods may vary the effect of the provisions of Article 2A by their agreement.

Article 2A is divided into five Parts.

Part 1

Part 1 of Article 2A consists of Section 2A-102 defining its scope (true leases of goods); Section 2A-103 on general definitions; Section 2A-104 indicating other law to which Article 2A is subject (such as consumer legislation); and Sections 2A-105 - 2A-109 stating general rules pertaining to leasing transactions, including choice of law provisions and provisions on waiver, unconscionability and acceleration.

Part 2

Part 2 of Article 2A deals with the formation and construction of a lease contract. This part contains a statute of frauds requirement in Section 2A-201; a parol evidence rule in Section 2A-202; Sections 2A-203 - 2A-208 on lease contract formation and modification; and provisions on identification (Section 2A-217), insurance (Section 2A-218) and risk of loss and casualty (Sections 2A-219, 2A-220 and 2A-221).

Key provisions in Part 2 are the warranty provisions. Warranties may be express or implied. An express warranty under Section 2A-210 arises from any affirmation of fact, description of the goods, or sample or model that is a basis for the bargain. Examples would be a manufacturer's warranty that is extended to the lessee, or a statement by a lessor that the goods will fulfill the lessee's needs as described to the lessor.

There are three implied warranties in Article 2A. Title is not protected since title remains in the lessor, but the lessor does warrant the lessee's enjoyment of the leasehold interest against "a claim to or interest in the goods that arose from an act or omission of the lessor." Section 2A-211. This warranty applies to all lease contracts. Infringement is warranted against by a merchant-lessor who deals regularly in goods of the kind.

Implied warranties of quality under Article 2A are of two kinds, merchantability and fitness for a particular purpose. The warranty of merchantability under Section 2A-212 operates where the lessor is a merchant, and assures the operability of the goods. The fitness warranty under Section 2A-213 presumes a particular purpose and reliance by the lessee upon the lessor to supply goods fit for the purpose.

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All implied warranties can be excluded or modified by agreement under Section 2A-214, which follows UCC Section 2-316.

Article 2A has the same three options on the privity issue that UCC Section 2-318 contains. In addition, it has a provision that states Article 2A contains no statement on the relation between the Article and strict tort liability to negate any argument similar to that adopted in *Cline v. Prowler Ind.*, 418 A.2d 968 (Del. 1980).

Part 3

Part 3 of Article 2A for the most part deals with the rights and duties of the lessor and of the lessee in relation to third parties.

A lease contract in Section 2A-301 is stated to be generally effective as between the lessor and the lessee and third parties. Thus a lessee's rights under a lease contract or the rights of a lessor are freely transferable unless the lease contract prohibits the transfer or unless the transfer risks the other party's contract rights. Section 2A-303.

If a subsequent lease of the goods is made by the lessor when there is an existing lease, under Section 2A-304 the subsequent lease is subject to the prior lease. However, a subsequent "lessee in the ordinary course of business" who deals with a lessor who is a merchant dealing in goods of the kind leased and to whom the goods are entrusted under the prior lease, will take the goods free of the prior lease contract.

A buyer or sublessee from a lessee takes the goods subject to the prior lease under Section 2A-305, unless the person buys or leases in the ordinary course of the lessee's business.

Another issue dealt with in Part 3 of Article 2A is the priority between liens and interests under the lease. Under Section 2A-306 a possessory statutory repairman's lien will have priority over an interest under a lease contract if the statute creating the lien does not otherwise provide. Otherwise, as provided in Section 2A-307(1), creditors of the lessee take subject to the lease contract. This generally means that the creditor's lien or security interest can only attach to what the debtor has.

Under Section 2A-307(2) creditors of the lessor with interests prior to those arising under a lease contract generally take priority over the interest arising under the lease contract, but where the lessee leases in the ordinary course of business under Section 2A-307(3) the lessee has priority over a creditor's interest even though the lease interest is subsequent in time. A prior interest of a lessee takes priority over a subsequent interest of a lessor's creditor.

Leased goods that become fixtures also present priority problems. As under UCC Article 9, the definition of a fixture generally is left to other law. But Section 2A-309 in most instances determines who has priority between the lessor and those holding real estate interests. Generally if goods are leased and become fixtures, with an exception in the case of a construction mortgage, the lessor has priority over the real estate interests if the lessor makes a fixture filing in accordance with Article 9 of the UCC. There also are some instances in which a lessor can retain an interest against the real estate holder without filing.

It might be noted that otherwise Article 2A does not require a lessor to file a financing statement to protect its interest or its priority position.

Part 4

Part 4 of Article 2A deals with performance of a lease contract, including substituted and excused performance, in Sections 2A-404 - 2A-406, and with anticipatory repudiation in Sections 2A-401 - 2A-403. Section 2A-407 provides for irrevocable promises in a finance lease that is not a consumer lease and thus provides a statutory "hell or high water" clause.

Part 5

In the event of default under a lease contract, Article 2A provides a remedy structure in Part 5 that will apply unless the parties otherwise agree. "Default" is defined to some extent in Article 2A (see Sections 2A-508 and 2A-523) but further events may and should be defined in the lease and the remedies of Article 2A made applicable to them. Section 2A-501.

The parties also may modify Article 2A remedies (Section 2A-503); liquidate damages (Section 2A-504); or design their own remedies.

The Article 2A remedy structure includes damages and equitable remedies such as specific performance under Section 2A-521, or, in

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the case of the lessor, a limited ability under Section 2A-529 to force the lessee to pay the present value of the unpaid rent for the remaining term. A lessee also, except as limited in the case of an installment lease and a finance lease, has the remedies of rejection and revocation under Sections 2A-509 - 2A-517, and the lessor has rights of identification and stoppage under Sections 2A-524 and 2A-526.

Article 2A permits damages to be measured by cover by a lessee and redisposition by a lessor or, alternatively, a general measure of damages by a market rent formula. See Sections 2A-518 and 2A-519; 2A-527 and 2A-528. The lessor also is entitled to reobtain the goods leased in the case of default by the lessee under Section 2A-525.

B. Specific Provisions Effectuating Purpose

1. Scope

The scope of Article 2A is limited to leases. Leases intended as security, i.e., security interests disguised as leases, are not included as they are adequately treated in Article 9.

Given the litigation to date on what is a lease, a revised definition of security interest was included. See Section 1-201(37), as amended. This revision sharpens the distinction between leases and security interestsdisguised as leases. Amended Section 1-201(37) states a transaction creates a security interest if the rent is an obligation for the term of the lease and:

(a) the term is equal to or greater than the economic life of the goods;

(b) the lessee is bound to renew for the remaining economic life or become owner;

(C) there is an option to renew for the remaining economic life for no or nominal consideration; or

(d) there is an option to purchase for no or nominal consideration. Two hypotheticals indicate the perimeters of the issue.

(1) Assume that A has purchased a number of copying machines, new, for $1,000 each, and the machines have an estimated useful economic life of three years. A advertises that the machines are available to rent for a minimum of one month and that the monthly rental

is $100. A intends to enter into leases where A provides all maintenance, without charge to the lessee. Further, the lessee will rent the machine, month to month, with no obligation to renew. At the end of the lease term the lessee will be obligated to return the machine to A's place of business. This transaction qualifies as a lease. While the lessee is obligated to pay rent for the one month term of the lease, the term of the lease is one month and the economic life of the machine is 36 months; thus, subparagraph (a) of Section 1-201(37) is not now satisfied.

Considering the amount of the monthly rent, absent economic duress or coercion, the lessee is not bound either to renew the lease for the remaining economic life of the goods or to become the owner. If the lessee did lease the machine for 36 months, the lessee would have paid the lessor $3,600 for a machine that could have been purchased for $1,000; thus, subparagraph (b) of Section 1-201(37) is not satisfied.

Finally, there are no options; thus, subparagraphs (c) and (d) of Section 1-201(37) are not satisfied.

(2). Assume that the facts are changed and that A requires each - lessee to lease the goods for 36 months, with no right to terminate. Under Section 1- 201(37), as amended, the lessee's obligation for the term is not subject to termination by the lessee and the term is equal to the economic life of the machine. This transaction is not a true lease and is subject to Article 9 and not Article 2A.

Between these extremes there are many transactions that can be created. Some of these transactions have not been properly categorized by the courts in applying the earlier versions of the UCC. Article 2A and amended Section 1-201(37) draw a brighter line, but, unfortunately, ultimately it was not possible to create a true safe harbor.

2. Certificate of Title Laws.

Many leasing transactions involve goods subject to certificate of title statutes. To avoid conflict with those statutes, Article 2A is subject to them. Section 2A-104(1)(b) and (c) and (2).

3. Consumer Leases.

Many leasing transactions involve parties subject to consumer protection statutes. To avoid conflict with those statutes, Article 2A is subject to them. Section 2A-104(1)(a) and (d) and (2). Further, certain consumer protections have been incorporated in Article 2A itself such as an expanded provision on unconscionability and restrictions on agreements for applicable law. However, extensive consumer protections for lessees should come by separate legislation.

4. Sale and Leaseback

Sale and leaseback transactions are increasingly common for valid business reasons. A number of state statutes treat transactions where possession is retained by the seller as fraudulent per se or prima facie fraudulent. That position is not warranted under business practices today and is changed by Article 2A "if the buyer bought for value and in good faith." Section 2A-308(3).

5. Finance Leases

Certain leasing transactions substitute the seller of the goods for the lessor as the party responsible to the lessee with respect to warranties and the like. The definition of finance lease (Section 2A-103(1)(g)) was developed to describe these transactions. Various sections of Article 2A implement the substitution of the seller for the lessor.

A finance lease is the product of a three party transaction. Assume that B has bought goods from C pursuant to a sales contract. After delivery to and acceptance of the goods by B, B negotiates to sell the goods to A and simultaneously to lease the goods back from A, on terms and conditions that will qualify the transaction as a lease. This may be done for tax or other valid reasons. In documenting the sale and leaseback, B assigns the original sales contract between B, as buyer, and C, as seller, to A. A review of these facts leads to the conclusion that the lease from A to B qualifies as a finance lease. Due to the limited function usually performed by the lessor, the lessee looks almost entirely to the supplier for representations, covenants and warranties. Article 2A codifies this practice by providing that the finance lessor basically makes no warranties under Sections 2A-212 and 2A-213, that the lessee's obligation to pay rent is irrevocable under Section 2A-407, and that warranties made by the supplier pass through to the lessee under Section 2A-209.

The definition of a finance lease focuses on the transaction, not the status of the parties. It is important to note that in other contexts, e.g., tax and accounting, the term finance lease has been used to connote different types of lease transactions, including leases that actually are disguised secured transactions.

If a transaction does not qualify as a finance lease, it is necessary to recognize that the parties may achieve the same result by agreement; no negative implications are to be drawn if the transaction does not qualify.

6. Remedies

Article 2A has not only provided for lessor's remedies upon default by the lessee (Sections 2A-523 through 2A-531), but also for lessee's remedies upon default by the lessor (Sections 2A-508 through 2A-522). This is a significant improvement from current practice, where the lease usually provides remedies only for the lessor upon default by the lessee. This development is compelled by the bilateral nature of the obligations between the parties to a lease. Like in Article 2, however, the remedies so provided can be modified or limited and a lessor should consider providing an express warranty of specified duration and limiting the remedy for its breach to repair or replacement with an exclusion of consequential damages and disclaiming implied warranties of quality or limiting them to correspond to the express warranty, as is often done in a sale transaction. See Sections 2A-214 and 2A-503.

Many leasing transactions are predicated on the parties' ability to stipulate an appropriate measure of damages in the event of default. The rule on liquidated damages with respect to sales of goods (Section 2-718) is not sufficiently flexible to accommodate this practice. Consistent with the common law emphasis upon freedom to contract, Article 2A has created a revised rule that allows greater flexibility with respect to leases of goods. Section 2A-504(1).

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SUMMARY OF PRINCIPAL AMENDMENTS TO ARTICLE 2A OF THE UNIFORM COMMERCIAL CODE

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Section 2A–103(1)(g). Definition of Finance Lease.

The Amendment procedurally (not substantively) broadens the definition to allow leases to qualify if, before signing the lease, the lessee either *(1)* receives an accurate and complete statement of the relevant terms of the supply contract, or *(2)* except in a consumer lease, the lessor advises the lessee such may be obtained from the supplier.

Reason: Uniform Article 2A required the lessee to receive a copy of the supply contract or approve it. Some lessors objected that this forced the disclosure of pricing and other confidential information to the lessee. The Amendments accommodate that concern.

Section 2A–104. Leases Subject to Other Law.

The Amendments *(1)* delete reference to United States statutes as controlling, leaving the matter to pre–emption principles, and *(2)* preserve consumer protection decisions rendered prior to enactment of Article 2A.

Reason: To accommodate positions taken by California and the New York Law Revision Commission study.

Section 2A–209. Lessee under Finance Lease as Beneficiary of Supply Contract.

The Amendments clarify the finance lessee's position in cases where the supply contract is rescinded or modified. Unlike under Uniform Article 2A, when the rescission or modification is effective against the lessee, the Amendments require the lessor to assume what the lessee lost through the rescission or modification, rather than subjecting the lessor and supplier to a damage remedy. This approach is believed to work better where it is not immediately apparent whether the rescission or modification will be prejudicial, such as a reduction in a warranty period from four years to one year under circumstances where it is not apparent yet that the goods are defective. The Amendments also clarify that this section does not displace any rights the lessee may have against the supplier under other law or agreement.

Reason: To accommodate positions taken by California and the New York Law Revision Commission study.

Section 2A–303. Alienability of Party's Interest Under Lease Contract or of Lessor's Residual Interest in Goods; Delegation of Performance: Transfer of Rights.

This section has been completely rewritten to *(1)* expressly cover default provisions as well as prohibitions on transfer, *(2)* provide that contractual provisions against transfer do not impair the transfer but only may lead, as applicable, to remedies for default or damages or other relief, *(3)* restrict the ability to enforce a prohibition or event of default, or to claim a transfer results in material prejudice, to actual transfers that *(a)* involve the lessee's right of possession

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or use of the goods, or *(b)* a delegation of a material performance, and *(4)* only require contractual provisions against transfer to be highlighted in a consumer lease.

Reason: The Amendments address issues that were highlighted primarily by Professor Steven Harris in an article published after promulgation of Article 2A in the Alabama Law Review. The Amendments principally are designed to alleviate concerns of lenders of lessors that security taken in the leased goods and in chattel paper is not compromised. As such, the Amendments conform to the policy of Section 9–318(4). The Amendments also *(1)* remove an assurance and cure procedure for transfers that are materially prejudicial, which works well enough in a bankruptcy context but may have left matters in too ambiguous a suspension outside of that context, and *(2)* remove built–in notice requirements for prohibitions except as to consumer lessees.

Section 2A–307. Priority of Liens Arising by Attachment or Levy on, Security Interests in, and Other Claims to Goods.

With respect to priority between a secured creditor of the lessor and a lessee, the Amendments drop a test designed to invoke Section 9–312(5)(a), which test was used for reasons of certainty, and instead adopt a test which treats the lessee as a buyer and is modeled upon Section 9–301.

Reason: Questions were raised as to whether the special purchase money rules of Section 9–312 in fact could be applicable rather than only Section 9–312(5)(a), and as to why the lessee was not treated as a buyer, as was the case in other parts of Article 2A. The Amendments track the action of California in amending Section 2A–307 on these issues, but do not adopt its provision that allows, unlike in the case of a buyer, a purchase money security interest to trump a lease.

Section 2A–311. Priority Subject to Subordination.

This Amendment tracks Section 9–316 as appropriate since the priority rules in Part 3 of Article 2A follow many of those in Article 9.

Section 2A–507. Proof of Market Rent: Time and Place.

The Amendment does not restrict the time to measure market rent to the time of default.

Reason: The Amendment tracks amendments made in Sections 2A-519 and 2A-528 that no longer measure damages solely at the date of default.

Section 2A–508. Lessee's Remedies.

The Amendments limit lessee's recovery of rent already paid, when the lease is an installment lease or the lessee cancels the lease for lessor's default, to that amount which is "just." They also specifically recognize that the lease agreement may grant the lessee other rights and remedies or may provide that the lessee has the right to cancel the lease for defaults which would not under the statute itself give the right to cancel. Finally, a remedy for non–material defaults is provided for cases where the lease contract does not.

Reason: Prior to the Amendments, the section had stated that the lessee, on cancellation of the lease, could recover the rent already paid. That rule failed to recognize that the lessee might terminate the lease for a default by the lessor after a substantial period of use, in which case it is not appropriate to require the lessor to return all rental payments made. The other changes emphasize the right of the parties to provide remedies in addition to those provided by the Act.

Section 2A–516. Effect of Acceptance of Goods; Notice of Default; Burden of Establishing Default After Acceptance; Notice of Claim or Litigation to Person Answerable Over.

The Act originally required the lessee in a finance lease to notify both the lessor and the supplier before asserting against either of them a claim based on a default as to accepted goods. The Amendment provides that recovery can be had against the person notified even if both are not notified.

Reason: The Amendment adopts the position taken by the New York Law Revision Commission. In the usual case, the lessor in a finance lease will have no responsibility as to the quality of the goods and it is, therefore, reasonable to allow the lessee to recover against the supplier upon notification to the supplier only of the defects in the goods.

Section 2A–517. Revocation of Acceptance of Goods.

The Amendment makes it clear that a lessee may revoke acceptance of goods (cancel the lease) for defaults by the lessor which do not relate to non–conformity of the goods themselves: for example, a failure to furnish supplies which are necessary for the operation of the leased equipment and which the lessor contracted to supply.

Reason: Clarification. This Amendment was proposed by the New York Law Revision Commission.

Section 2A–518. Cover; Substitute Goods.

The Amendment changes the time for measuring the difference between the present value of the rent due under the original lease and the cover lease from the date of default to the day the cover lease begins and also separately discounts each income stream rather than the difference between the two. *See item 11 on Section 2A–519 as to this last point.* It also specifically states that the parties may by contract provide for a cover remedy where it would not be available under the Act itself.

Reason: The beginning of the cover lease term is the more appropriate date for discounting to present value the difference in rentals between the original and the cover lease. This Amendment was proposed by the New York Law Revision Commission.

Section 2A–519. Lessee's Damages for Non–Delivery, Repudiation, Default, and Breach of Warranty in Regard to Accepted Goods.

The Amendment more precisely calculates the difference between market rent and rent due under the lease by separately discounting each income stream. The Amendment also specifically refers to the right of the parties to alter the remedies given by the section or to contract for the remedies given by the section in situations where the remedy would not be available under the Act itself.

Reason: The original statutory language required a determination of the present value of the "difference between the market rent and the original rent." The Amendment requires that the present value under the original lease and of market rent for the remaining term of the original lease be calculated separately and then the present value of the market rent be subtracted from the present value of the rent under the original lease. The new provisions, therefore, take account of the fact that there may be differences between the way market rent is paid and the way rent was to have been paid under the original lease which would make discounting to present value of the difference between the sums due a less accurate measure of damages. If, for example, in a one year lease, the defaulted lease required that payment be made semi–annually, but market rent is ordinarily paid monthly, merely subtracting the total rent to be paid under market rent from the total amount to be paid under the defaulted lease would not accurately reflect the present value of the difference.

Section 2A–523. Lessor's Remedies.

The Act as originally drafted did not clearly provide statutory remedies for defaults by a lessee other than the defaults specifically described in the Act: wrongful rejection or revocation of acceptance, failure to pay the rent, or repudiation. The Amendments provide statutory remedies for other defaults by the lessee and state that, if those defaults substantially impair the value of the lease to the lessor, the lessor can exercise the remedies for statutory defaults, or, if the defaults do not substantially impair the value of the lease to the lessor, the lessor can recover damages. The Amendments also make clear the right of the parties by contract to modify the remedies available or provide other remedies. The Amendments also provide that, even though the default is a material one for which the lessor could cancel the lease, it need not do so, but may instead merely bring an action for recovery of damages.

Reason: The Amendments clarify the application of the Act to non–material defaults by the lessee and, in general, make it clear that the usual contract rules as to available remedies are applicable.

Section 2A–527. Lessor's Rights to Dispose of Goods.

The Amendment changes the time for measuring the difference between the present value of the rent due under the original lease and the replacement lease from the date of default to the day the replacement lease begins and calculates the difference after each income stream is reduced to present value for the reason explained in relation to Section 2A–519. It also specifically states that the parties may by contract provide for a replacement lease remedy where it would not be available under the Act itself.

Reason: The beginning of the replacement lease term is the more appropriate date for ending recovery of rent due and calculating damages by discounting to present value the rentals under the original and the replacement lease and taking the difference. This Amendment was proposed by the New York Law Revision Commission.

Section 2A–528. Lessor's Damages for
Non–Acceptance, Failure to Pay, Repudiation, or Other Default.

The Amendment more precisely states the method of calculating the difference between the market rent and present value of rent due under the lease, and the date as of which the calculation is to be made. The Amendment also specifically refers to the right of the parties to alter the remedies given by the section or to contract for the remedies given by the section in situations where the remedy would not be available under the Act itself.

Reason: As to the method of calculation of the difference between the market rent and the rent under the defaulted lease, the issues are the same as in the case of a default by the lessor which were discussed above *(see the discussion under Section 2A–519)*. As to the time as of which the present value calculation should be made, the Amendments recognize that, if the lessee has had possession of the goods under the lease, a contract rent — market rent comparison should not be made until the lessor has possession of the goods, or the lessee has tendered the goods back.

Section 2A–529. Lessor's Action for the Rent.

The Amendment provides that the lessor can recover the rent due for accepted goods only if the goods have not been repossessed by, or tendered to, the lessor by the lessee.

Reason: The original Act apparently allowed a lessor to recover the present value of the full rent due under a lease even though the lessor had repossessed the goods or the lessee had tried to tender the goods back but tender was refused. The California legislature, in adopting Article 2A, took the position that a lessor had a duty to mitigate damages by making good faith efforts to dispose of repossessed goods or goods tendered back by the lessee. Also, some argued that the general common law rules as to damages mitigation would apply under Article 2A to achieve the same result as the California amendments. The New York Law Revision Commission also recommended language like that adopted in California.

Section 2A–532. Lessor's Rights to Residual Interest.

This is a new section which specifically gives the lessor a remedy against the lessee for defaults which injure the lessor's residual interest in the goods.

Reason: The other sections of the Act contained no specific provision stating that the lessee is liable to the lessor for actions which damage the lessor's residual interest. Such actions include, for example, failure to properly maintain the leased goods, or failure to return at the end of the lease term. In the interest of certainty of a remedy in such situations, the section has been added. The section is unchanged from the California enactment of Article 2A.

UCC Article 2A: A Status Report

John Levin, Esq.

There is a need for a uniform law of leasing, and Article 2A addresses several issues that have been troublesome in the past.

Article 2A of the Uniform Commercial Code, adopted by the National Conference of Commissioners on Uniform State Laws in 1987, codifies the law respecting the leasing of goods. Existing law has worked fairly well in most cases. Nevertheless, the existence of continuing problems in the context of the explosive growth in leasing over the past decades favors making the law both clearer and more consistent.[1]

Certain aspects of the 1987 version of Article 2A have been criticized. California adopted Article 2A in 1988 and included several significant changes to the official text.[2] Other states have also suggested changes. This year, the commissioners recommended amendments to the 1987 text addressing issues raised in California and elsewhere.

Most of the substantive provisions of Article 2A were derived from Article 2, governing sales. The provisions reflecting fundamental contract law common to both articles are not reviewed in this article. This article will analyze the 1987 version of Article 2A peculiar to leasing transactions and consider the effect of the amendments adopted by the commissioners this year.

Definitions

The definitions contained in Article 2A categorize transactions. The substantive effects of Article 2A flow from these categorizations.

Lease. The term "lease" is defined in Section 2A-103(1)(j) as a transfer of the right to possession and use of goods for a term in return for consideration, but a sale, including a sale on approval or a sale or return, or retention or creation of a security interest, is not a lease. Unless the context clearly indicates otherwise, the term includes a sublease.

Sale. A "sale" consists of the passing of title from the seller to the buyer for a price.[3] Title generally passes to the buyer upon delivery of the goods,[4] and any rights retained or reserved by the seller in the title are limited to a security interest.[5]

Security Interest. The definition of "security interest" contained in the current version of Section 1-201(37) is "an interest in personal property or fixtures which secures payment or performance of an obligation." Section 1-201(37) continues, "[w]hether a lease is intended as security is to be determined by the facts of each case. . . ." The section then provides that the mere inclusion of an option to purchase does not make the lease one intended as a security interest, but if the lessee becomes or has the option to become the owner at the conclusion of the term of the lease for no additional consideration, the lease is intended as a security interest.

The reference to intent in the current text has led to confusion in the interpretation of Section 1-201(37), and the commissioners recommend a conforming amendment (to be adopted contemporaneously with the adoption of Article 2A) that eliminates such reference. The amended definition states that "[w]hether a transaction creates a lease or security interest is determined by the facts of each case . . ." and then continues with the following specific rules:

> A transaction will create a security interest if (1) the consideration the lessee pays the lessor for the right to use the goods is for the term of the lease and not subject to termination by the lessee, and (2) one of the following is also true: (a) the original term of the lease is equal to or greater than the remaining economic life of the goods, (b) 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, (c) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional [or only nominal] consideration, or (d) the lessee has an option to become the owner of the goods for no additional consideration or nominal consideration.

The recommended definition then continues that a lease does not create a security interest merely because it provides that: (1) the present value of the rental stream is equal to or greater than the fair market value of the goods at the time the lease is entered into, (2) the lease is a net lease, (3) the lessee has an option to renew the lease or purchase the goods, (4) the lessee has an option to renew the lease at a rent equal

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[illegible] greater than fair market value, or (5) the lessee has the option to purchase the goods at a price equal to or greater than fair market value.

These criteria all focus on the economics of the transaction and not the intent of the parties. If the lessor is left with a significant economic interest in the goods at the termination of the lease term, the transaction should be considered a true lease governed by Article 2A. If the lessor retains no such signficant interest even though retaining title, the transaction should be considered a security interest governed by Article 9. If title to the goods passes to the other party for no additional or only nominal consideration, the transaction should be considered a sale governed by Article 2.[6]

Consumer Lease. Assuming that a transaction is a lease under Article 2A, there are two further subclassifications. The first is a "consumer lease," which is defined in Section 2A-103(e) as "a lease that a lessor regularly engaged in the business of leasing or selling makes to a lessee, except an organization, who takes under the lease primarily for a personal, family, or household purpose, if the total payments to be made under the lease contract, excluding payments for options to renew or buy, do not exceed $25,000." The 1990 amendments narrow the definition to a lease to an "individual" and make the dollar limitation optional. These changes have limited effect.

Finance Lease. The second term is "finance lease." This term is defined as:

> a lease in which (i) the lessor does not select, manufacture or supply the goods, (ii) the lessor acquires the goods or the right to possession and use of the goods in connection with the lease, and (iii) either the lessee receives a copy of the contract evidencing the lessor's purchase of the goods on or before signing the lease contract, or the lessee's approval of the contract evidencing the lessor's purchase of the goods is a condition to effectiveness of the lease contract.

The 1990 amendments add two other options to clause (iii). These options allow the lessee to be provided with a statement of the relevant terms of the supply contract, including information regarding supplier's warranties, rather than a copy of the supply contract itself. The amendment allows a lessor to withhold possibly sensitive information such as the purchase price of the leased property, from the lessee.

Under both the original and amended definitions, some transactions that historically have been called security interests, leases or finance leases may not have the same meanings under Article 2A and amended Article 1. Also, while the definition of finance lease resembles many leasing transactions intended as financing vehicles, the definition does not necessarily include the commonly used form of lease that has been drafted to accomplish certain tax effects in compliance with Revenue Procedure 75-21[7] or conform to the accounting definition of "capital lease."[8]

These criteria all focus on the economics of the transaction and not the intent of the parties.

Application

A fundamental principle of Article 2A is that the parties have the ability to vary the effect of its provisions subject to certain specific limitations and the general obligations of good faith, diligence, reasonableness and care of Section 1-102(3). Thus, Article 2A supplies a general legal framework to the leasing relationship and fills the interstices left in incomplete lease agreements.

Consumer leases. The limitations placed on consumer leases, in most part, attempt to protect the consumer from the greater sophistication and bargaining power of the lessor. Section 2A-106 provides that choice of law and forum provisions in a consumer lease are unenforceable if they select jurisdictions not otherwise applicable to the lessee. Section 2A-108, a provision parallel to the unconscionability provisions of Section 2-302, provides that, with respect to a consumer lease, if the court finds that the lease was induced by unconscionable conduct or if unconscionable conduct occurred in the collection of a claim under the lease, the court may grant appropriate relief.

Also, under Section 2A-108 the court must grant reasonable attorney's fees in an action brought under a consumer lease to the lessee if the court finds that unconscionable conduct occurred or to the lessor if the court finds that the lessee's claim was groundless.

A party exercising an option to accelerate duties under a lease or require collateral "at will" may do so only if the party so exercising believes in good faith that the prospect of payment or performance is impaired.[9] While normally the burden of establishing the lack of good faith is on the person against whom the power has been exercised, in a consumer lease the burden is on the party exercising the power.[10]

Finance leases. The provisions regarding finance leases attempt to codify much of what has been done in practice. As noted above, however, the definition of finance lease contained in Article 2A may exclude leases that are intended for financing purposes. Thus, a

From the point of view of the lessor, a finance lease should contain appropriate warranty exclusions permitted under Section 2A-214.

finance lease agreement should contain all necessary provisions notwithstanding Article 2A. For example, Sections 2A-210 and 211(1) provide that a lessor under a finance lease is responsible for express warranties and warranties of title. From the point of view of the lessor, a finance lease should contain appropriate warranty exclusions permitted under Section 2A-214.

The most significant provision respecting finance leases (which are not consumer leases) is the "hell or high water" benefit contained in Section 2A-407. This section provides that "the lessee's promises under the lease contract become irrevocable and independent upon the lessee's acceptance of the goods." The official comment, however, states that the provisions of Section 2A-407 remain subject to the obligation of good faith under Sections 2A-103(4) and 1-203 and the lessee's revocation of acceptance under Section 2A-517, which provides that a lessee may revoke a finance lease if the acceptance of the goods under the lease was made without discovery of a material nonconformity and was reasonably induced by the lessor's assurances.

The 1987 version of Section 2A-407 is silent, however, on whether a "hell or high water" provision would be enforceable if contained in a lease that was not a finance lease as defined in Article 2A. The 1990 amendments change Section 2A-407 to specifically provide that the "section does not affect the validity under any other law or a covenant in any lease contract making the lessee's promises irrevocable and independent upon the lessee's acceptance of the goods." This amendment should end the uncertainty created by the 1987 draft.

The remainder of the provisions respecting finance leases revolve around the principle that the true parties in interest with respect to the purchase and sale of the leased goods are the lessee and the manufacturer and that the lessor's role is limited.[11] For example, the lessee is the beneficiary of the supply contract for the goods,[12] and provisions imposing lessor's warranties do not apply in many instances.[13] Also, the passage of risk of loss has different rules under finance leases.[14]

Security interests. Whether a given transaction is classified as a lease or a security interest will have a significant effect on the rights of the lessor/lendor in exercising its remedies. Section 2A-301 states the general rule that, except as otherwise provided in Article 2A, a lease contract is effective and enforceable in accordance with its terms "between the parties, against purchasers of the goods and against creditors of the parties." Article 2A applies whether or not the lessor or a third party has title to the goods or whether the lessor, the lessee or a third party has possession of the goods.[15]

The strict application of these general rules would seriously impair the ability of lessors and lessees to finance goods that are the subject of leases. The remaining provisions of Part 3 of Article 2A attempt to remedy this problem.

Section 2A-303(1) begins with the proposition that "[a]ny interest of a party under a lease contract and the lessor's residual interest in the goods may be transferred. . . ." The 1987 version of the section then imposes two significant restrictions. The transfer is prohibited if (a) "the transfer is voluntary and the lease contract prohibits the transfer," or if the transfer "materially changes the duty of or materially increases the burden or risk imposed on the other party to the lease contract" and the transferee does not comply with certain requirements after notice by the other party.[16] The requirements placed upon the transferee are generally to cure or provide adequate assurances that any default under the lease will be cured or to assume the lease.[17]

These two restrictions would complicate financings where an interest in or under a lease is collateral. The 1990 amendments remedy this problem. Amended Section 2A-303 would permit any transfer of rights notwithstanding the provisions of the lease agreement, though the section validates provisions that make such transfer a default under the lease agreement. The amended section provides that the lease agreement may not treat as an event of default the creation by the lessor of a security interest in the agreement or the lessor's residual, but it may treat as a default the delegation of performance of either party or the transfer of the right of possession of the lessee in the goods. If a prohibited transfer takes place without the consent of the other party, the prejudiced party has an action for damages or equitable relief if damages are inadequate.

The priority of liens and security interests with respect to leases is governed by Sections 2A-306 and 307. Though there was serious discussion about imposing a filing requirement to establish the priority of leases,[18] no such requirement is imposed by Article 2A except for a "fixture filing" under Section 2A-309 when goods become so related to a particular parcel of real estate that an interest in them arises under real estate law.

Section 2A-306 provides that a lien for services or materials furnished in the ordinary couse of business generally takes priority over any interest of the lessee or lessor under a lease contract. Section 2A-307(1) states that a creditor of a lessee generally takes goods subject to a lease contract.

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The provisions respecting lessor's creditors are more complex. Section 2A-307(2) begins with the general rule that a creditor of the lessor takes goods subject to the lease contract. The 1987 version of the section then lists the following exceptions: (1) "unless the creditor holds a lien that attached to the goods before the lease contract became enforceable," or (b) unless the creditor holds a security interest in the goods that under Article 9 would have priority over any other security interest perfected by a filing made at the time the lease contract became enforceable.

Section 2A-307 also provides that a lessee in the ordinary course of business takes goods free of a security interest in the goods created by the lessor and a lessee other than in the ordinary course of business generally takes free of a security interest to the extent that it covers future advances.

The 1987 version of Section 2A-307(2) has been criticized as being too indefinite.[19] The 1990 amendments resolve many of these criticisms. Under the amendments a creditor of the lessor takes subject to the lease unless the creditor holds a security interest in the goods and the lessee did not give value and take delivery without knowledge of the security interest or unless the creditor holds a security interest in the goods that was perfected before the lease agreement became enforceable.

As is currently the practice, filings will need to be made under Article 9 in order to perfect a security interest in a party's interest under a lease or in the goods subject to a lease. Also, protective filings should continue under Section 9-408 with respect to the lessor or lessee of goods. However, with the adoption of the new definitions of "lease" and "security interest," there will be some short-term uncertainty in the financing of leases and goods subject to leases.

Remedies

While Section 2A-503(1) and the official comment to that section emphasize the overriding importance of the concept of freedom of contract in all of Article 2A, Sections 2A-508(3) and 2A-523(2) both provide that an injured party may "exercise the rights and remedies provided in the lease contract and this Article." The official comments reiterate that the purpose of these sections is to give the injured party "access to the remedy scheme of this Article" as well as the remedies contained in the lease contract. While the practitioner is given wide latitude in creating defaults and remedies in a lease transaction, the provisions of Sections 2A-501 thorugh 530 limit flexibility.[20]

Lessee's remedies are set forth in Sections 2A-508 through 522. A lessor default is defined as follows: (a) lessor's failure to deliver in conformity with the contract, (b) lessor's repudiation of the contract, (c) lessee's rightful rejection of the goods, or (d) lessee's justifiable rejection of the goods.[21] If the lessor defaults, then the lessee may (i) cancel the lease contract, (ii) recover so much of the rent and security as has been paid (with certain limitations for installment lease contracts), and (iii) cover and recover damages or recover damages for nondelivery.[22] The lessee may also recover the goods or obtain specific performance under appropriate circumstances, and breach of warranty is recoverable in damages.[23]

The 1990 amendments broaden lessee rights by suggesting a change to Section 2A-517 that would permit (except in finance leases) a lessee to revoke acceptance of a lot or commerical unit if the lessor commits a default under the lease that would significantly impair the value of the lot or unit to the lessee or if the lease agreement permits revocation for breach by the lessor.

The lessee's remedies are cumulative as Article 2A rejects the concept of election of remedies.[24] On rightful rejection or revocation of acceptance, the lessee retains a security interest in goods in the lessee's possession for rent and security paid and any expenses reasonably incurred in the inspection, receipt, transportation, care and custody of the goods. The lessee may dispose of the goods in accordance with the provisions of Article 2A.[25]

Lessor's remedies are contained in Sections 2A-523 through 530. A lessee default is defined in Section 2A-523(1) as follows: (a) lessee's wrongful rejection or revocation of the goods, (b) lessee's failure to make a payment when due, or (c) lessee's repudiation in part or in whole. If the lessee defaults, then the lessor may (i) cancel the lease contract, (ii) proceed with the goods not yet identified to the lease contract, (iii) withhold delivery of the goods and take possession of the goods already delivered, (iv) stop delivery of the goods by any bailee, and (v) dispose of or retain the goods and recover damages or in certain circumstances, recover rent. Lessor's remedies are, as lessee's, cumulative.[26] Section 2A-504 provides that the lease agreement may contain provisions for liquidated damages provided such damages are calculated in a manner that is "reasonable in the light of the then anticipated harm caused by the default or other act or omission."

The 1990 amendments suggest an addition to Section 2A-523 that increases the lessor's options in the event of lessee default. The lessor would be permitted to allow the lessee to keep possession of the leased goods and recover damages for the breach. The lessor is also given

The 1990 amendments suggest an addition to Section 2A-523 that increases the lessor's options in the event of lessee default.

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The amendments suggested by the commissioners in 1990 remedy the most serious criticisms of the 1987 draft.

remedies for lessee's defaults not specifically enumerated in Section 2A-523(1). In addition, a new Section 2A-532 is suggested that makes clear that the lessor can recover from the lessee for loss or damage to the lessor's residual interest in the leased goods caused by the lessee's default.

The 1987 version contains a number of provisions in which damages are to be calculated on the basis of a comparison of the present value of the original rent and the present value of the market rent or cover. Many of these provisions were justly criticized for an unfair result. The 1990 amendments address these criticisms by restating how and from what date the rental streams are to be discounted.

For example, the 1987 version of Section 2A-518 provides that in the event of lessor default, the lessee may cover, and if cover is by a lease agreement substantially similar to the original lease agreement, the lessee may recover from the lessor in damages "the present value, as of the date of default, of the difference between the total rent for the lease term of the new lease agreement and the total rent for the remaining lease term of the original lease agreement."

The 1990 amendments provide that the lessee may recover "the present value, as of the date of commencement of the term of the new lease agreement, of the rent under the new lease agreement applicable to that period of the new lease term that is comparable to the then remaining term of the original lease agreement minus the present value of the same date of the total rent for the then remaining lease term of the original lease agreement."

The 1990 amendment corrects two problems with the 1987 version. First, it permits recovery even if the original lease and the new lease agreements are for different terms. Second, it provides for a more precise calculation of difference between the present values of the rental streams under the original lease and new lease agreements.

Conclusion

Article 2A has been and will continue to be the subject of debate as the article is proposed for adoption in various states. There is a need for a uniform law of leasing and Article 2A addresses several issues that have been troublesome in the past. In the view of the author, the amendments suggested by the commissioners in 1990 remedy the most serious criticisms of the 1987 draft, and the amended version should become the standard text to be adopted by the states.

Commentators and state legislators should avoid the temptation to continue to revise the amended version for purely parochial reasons or from a desire to improve the text technically. It would be unfortunate if the practitioner had to deal with a significant number of variations to an allegedly uniform code.

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Footnotes

[1] Boss, "The History of Article 2A: a Lesson for Practitioner and Scholar Alike," 39 Alabama Law Review 575 (1988).

[2] Sigman, Harry C. and Turner, Jeffrey S., "Preface to the California Report on Article 2A," 39 Alabama Law Review 975 (1988). For a listing of the significant variations adopted in California from the uniform text, see Wong, Jeffery, "Article 2A (Leases) of the Uniform Commercial Code: Selected Issues," 94 Commercial Law Journal 57 (1989).

[3] U.C.C. Section 2-106(1).

[4] U.C.C. Section 2-401(2).

[5] U.C.C. Section 2-401(1).

[6] For a further discussion of this subject see Huddleson, "Old Wine in New Bottles: UCC Article 2A-Leases," 39 Alabama Law Review 615 (1988) and "U.C.C. Article 2A; Distinguishing Between True Leases and Secured Sales," 63 St. John's L. Rev. 69 (1988).

[7] Rev. Proc. 75-21 sets forth guidelines which the Internal Revenue Service uses for advance rulings to determine if a given lease transaction will be treated as a lease for tax purposes. The relevant provisions of Rev. Proc. 75-21 are:

> . . . 1(C) The lessor must represent and demonstrate that an amount equal to at least 20 percent of the original cost of the property is a reasonable etimate of what the fair market value of the property will be at the end of the lease term. . . . In addition, the lessor must represent and demonstrate that a remaining useful life of the longer of one year or 20 percent of the originally estimated useful life of the property is a reasonable estimate of what the remaining useful life of the property will be at the end of the lease term.
>
> . . . (3) No member of the Lessee Group may have a contractual right to purchase the property from the lessor at a price less than its fair market value at the time the right is exercised.

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lease meets one of the following criteria, it shall be classified as a capital lease by a lessee: (1) the lease transfers ownership of the property to the lessee at the end of the lease term, (2) the lease contains a bargain purchase option, (3) the lease term is equal to at least 75 percent of the estimated economic life of the property, or (4) the present value at the beginning of the lease term of the minimum lease payments equals at least 90 percent of the fair value of the lease property to the lessor. A lease shall be classified as a capital lease by a lessor if the lease meets any one of the above criteria and both of the following: (a) the collectibility of the minimum lease payments is reasonably predictable, and (b) no important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease. The complete language of the accounting principles is more extensive than outlined above.

[9] U.C.C. Section 2A1-09(1).

[10] U.C.C. Section 2A-109(2).

[11] See U.C.C. Section 2A-103(g) and official comment and the official comment to Section 2A-109.

[12] U.C.C. Section 2A-209.

[13] See U.C.C. Sections 2A-211(2), 212(1) and 213.

[14] See U.C.C. Sections 2A-219(1), 220(1)(a) and 221.

[15] U.C.C. Section 2A-302.

[16] U.C.C. Section 2A-303(1)(b).

[17] U.C.C. Section 2A-303(2).

[18] See Mooney, "The Mystery and Myth of 'Ostensible Ownership' and Article 9 Filing: A Critique of Proposals to Extend Filing Requirements to Leases," 39 Alabama Law Review 683 (1988).

[19] Harris, "The Rights of Creditors Under Article 2A," 39 Alabama Law Review 803 (1988).

[20] For a further detailed studies of remedies under Article 2A, see Huddleson, "Old Wine in New Bottles: UCC Article 2A-Leases," 39 Alabama Law Review 615 (1988); Rapson, "Deficiencies and Ambiguities in Lessor's Remedies Under Article 2A: Using Official Comments to Cure Problems in the Statute," 39 Alabama Law Review 875 (1988) and Benfield, "Lessor's Damages Under Article 2A After Default by the Lessee As to Accepted Goods," 39 Alabama Law Review 915 (1988).

[21] U.C.C. Section 2A-402, 2A-508, 2A-509, and 2A-517.

[22] U.C.C. Section 2A-508(1).

[23] U.C.C. Section 2A-508(2) and (3),

[24] See U.C.C. Section 2A-508 official comment.

[25] U.C.C. Section 2A-508(5).

[26] U.C.C. Section 2A-523 official comment.

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THE IMPORTANCE OF THE UNIFORM COMMERCIAL CODE

Beginning in 1991, the National Conference of Commissioners on Uniform State Laws, celebrates the 100th birthday of its founding. At 100 years, the Conference may look back on an illustrious record: the successful promulgation of many uniform and model acts; achievement of uniformity in a diverse portfolio of acts; a prestigious membership; and an unbroken record of service to state government.

It is fitting to pause a moment to reflect on that 100 years at the mid–point of an effort to update what is perhaps the most important effort of the Conference – the Uniform Commercial Code (UCC). The Conference focused on commercial law almost from the beginning: the Uniform Negotiable Instruments Law was promulgated in 1896, only four years after its first annual meeting.

For those interested in historic conjunctions, William Jennings Bryan made his "Thou shalt not crucify this nation on a cross of a gold" speech in that year, reacting to the depression precipitated by President Grover Cleveland's withdrawal of the silver standard in 1893. These are events lost in a mythic past, but perhaps they should inform us as we enter the decade of the 1990s – with not only a new Article 3 as a second generation successor to the Uniform Negotiable Instruments Law, but also updates of other UCC Articles and completely new Articles to serve in what may be perilous economic times.

The issue is fundamentally the same. Can we create law for a viable, functioning community in a federal system of government? Twice in history the legal profession, the financial institutions, the citizens of the United States and state government have answered yes. The Uniform Negotiable Instruments Law and other uniform commercial acts like the Uniform Sales Act were uniformly adopted. So was the original Uniform Commercial Code – even for the most part in Louisiana, which recently adopted Article 9 because people interested in doing business in Louisiana demanded law that they were familiar with. Uniform commercial law is good for business. But it will be interesting to see if widespread enactment of necessary revisions can be done uniformly.

The National Conference is a unique institution. Uniform law commissioners are all lawyers by the rules of the Conference and by the tradition governing their appointment. They are also state officials, though unpaid state officials, and regard state government as a kind of client for their wares – the uniform and model acts. So commissioners have both a double identity and a double obligation – they are part of the spectrum of organizations of the legal profession and part of the spectrum of organizations representing state governmental interests.

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The Conference began in true grassroots fashion. State commissions began to form in 1889, following resolutions passed by the state legislatures. In 1892, there were seven such commissions, enough to hold the first national conference in the suite of one of the commissioners at Saratoga Springs, New York, just following the American Bar Association meeting of that year. The entire uniform law movement grew from that modest beginning, sustained by the states to this day.

What is even more remarkable than the grassroots quality of its origin, is the everpresent "against the grain" orientation of its activities. This is a profession enamored with the common law in its training and traditions, notwithstanding the intentions of our forefathers (and probably some mothers, too), who seemed to regard law-making as a legislative activity. The 19th century scholastic battles between "common law" and "statute" mostly were won by common law, at least in academic circles. Statutes and legislation continued to be virtually ignored. The Conference, in the profession and among its own academic members, remains a kind of vestige, in the minority, in the image of David Dudley Field, the great 19th century proponent of statute.

But the UCC may be seen in our time as a watershed event. For here is the monumental distillation of the common law, modified for sound economic reasons, into statute. It was unprecedented, and is extraordinarily successful. It should be regarded as a triumph of democratic processes, and should commend those processes to the ever skeptical legal profession as we enter a new phase of the UCC — that of revising it to meet modern business practices and technologies.

The success of the UCC is rooted in a very simple proposition. It is a proposition that should give pause to significant areas of common law persistence. Further, it is a proposition that has nothing to do with sustaining a federal system of government. This proposition is that the common law is inadequate to govern any complex transactional environment. The UCC reflects commercial necessity. The alternative simply costs too much. The law must emanate from the legislatures, and there must be uniformity — meaning a common language of the law upon which both business and the legal profession can rely. This is the simple truth about the Uniform Commercial Code, a truth that the business and financial world instinctively understood, and so it became a reality in the time of economic expansion following World War II.

The uncertainty of the common law makes it an unreliable source for complex transactional environments. But private law, with its inherent complexities, requires refined legislative development. It requires institutions with the capacity to do the careful work in the policy arena coupled with devotion to careful drafting. This is a combination of policy and craft. The institutions must be situated within the broader boundaries of the legislative branch of government, if they are to function adequately, and if they are to reflect the norms of a democratic society.

When we look at government in the United States at any level, we find very little commitment to the development of such institutions. The federal government has none at all. At the state level, there are several law revision commissions which have some of the essential characteristics. But despite the excellence of some of the work in these state institutions, their influence ends at the borders of the states that have created them. For the development of national legislation, and for the advocacy of uniformity, there is only one institution — the National Conference of Commissioners on Uniform State Laws. If there were no Conference, it would have to be invented. This is a necessity in a democratic society with a federal system of government.

The devotion of the Conference to the UCC, then, should come as no surprise. It is the institution charged by state government with the responsibility for private law development and for the promotion of uniformity. It was natural for it to take up the responsibility for commercial law development as business and the legal profession found the common law inadequate for the task. The need for craftsmanship, for a studied, non–partisan approach to development of the law, all these factors led the Conference to the field. After half a century of individual commercial acts, some of them more successful than others, the leadership of the Conference steered it towards the Uniform Commercial Code. They got it drafted and they got it adopted. There was virtually no other institution with the position, the opportunity and the ability to get the job done.

Today the task is somewhat different. The UCC is simply the familiar landscape which is a background for business and the practice of law. We are three and four generations of commercial lawyers removed from its founders, and are confronted with the problem of maintaining the commercial law, much in the image that the founders cast it, while updating it for utility into the next century. It is a much larger commercial world than existed in the formative period after World War II. There is a commercial bar that did not exist in the time of its founding, and that would not exist but for the UCC. The specter of federal preemption does not abate, but continues to grow as the United States approaches this final decade of the 20th century, our gay '90s — or so we hope it is reported when the annals are written.

But the principal task is much the same. The need for an institution that can carefully and expeditiously carry out the codification of private commercial law remains, as it must remain in a diverse, federal system of government. It now must reestablish the Uniform Commercial Code as revised and updated. Uniformity must be reestablished within a reasonable timeframe. The functioning of the financial community depends upon the swift action on the part of the legislatures.

Everybody should take into account the question: what happens if this enterprise of revision does not succeed? Can we rely upon the federal government? There is no agency with the tradition, experience or mission in the federal government that can be identified. Further, the development of such an institution is more than highly unlikely. In the matter of reliance over time, there is no alternative to the Conference and the state legislatures.

The prospect suggests substantial reliance upon the institutions — the National Conference in partnership with the American Law Institute — that have promulgated these revisions. Reliance and forbearance must be the watchwords. We must allow uniformity to become a primary value in evaluating the work of the revision of the UCC. Otherwise, the unthinkable may be thought, and the commercial law be uniform no more.

Reliance and forbearance and relinquishment of some of our common law orientation are the needs of our time. We must bring ourselves to rely upon the process that brings these acts into being. We must forbear when they are presented to the various legislatures from unnecessary and delaying amendments. And we must adopt an analytic approach to statute–making that looks for essential policy. Once that essential policy is articulated within the process of the institution that develops that legislation, we must rely upon the chosen language unless that language is so faulty as to defeat the policy entirely.

In 1991, the Conference embarks upon its 100th year of advocacy for uniform acts, and most particularly its advocacy of the Uniform Commercial Code. After 100 years, there is much to be done. The Conference invites the legal profession to join it in that celebration by recreating uniformity in commercial law as soon as possible.

A Few Facts About

New Article 4A of the Uniform Commercial Code

– Funds Transfers –

Purpose: To provide a comprehensive body of law on the rights and obligations connected with funds transfers.

Origin: Completed by the Uniform Law Commissioners in 1989.

Endorsed by:

American Law Institute
American Bankers Association
American Bar Association

State Adoptions:

California
Colorado
Connecticut
Illinois
Kansas
Louisiana
Minnesota
New York
Oklahoma
Utah
Virginia
West Virginia

1991 Introductions:

Arizona
Arkansas
Florida
District of Columbia
Hawaii
Idaho
Indiana
Maryland
Massachusetts
Montana
Nevada
New Mexico
North Dakota
South Dakota
Washington
Wyoming

For any further information regarding Article 4A of the Uniform Commercial Code, please contact John McCabe or Katie Robinson at 312-915-0195.

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Why states should adopt Article 4A of the UCC

New Article 4A of the Uniform Commercial Code concerns a type of payment made through the banking system called a "funds transfer." (A popular term for the bulk of these kinds of transfers is "wholesale wire transfer." This term is not used in Article 4A because all "funds transfers" are not "wholesale" and not "wire" transfers.) A "funds transfer" is, generally, a large, rapid money transfer between commercial entities. In the average "funds transfer" $5,000,000.00 changes hands. In most instances, such transfers will occur between banks using computers and electronic communications. (Consumer transfers through credit cards and ATM machines are not governed by Article 4A, but are governed by federal law.) Article 4A provides a body of law on the rights and obligations connected with "funds transfers."

There is currently no comprehensive body of law that defines the rights and obligations that arise from "funds transfers." Some aspects of "funds transfers" are governed by rules of the principal transfer systems. Transfers made by the Federal Reserve network (Fedwire) are governed by Federal Reserve Regulation J and transfers over the Clearing House Interbank Payment System (CHIPS) are governed by CHIPS rules. But these rules apply to only limited aspects of "funds transfer" transactions.

Article 4A will provide:

CERTAINTY

Currently, no participant in a "funds transfer" can know with certainty what the rights and obligations of parties are. Enactment of Article 4A solves the problem.

BALANCE

Article 4A carefully addresses the interests of banks, commercial users of this payment method and the public. It seeks a fair balance between interests involved in "funds transfers."

REMEDIES

What law exists does not provide clear remedies for "funds transfers" when something goes wrong. UCC–4A establishes who takes the risk of loss, who will be liable and what will be the damages.

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EFFICIENCY

Article 4A is designed to facilitate a speedy and inexpensive system to transmit huge sums that are substantially cash equivalent, benefiting both the national and international economies.

FREEDOM OF CONTRACT

Users and banks are free to vary many provisions of UCC–4A by individual contract. They are not locked into invariable rules that might impede transactions between them.

UNIFORMITY

"Funds transfers" are an important part of business and are interstate in character. Uniformity is as important to the conduct of "funds transfers" as it is to other current payment methods.

CONCLUSION

The growing role that "funds transfers" have in the business world today makes it clear that modern law on this subject is needed. Users of "funds transfers" now depend mainly on court cases, or their own rules, to resolve disputes. This creates great uncertainty. UCC–4A answers these immediate needs.

UNIFORM COMMERCIAL CODE
ARTICLE 4A – FUNDS TRANSFERS

– A Summary –

The payment of obligations is of vital importance to almost all commercial transactions. Occasionally problems arise when payment is not made, or is made improperly. It is neither convenient nor prudent to pay large or even modest obligations in actual cash. So, individuals and corporations, big account holders and small, have turned to bank accounts and bank credit, and have paid obligations by written instruments that accomplish a transfer of bank credit - check, money order, bank draft, etc. For the past twenty years, in every state, the rights and obligations of parties to payment by check have been governed by Articles 3 and 4 of the Uniform Commercial Code (UCC). Checks will remain the method by which many obligations are paid for the foreseeable future. However, electronic technology is now a fact of life and new methods for transferring bank credit for the purposes of payment are a result. Article 4A is a reflection of this fact.

How has technology affected systems of payment? Most people are aware of automated teller machines for their personal use. Indeed, these machines have become very popular. But such technology is widely used to make large transfers of funds that satisfy obligations arising from commercial transactions as well. The technology is simply too convenient and too fast not to be used for the transfer of large sums around the world.

The amounts which move through the large value automated systems are truly staggering. In 1989 as Article 4A is promulgated, one trillion dollars are transferred on an average day. In 1989, a record day of three trillion dollars was recorded. This is roughly the 1989 gross national product of the United States. Undoubtedly, this record will be surpassed in due course and probably frequently in the future. Such figures indicate the impact of the technology. They also indicate the need for some governing law.

In 1989, as the new Article 4A is proposed to the states for adoption, there is no backstop statutory law to govern funds transfers. The rules for checks in Articles 3 and 4, which utilize the signatures and endorsements on the check as the basis for determining liability, do not apply to electronic funds transfers. Nor are the rules governing the liability of banks to customers under Article 4 helpful. Many transfers in the United States are effected through electronic transfer networks; one is owned and operated by the Federal Reserve and is known as FedWire and the other is owned and operated by the New York Clearing House and is known as CHIPS (Clearing House Interbank Payments Systems). Each of these systems has rules to govern transactions between participating banks, but they do not affect bank customers. Outside FedWire and CHIPS, common-law contract rules are the basis for determining liability. However, serviceable, negotiated contracts are rare. Bank customers usually need a funds transfer immediately and do not take the time to negotiate a contract. Transfers are frequently made in a legal void.

Article 4A is the remedy for this void. Because the total volume of funds transfers is very great and because many individual transactions are very large, the cost of uncertainty in the law could be very high. Article 4A is necessary to the continued usage of existing funds transfers and for the anticipated future expansion in this usage.

Some terminology is necessary to follow a funds transfer under Article 4A. A "sender" is any person or entity who sends a "payment order." The first sender

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is the originator, and subsequent senders are banks participating in the transfer. A sender communicates a "payment order" to a "receiving bank." Receiving banks become senders if they forward "payment orders" to other banks. The last bank in the communications chain is the beneficiary's bank, and it can never be a sender with respect to the specific funds transfer. The "beneficiary" is the entity that the sender intends to pay. A "payment order" is simply the form of communication that the parties to a funds transfer agree to use. The payment order's salient characteristics are that it calls for an unconditional payment of money from the sender to the beneficiary and that it is transmitted to a receiving bank.

Unless the persons or entities involved in a payment of money use the same bank, a funds transfer involves at least four parties: the originator of the payment; the bank to which the originator communicates the first payment order; the beneficiary's bank that receives the final payment order; and last, the beneficiary. Intermediary receiving and sending banks also may be involved. These are banks that act as conduits of payment when there is no capacity to communicate directly between the originator's bank and the beneficiary's bank.

An example illustrates the process of a funds transfer. Suppose Alpha Corporation wants to pay money to Beta Corporation to satisfy a large contractual obligation. Alpha is in New York, and Beta is in California. Alpha has a bank account with a balance sufficient to pay Beta at First Bank in New York. Beta maintains an account at Second Bank in California. The process of payment is simple. Alpha orders First Bank to pay the owed money to Beta through a transfer to Second Bank. Alpha's order is pursuant to an agreement that Alpha has with First Bank. When First Bank receives the payment order from Alpha, it communicates with Second Bank. The communication indicates that a specific amount at First Bank held for Alpha will be transferred to Second Bank with the understanding that it will be passed on to Beta. Second Bank accepts this second payment order and notifies Beta that the money is available to Beta. Value passes between the two banks through accounting entries in a process known as settlement.

With simple transactions, why do we need a whole new article in the Uniform Commercial Code? New law - or any law - isn't necessary if everything works. But what if something goes wrong? What if First Bank makes a mistake as to the amount to be paid? What happens if Second Bank doesn't notify Beta? What happens if the payment order is fraudulent, and not actually issued by Alpha? What happens if there is a bank failure? These are a few examples of possible errors.

A funds transfer is like a string of Christmas lights: everything is fine until a light burns out. There must be a remedy for the burned out light, and to the extent there are losses they must be paid. What are the remedies if someone takes a loss? Who bears the risk of loss at a given time in the transactional process? No adequate answers to these questions exist without a backstop statutory law that allocates the loss at the appropriate places in the funds transfer. Article 4A provides clear and reliable answers, and thereby keeps the string of lights burning.

To resolve the problem of who is responsible when something in a funds transfer goes wrong, Article 4A divides the actions of the parties to a funds transfer into three essential parts. First, a funds transfer is initiated by the originator and accepted by the originator's bank. Part 2 of Article 4A, entitled "Issue and Acceptance of Payment Order," governs the relationship between the sender of a payment order and the receiving bank that will execute the payment order. What constitutes acceptance and rejection (both rightful and wrongful) of a payment order, and what must be done to amend a payment order, are determined by the rules of Part 2, as these involve the relationship between the sender and receiving bank in a funds transfer.

As between sender and receiving bank, who suffers a loss if there is a mistake? Part 2 of Article 4A resolves this critical issue. Two kinds of mistakes can occur between sender and receiving bank, an unauthorized payment order and an erroneous payment order. The key to the rules on an unauthorized payment order is the "security procedure" that exists between sender and receiving bank. This is the agreed procedure that verifies the authenticity of a payment order or other relevant communication. In electronic funds transfer systems, the security procedure is an important element, and may involve codes, encryption, callback procedures, and the like. Any procedure that can be devised to protect the transaction is eligible. To be legally effective, it must only be commercially reasonable.

The security procedure determines who takes the risk of loss when there is an unauthorized payment order. If there is a commercially reasonable security procedure that is followed by the receiving bank, the sender must absorb the loss. If the sender proves that the security procedure was not followed or was breached by someone outside the control of the sender, the receiving bank takes the loss. The assumption is that the security procedure, if followed and not breached, will verify the authenticity of payment orders.

The risk of loss for an erroneous payment order also hinges upon compliance with a security procedure for detecting error. If the sender proves that it complied with the security procedure, the receiving bank takes the loss. Otherwise, the sender is responsible for erroneous orders.

The second part of a funds transfer is the passage of funds from receiving bank to receiving bank, until the beneficiary's bank is contacted. This is covered by Part 3 of Article 4A, which is entitled "Execution of Sender's Payment Order by Receiving Bank."

Rules governing the relationship between receiving banks are contained in this part. A principal obligation of a receiving bank (other than the beneficiary's bank) is to "execute" a payment order once it has accepted the order - that is, pass it on to the next bank in the string. It executes by issuing a payment order to the next bank. (The beneficiary's bank has a different obligation. It must pay the obligation to the beneficiary, and that is covered in Part 4 of Article 4A.) Unless agreed otherwise, a bank may use any commercially reasonable method to issue a payment order. A receiving bank is, generally, responsible for any error it commits in issuing a payment order. If a receiving bank overpays the beneficiary of a payment order, the excess is recovered from the beneficiary, not from prior senders. If a receiving bank pays a person or entity that is not the intended beneficiary, recovery is from the person receiving the money, and not from any prior sender. Only if a receiving bank underpays in a payment order, may the bank recover from prior senders, and then only an amount to cover the error and only if it issues a curative order.

Part 3 of Article 4A covers other issues pertaining to receiving banks. For instance, rules on reporting an erroneous payment order and late execution of a payment order are furnished.

The last part of a funds transfer involves actual payment to the beneficiary. It is the subject of Part 4 of Article 4A, "Payment." Each sender, going back to the originator, is obligated to pay. At a given time, the beneficiary is considered to have been paid. There is a two step approach to actual payment, although the steps are accomplished simultaneously if the transfer is made by Fedwire. First, credit is extended by each receiving bank to each sender when the sender's payment order is accepted - basically, a communications function. The second stage involves settling up between participants - the actual passage of value.

Perhaps the most important section in Part 4 is Section 4A-402. It provides that a sender of a payment order is obliged to pay the amount of the order to the receiving bank if the funds transfer is properly completed. It is essential to distinguish, in this regard, a payment order from a check.

A check is a kind of payment order. When a per son writes a check on an account, it orders the institution in which the account resides to pay money to a named person (whose technical name is the payee). Although a check suspends the liability of the person who writes it for an underlying obligation until the instrument is rightfully presented for payment and paid at the institution in which the account resides, it can be passed from person to person as payment for other obligations and accrues and extinguishes liabilities for those persons as it passes between them. If the institution refuses to pay when the check is presented, then the person who initially wrote the check is liable for the underlying obligation as well as for the check. In contrast, acceptance of a payment order for a funds transfer by a receiving bank obligates the sender to pay that bank, and that bank alone. There is no instrument that may be passed from hand to hand as payment between other people. There are no lingering liabilities that result from the negotiability of an instrument. A payment order for a funds transfer is simple and direct.

How does settlement take place? If the sender is a bank, and the funds transfer is through one of the funds transfer systems, payment takes place according to the rules of the system that govern settlement between banks. Typically, payment is a matter of debiting an account of the sender with the receiving bank, and crediting the receiving bank's account. These methods hold whether the sender is an individual or a bank.

The beneficiary's bank, the last bank in the string, is responsible for paying the beneficiary. Payment generally takes place by crediting an account of the beneficiary, although satisfaction of a beneficiary's debt also constitutes payment, and payment in general occurs when the funds are available to the beneficiary for withdrawal. The originator of a payment order, that first light in the string of lights, generally is deemed to have paid the beneficiary on the underlying commercial obligation when the beneficiary's bank accepts the payment order. If it seems premature to discharge the originator, it is because at the time of acceptance by the beneficiary's bank, the originator has done all in its power to see that the beneficiary has obtained a credit balance at the beneficiary's bank in the agreed-upon amount. It is analogous to a situation where the originator has deposited cash to the beneficiary's account at beneficiary's bank. At that point, the originator's obligation to the beneficiary should be considered satisfied.

Finally, there are some other features of Article 4A to be considered. First, any transaction that is subject to the Electronic Funds Transfer Act of 1978 is not subject to Article 4A. This express exclusion places consumer transactions outside Article 4A, and leaves them to federal law. Second, the regulations and operating circulars of the Federal Reserve Board supersede any inconsistent provision of Article 4A. Third, transfer system rules will prevail if inconsistent with any part of Article 4A. Fourth, it is possible to vary the effect of most of the provisions of Article 4A, honoring the general Uniform Commercial Code policy of freedom of contract.

The fifth matter of special interest needs extra emphasis. Funds transfers occur and are useful so long as it is fast, efficient and inexpensive to use current and future electronic methods. A great deal of money can be passed through the current system for very little comparative cost. Therefore, Article 4A limits consequential damages for improper payment orders. Consequential damages might raise costs, reduce transaction speed by requiring the exercise of discretion by management, and increase uncertainty.

Article 4A of the Uniform Commercial Code is essential law. The continuance and viability of funds transfers depends upon its advancement in the states. And uniformity is an absolute requirement in every state, unconditionally and without deviation. Otherwise, there will be impairment of the functioning of funds transfers for the long term.

Important Information on Article 4A of the UCC

In 1989, as Article 4A of the UCC is proposed for enactment by the states, over $1 trillion is transferred daily by "funds transfers." Five years ago the daily average was $300 million and two years ago it rose to $500 million. Some peak days now exceed $2 trillion, while utilization continues to grow. "Funds transfers" exceed the total amounts transferred in all other payment systems — credit and debit cards and checks combined. The average "fund transfer" exceeds $5 million.

Yet there is no comprehensive law governing commercial "funds transfers." Regulation J covers the interbank part of any commercial "funds transfer" by the Federal Reserve network (Fedwire). The Clearing House Interbank Payment System (CHIPS) rules cover the bank participants in that system. The Electronic Funds Transfer Act of 1978 covers consumer transactions. In spite of all of that, when a commercial customer initiates a "funds transfer" through a bank for payment to a designated beneficiary, no comprehensive rules and no readily ascertainable law pertains. As a result, most commercial "funds transfers" are made with no provision for the significant liabilities that will accrue if something goes wrong.

Article 4A fills the void. It comprehensively provides coverage of commercial "funds transfers" from the order of the originator to the originator's bank, through intermediary banks, to the beneficiary's bank. No other country has such a comprehensive law, proposed or in being.

Article 4A sets forth safety net rules absent agreement of the parties, covering liabilities and obligations arising from: unauthorized payment orders; proper and improper (wrongful and erroneous) execution of payment orders; fraud; and, insolvency of participating banks. What constitutes payment for the discharge of an underlying obligation is, also, governed by Article 4A.

The major objectives of Article 4A are to preserve a fast, efficient, reliable system for the transfer of large volumes of funds rapidly at a low cost; to provide certainty as to the obligations and liabilities; to safeguard the integrity of the "funds transfer" system; and to establish the basic rights and responsibilities of the participants, except as varied by agreement of the parties.

Benefits to Corporate Users

Most senders of payment orders in a "funds transfer" are banks and corporations. Senders under Article 4A enjoy the following benefits:

1. *Finality of payment* — Funds transferred are essentially equivalent to cash with a more certain degree of finality than is currently the case.
2. *Moneyback guarantee* — If the "funds transfer" is not completed, the originator's bank must return the originator's money.
3. *Discharge of underlying obligation* — A statutory discharge of the underlying obligation generally occurs upon acceptance by the beneficiary's bank.
4. *Commercially reasonable security procedures* -— Substantial incentives for banks to provide reasonable security procedures are fostered or the bank may absorb the loss for an unauthorized order.
5. *Error reporting* — While users have a duty to report errors, failure to do so within a reasonable time results only in possible interest losses. No other damages are imposed.

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6. *Loss apportionment* – If a loss results from an unauthorized order, when there is an agreed security procedure, the receiving bank suffers the loss unless the bank can prove:

the security procedure was commercially reasonable;

the bank followed the procedure;

the bank acted in good faith; and

the bank complied with the customer's written agreement or instructions restricting acceptance of payment orders.

Even if the bank proves the above, should the customer prove that it's without fault, pure interloper losses fall on the bank.

7. *Damages for dishonor* – If the beneficiary's bank has accepted the order and the beneficiary demands payment, the bank, for failure to pay, may be liable for damages, including consequential damages, if the beneficiary gave notice of the particular circumstances that would give rise to such damages and indication of the magnitude of them.

Benefits to Banks

The banking community will benefit as follows from Article 4A:

1. *Certainty* – There is no statutory or case law that adequately governs these transactions. Frequently, contracts between customers and banks are absent or inadequate. Perhaps no contract could be adequate to govern the risks, given the paucity of applicable law. Therefore, all parties to "funds transfers" operate in an uncertain legal environment. Article 4A removes the uncertainty. Certainty as to liability and responsibility promotes sound credit policy and financial management. Since Article 4A largely embraces current operating practices, the efficiency of the present system is preserved.

2. *Banks as users* – As the principal users of the "funds transfer" system, banks will enjoy all of the benefits of Article 4A listed above for users.

3. *Limitation of liability* – Article 4A limits liability to loss of interest and principal, or in certain cases other incidental costs and reasonable attorney's fees. Only in the event of intentional dishonor and with specific notice of the particular circumstances and contemplated magnitude, are consequential damages recoverable.

4. *Statute of limitations* – Article 4A precludes objection to payment of an order executed by a bank unless made within one year from the time the customer receives notice the order was sent.

5. *Creditor processes* – Under Section 4A–502, banks are protected from creditor processes during the fast electronic batch processing of payment orders.

6. *Choice of law* – Section 4A–507 contains rules as to choice of applicable law that will promote certainty.

7. *Netting of obligations* – If banks owe other banks and are owed by those same banks on payment orders sent and received, Section 4A–403

gives statutory authorization for bilateral and unilateral netting of payment obligations among banks to reduce insolvency risk.

8. *Number and name of account* — If a bank discloses to its customer that it may rely upon numbers to identify a beneficiary in a payment order, Section 4A–305(3) authorizes it to rely upon the number used by the customer to identify the beneficiary. Because processing is electronic and rapid, reliance on numbers facilitates "funds transfers."

9. *Rely on tested message* — Banks can rely upon the message that tests against the security procedure, unless the customer proves that the payment order is unauthorized and the breach of the confidential security information did not result from a source controlled by the customer. The bank, however, must have offered a commercially reasonable security procedure to the customer and have followed that procedure and any customer written agreement or instruction, all in good faith.

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Big-Buck Transfers A Big Risk

The law tries to catch up with technology.

BY MARCIA COYLE
National Law Journal Staff Reporter

TAKE A COOL half-billion dollars. Through the miracle of electronic wizardry, zip it from your bank account in Dallas to another account in Zurich — and pray that nothing goes wrong.

If prayers fail, prepare to enter the twilight zone of rights and liabilities, where technology has outpaced law, and law is scrambling to catch up.

The denizens of this uncomfortable twilight zone are big banks, big corporations, big bucks and big risks.

For nearly four years, a committee of the Uniform Law Commissioners, in conjunction with the American Law Institute, has been working feverishly to end the legal ambiguities surrounding so-called wholesale wire transfers, a particular way of making a dollar payment. That effort — expected to produce a new article to the Uniform Commercial Code — has often involved an intense battle between banking and corporate interests.

There is no comprehensive body of law governing wholesal wire transfers, as currently exists for checks and other types of payments, and the financial fallout can be enormous when errors occur. The average transfer — typically between banks and their corporate customers — is $5 million, and total daily transfers now average more than $1 trillion.

"When you look at the amount of money moving, it's striking that there are no backstop rules," says one bank lawyer. "People are transferring the net worth of their companies routinely and relying on private agreements with their banks, or no agreements at all."

Risky Business

The wholesale wire transfer is basically a very simple transaction, says Prof. Robert L. Jordan of the University of California at Los Angeles School of Law, reporter for the ULC drafting committee. If, for example, someone in Los Angeles wants to make a payment to someone in New York, he simply tells his Los Angeles bank to send the money to the other person's bank account in New York, explains the professor. By electronic transfer, the Los Angeles bank sends the payment order to the New York bank, which then credits the amount to the account of the so-called beneficiary — often before the money arrives from L.A.

Small-business users pick up the phone, call their bank and use a code word for authentication to order payment. Large corporate users, such as oil companies that engage in "Star Wars"-like transfers, may be so sophisticated that their computers talk to their banks, adds Thomas Baxter, associate general counsel of the Federal Reserve Bank of New York.

"You really have a spectrum of use," says Mr. Baxter, who, along with the American Bar Association and others, has been advising and monitoring the ULC effort. "In the middle of all this, you have banks debiting accounts of senders and crediting the banks of receivers. We accomplish this by the wonders of technology."

Wholesale wire transfers generally travel over two payment systems — the Fed Wire, operated by the Federal Reserve System, and CHIPS, the Clearing House Interbank Payments System in New York, the largest and only competitor to the Fed Wire. Another system — SWIFT — ties the U.S. systems with other international funds-transfer systems.

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have rules and regulations governing certain aspects of interbank transfers among their members, there are no rules governing the entire transaction — beginning with the so-called originator, who initiates a payment order, and ending with the so-called beneficiary, who gets paid.

Some banks and corporate users rely on private agreements to apportion risks if something goes wrong. "But there has been difficulty getting these agreements," says Mr. Baxter. "It also became clear over time that the rights of third parties could be affected by those agreements."

For example, he adds, what if there is a third-party intermediary bank in the transaction and it fails to settle, i.e., pay the balance? "Neither the originator nor the beneficiary may have selected that bank," he explains. "Who bears the loss?"

There never has been a failure on the CHIPS system, says general counsel Norman Nelson, but that does not mean the clearinghouse is ignoring the potential for one. Although working with the ULC to draft a uniform law, CHIPS also has been working independently to ensure so-called settlement finality, he says.

"If a bank is unable to pay the balance, we're looking at having all other participants to the agreement pay pro rata to make sure the system will settle," Mr. Nelson explains.

CHIPS has 140 participants, international banks with offices in New York through which funds are transferred. "Our record day was the day after Memorial Day when we moved $1.25 trillion," says Mr. Nelson. "On a normal day, we move $600 billion to $700 billion."

DIFFICULT: Washington attorney Carlyle C. Ring Jr. says it's difficult to work out uniform wire transfer laws.

Established in 1970, CHIPS, he says, has "grown and grown and grown," as has the entire wholesale wire trans system. "The main thing now is to a comprehensive body of law."

Commercial lawyers and others close to the wire-transfer field estimate that 90 percent of these transfers are now done without agreements covering rights and obligations.

Computer-Age Growth

Wire transfers have existed for many years, says ULC reporter Professor Jordan, but the volume of money moved has grown dramatically in the past two decades. One major reason for the increase in the number of wholesale wire transfers and their amounts is the arrival of computers, he explains.

Before the computer age, transfers were made on a more primitive basis, such as by paper-fed telex machines, recalls Professor Jordan.

"Along with the computer, there has grown up a whole new profession of cash managers who make sure that business is always using its money so it is earning money," he adds. "The ability to move instantly large sums of money from one part of the world to another has increased the volume of transfers.

"And the potential liability of banks has grown also, to the point where they have become very uncomfortable with the lack of any body of law governing what happens when something goes wrong."

The wholesale wire transfer, says Professor Jordan, is a system based on speed and low cost. The liability question for banks is very important, he explains, adding, "If you load up the liabilities, the costs will be greater."

Some of the financial land mines in the wholesale wire transfer are also a product of the new technology.

"There is now great danger that a computer hacker could get on the line, intercept a payment message and change the beneficiary," says Professor Jordan. "Unauthorized messages also present great potential for fraud."

There also are potential bank insolvency problems, he adds. In many cases, the beneficiary bank pays the beneficiary before it gets the money from the originator bank, he explains. It is customary then for the beneficiary to immediately withdraw the money.

"If the originator bank becomes insolvent, the beneficiary bank has a problem and it's not clear whether the beneficiary bank can get its money back from the beneficiary," he says.

And then there are transfers involving multiple transactions, says Professor Jordan. "What happens if there is a large bank failure? It could set off a chain reaction of other banks failing because of the enormous sums of money they are dealing with."

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When errors occur and banks and their corporate users find themselves in litigation, he says, the courts "have to make up the law as they go along."

Court decisions have been unsatisfactory, according to the professor, because courts must fall back on ordinary negligence rules or analogize the situation to problems involving the more traditional check.

"The rules governing payment by check don't always apply," he explains.

Mr. Baxter agrees, noting that in a check transfer, the authentication device is the signature of the drawer. "In the wire transfer world, we don't have any signature. We're getting into an area where the law is not that sophisticated. Payment law is built around the signature. Now we have to think about new alternatives."

Growing Pains

For the past four decades, the Uniform Commercial Code has been the "premiere product" of the ULC, a confederation of state commissioners on uniform laws, says Carlyle C. Ring Jr., of counsel to Washington, D.C.'s Ober, Kaler, Grimes & Shriver. But it was getting rapidly out of date, he adds.

Ten years ago, he recalls, the permanent editorial board of the UCC appointed a committee to look at whether the commercial code needed to be revised because of electronic developments. The committee launched an ambitious effort to draft a comprehensive payment code covering checks, wholesale wire transfers and other payment instruments.

"The committee got into trouble because it was trying to do too much," explains Mr. Ring, a UCC board member. "Consumer groups and banks were not happy at all."

In 1986, the project was scaled down to focus only on wholesale wire transfers. "Uniform laws have been successful where we've been able to get the various interest groups together," says Mr. Ring. "When we step into an area of strong policy disagreement, it's very difficult to achieve uniformity."

If the uniform law effort fails to address the changing technology, he adds, the federal government will preempt the field. Pressures driving the modernization move, he says, include the Federal Reserve System's concern about major bank failures given the uncertainty over rights and liabilities, banks' anxiety over how they fare in the courts when problems occur and corporate users' demands for fair rules.

When the wholesale wire transfer project began three years ago, Mr. Ring, who is co-chairman of the ULC drafting committee, was in private practice. "My role was to be a neutral facilitator, to keep it on track." Today, still co-chairman, he is also general counsel and vice president of Atlantic Research Corp., a corporate user.

After roughly 12 drafts, proposed Article 4A, governing wholesale wire transfers, has the support of the banking and corporate communities and the Federal Reserve System, according to Mr. Ring, who calls the article "basically a safety net." It will not apply to consumer transactions, which continue to be governed by the federal Electronic Fund Transfer Act.

A 'Hard Fight'

But bringing those three groups together was neither easy nor pleasant, says Arthur L. Herold of Washington, D.C.'s Webster, Chamberlain & Bean.

Mr. Herold is not a member of the drafting committee, but he does represent the National Corporate Cash Management Association, an organization of corporate treasury officers. The corporate community, he recalls, was not aware of the 4A movement until about a year after the drafting committee began work.

During that year, he and colleagues from Exxon, Shell Oil Co., Kidder Peabody and Sears, Roebuck and Co., attended drafting meetings where, he says, "We were treated as outsiders, shouted down and outvoted."

Throughout 1988, he recalls, his association built a coalition of the oil companies, insurance and railroad industries, and retailers to increase its "voice" at the drafting sessions.

"We felt 4A was being bank-driven," Mr. Herold says. "We don't object to a 4A that equitably distributes risks, but if the rules aren't fair, we'd rather take our chances in the courts.

"We told the committee if they wanted corporate support, they would have

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ACTIVE: Thomas Baxter is associate general counsel of the Federal Reserve Bank of New York.

to begin to accommodate our concerns, and if they didn't care, we would have to vigorously oppose enactment of 4A in the states. That tended to get their attention."

Mr. Herold called the effort a "hard fight" that became unnecessarily hostile and personal at times. His association has taken a neutral position on Article 4A even though an internal vote showed more members would support it than oppose it. "We felt the members should feel free to express their own feelings," he says.

But whether Article 4A ultimately will be equitable or will impose significant risks on the corporate community, Mr. Herold says, is still unknown.

"The banks are free from a lot of risk," he adds. "Banks don't like having no law and don't like the current common law. If anyone has a worse reputation with juries than big corporations, it's banks. The banks felt it was better to play with rules than without, and they basically wrote the rules."

But Mr. Herold and others involved in the drafting process credit Professor Jordan for pulling the disparate interests together. "He's a special person," says Mr. Herold. "We had great confidence in his fairness. Without him, I don't think this would ever have been done."

Article 4A, says Professor Jordan, tries to provide more certain rules for these transfers and to reduce the possibility of litigation. "It represents compromises and trade-offs," he explains. "We think we've come up with a fairly well-balanced statute for allocating risks and liabilities."

Into the States

The proposed Article 4A already has been approved by the American Law Institute. Following ULC approval, the next step will be to win enactment in state legislatures, says Mr. Ring.

"Our goal is to pick up four or five big banking states — New York, California, Texas, Illinois, Georgia and Massachusetts — and then the remaining states, we think, will move quickly," he says. "The rest will want to act rapidly to preserve banking business for themselves and because the courts probably will adopt the rules of 4A even before the legislatures act."

Taking the uniform law route is often time-consuming, notes Mr. Ring, adding there was considerable debate about whether new rules should be enacted instead at the federal level.

"But the federal government and the other parties are willing to give us a chance to use the prestige of the UCC to get these rules adopted," he says.

There has been historical deference to state development of commercial law, he explains. The Federal Reserve, he adds, is reluctant to take on new and substantial regulation. And Congress, he says, has become "such a grab bag" that the banking and corporate communities feared legislation could become enmeshed in extraneous issues.

Most uniform laws, Mr. Ring says, draw on experiments in states or other nations. But Article 4A, he adds, did not fit the pattern. England, Japan and the United Nations are looking to the ULC for guidance on similar projects.

"We're not looking at any models because there are none," he says. "As a matter of fact, we're ahead of the rest of the world."

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Early Warning

ONE OF THE BEST and worst aspects of the law is the speed with which it changes. A slow, deliberate pace of legislative enactments produces the most error-free laws. And the doctrine of stare decisis — by which courts generally adhere to decided cases — helps to guarantee stability in the law.

But none of this is helpful in confronting the megaleaps of today's technology, and nowhere is this more apparent than in computers, banking and high finance.

In an era when trillions of dollars move across state and international borders in electronic blips, the law has failed to keep pace. Eventually mistakes, even big ones that could cause banks to fail, are bound to occur. There is currently no comprehensive body of law that will help lawyers and the courts unscramble the ensuing mess. As one bank lawyer noted, "When you look at the amount of money moving, it's striking that there are no backstop rules. People are transferring the net worth of their companies routinely and relying on private agreements with their banks, or no agreements at all."

For the past 3½ years, one group — the Uniform Law Commissioners — has been drafting a model law that tries to apportion risks and liability fairly when problems arise in these multibillion-dollar wire transfers. The ULC, bringing to the process its unique approach to building consensus, apparently has succeeded in gathering together such disparate interests as the nation's banking community, corporate users and the federal government.

But the ULC's effort is just the first step toward bringing the law into the 21st century of finance. The real challenge rests with the states. If fairness and certainty — the two primary goals of the model law — are to govern, the states must move quickly to enact this model legislation. For the entire legal profession — from bar groups to legislators — the ULC effort should serve as one more lesson on the need for early warning systems to detect and confront changes in the law mandated by rapidly changing technology.

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REPORT OF THE AD HOC PAYMENT SYSTEMS LAWS TASK FORCE TO THE BOARD OF DIRECTORS OF THE AMERICAN BANKERS ASSOCIATION

ON

UNIFORM COMMERCIAL CODE ARTICLE 4A FUNDS TRANSFERS

NOVEMBER 21, 1989

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EXECUTIVE SUMMARY

On August 3, 1989 the National Conference of Commissioners on Uniform State Laws approved Article 4A as an addition to the existing Uniform Commercial Code. Article 4A, when enacted into law by the various states, will govern a class of payment transactions known as wholesale funds transfers. Present law, regulation and private agreements covering funds transfers are considered inadequate and generally incapable of efficiently resolving such issues as liability for mistakes, fraud and insolvency.

The provisions of Article 4A were drafted through the joint efforts of Uniform Law Commissioners, academics, bankers, corporate users of funds transfers and regulators. The final version of 4A represents a compromise which attempts to strike a balance between the interests of the public, those of the providers of funds transfer services and those of the users. While the banking representatives would have resolved several issues differently, it is the general consensus of the bankers that participated in the drafting process, as well as the Ad Hoc Payment Systems Laws Task Force, that Article 4A's benefits to the banking system significantly outweigh its disadvantages.

The task force urges the American Bankers Association Board of Directors to adopt a resolution indicating the Association's support for Article 4A and encouraging State Legislatures to enact 4A into law.

Board for the UCC (which is composed of NCCUSL members and members of the American Law Institute) has supervised changes to the UCC when, for example, new commercial practices have made additional UCC provisions desirable.

The adoption of Article 4A is the culmination of a project begun in 1977 to revise the payment provisions of the present UCC (i.e., Articles 3 and 4). The initial drafting effort produced a document known as the Uniform New Payments Code which was designed to cover all types of payments (check, credit card, wholesale wire transfer, etc.) under one uniform set of rules. This work was criticized by the banking industry and due to the efforts of the American Bankers Association, among others, the New Payments Code approach was eventually dropped.

In late 1985 a new committee was organized to draft less sweeping changes to present Articles 3 and 4 of the UCC and to develop a new Article to govern wholesale funds transfers. The drafting committee was composed of Uniform Law Commissioners, academics, and advisors from the banking, legal, regulatory and corporate communities. During the past three years numerous meetings on Article 4A were held by the drafting committee as well as other groups such as the American Bankers and American Bar Associations.

Provisions of Article 4A

Two major interest groups participated in the drafting of Article 4A, the banking industry and the corporate users of funds transfers. The final version of 4A reflects the compromises which were necessary to achieve the support of both groups and, consequently, neither side is entirely satisfied with each and every provision of the proposed law. The remainder of this section highlights the public benefits of 4A and notes the advantages and disadvantages of 4A from the banking industry's perspective.

Public Benefits

One of the key public benefits of Article 4A is that it creates a uniform body of law governing the rights and obligations of participants in a funds transfer. The interconnected nature of the funds transfer system requires that the basic rules underlying the system be the same for all participants. Of course, 4A permits a degree of flexibility by allowing many provisions to be varied by agreement in order to accommodate the needs of different users and providers of funds transfer services.

The public also gains from the certainty created by 4A. One by-product of such certainty is the ability to identify which party to a funds transfer is liable when a transfer is mishandled or when payments are not completed due to the insolvency of a participant in the transfer. This, in turn, permits parties to implement procedures to for late or improper execution of a funds transfer except where the bank has expressly agreed in writing to undertake such liability.

Another troublesome situation for banks addressed by 4A is the problem of name and account number discrepancies in payment orders. The issue often arises in the context of a fraud committed on a bank which is misled into believing that it is sending funds on the behalf of its customer to the customer's account with another bank. Unfortunately, the account number is for the account of the malefactor, not the customer, but the bank receiving the funds does not recognize any discrepancy because it acts on the payment order solely on the basis of the account number. Article 4A resolves such disputes by providing, generally, that the bank receiving the payment order may pay the person identified by the account number and has no duty to determine whether the name and number refer to the same person..

Finally, 4A establishes a relatively short one-year period in which a customer must notify its bank of unauthorized transfers from its account. Failure to raise objection to a transfer within one-year after the customer receives notice of the transfer bars subsequent assertions that the transfer was not proper.

Disadvantages to Banks

While "disadvantages" may be too strong a term, there is no question that Article 4A establishes rules that may be less for example, an intermediary bank in a funds transfer fails and the customer must be refunded (because the transfer was not completed) but the customer's bank is unable to get its own funds from the failed institution.

A somewhat related rule applies to payment to the beneficiary and gives rise to similar concerns regarding inscivency risk. As a general rule Article 4A prohibits the beneficiary's bank from recovering funds once they are paid to the beneficiary. Therefore, a bank which permits its customer to use funds from a funds transfer before the bank itself receives payment assumes the risk in the event that the order is not paid. There are two exceptions to this rule. The first, intended to address transfers conducted through the Automated Clearing House system, would permit a funds transfer system rule to provide that funds transfers through the system are provisional until the beneficiary's bank receives payment. The second addresses transfers through a system (such as the one envisioned for CHIPS) which multilaterally nets participants' obligations and has a loss sharing agreement in place to complete settlement if one or more participants fail to settle. If, despite such loss sharing rules, the system is unable to settle, then the beneficiary's bank would be able to recover payments from the beneficiary.

Conclusion

The task force believes that the present lack of comprehensive rules governing funds transfers must be remedied if this method of

Resolution of the Board of Directors
# of the
American Bankers Association
December 5, 1989

Whereas, The Board of Directors has reviewed the report of the American Bankers Association's Ad Hoc Payment Systems Laws Task Force and recognizes the need for comprehensive and uniform law to govern wholesale funds transfers;

Now Therefore Be it Resolved by the Board of Directors of the American Bankers Association, acting under authority granted to it under the Bylaws of the Association:

1. That the American Bankers Association endorses the addition of Article 4A to the Uniform Commercial Code as approved by the National Conference of Commissioners on Uniform State Laws and the American Law Institute; and

2. That the American Bankers Association urges each state legislature to consider and enact Article 4A in an expeditious manner.

Date ______________________ ______________________
President

Sworn before me this __________ ______________________

day of ____________________, 1989 Secretary

____
Notary Public
District of Columbia

My term expires _____ day of _________, 19__.

APPROVED BY UNANIMOUS VOTE ON DECEMBER 5, 1989

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Business and the Law

Stephen Labaton

States to Regulate Money Transfers

THE sweeping set of regulations for commercial transactions is about to get the most significant addition in decades.

The Uniform Commercial Code is the law in all states except Louisiana and governs everything from checks to the sale of all goods of more than $500. Despite its broad scope, the Code has failed to keep pace with technology: it does not address the electronic transfer of money among banks, a process that has grown in recent times more than 20 percent a year.

But that is about to change. Within the coming months, a new chapter is expected to be adopted by several large states that will for the first time regulate the computerized transfer of funds between banks. Businesses and banks now move more than $1 trillion a day electronically without any clear guidelines about what happens if someone goofs. The average transfer is $5 million.

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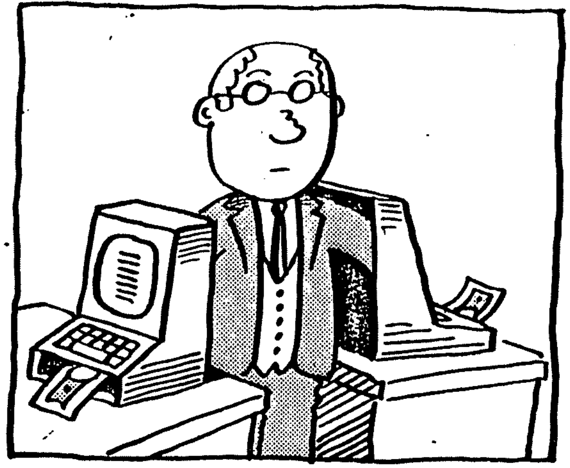
As a practical matter, the courts have tended to define the liabilities and rights of businesses who use the system in terms of contract law. Yet lawyers and banks say only a small percentage of those businesses have signed any contracts with the banks or other businesses on the transfer of funds.

In a typical transfer, the computer of a corporate customer notifies the computer of a bank, which then forwards the information about the transfer to a clearinghouse's computer. It, in turn, notifies the computer of the receiving bank to credit the account of the intended beneficiary of the funds.



Stuart Goldenberg

While the clearinghouses have their own sets of rules, no established laws govern the relationship between the sender and receiver of money. As a result, it is left uncertain who bears the loss for a glitch in the system, a mistake in the transaction, an unauthorized transfer or the meddling of a computer hacker. In many of the dozens of cases that have cropped up, courts have had to draw imprecise analogies to other provisions of the code that do not directly speak to the issue of computer transfers.

A four-year effort to draft the new chapter, known as Article 4A, has recently been completed and legislators say it will soon be introduced in New York, California, Massachusetts, Connecticut, Virginia and West Virginia. With the support of the American Bankers Association and the expected approval soon of the American Bar Association, some legislators in New York and California say the chapter will likely be approved by the summer.

"It will bring a substantial amount of certainty to these kinds of transactions," said Carlyle C. Ring Jr., a co-chairman of the committee that wrote the new rules. "No one really knew in the event of a mishap what would happen. And since such a large amount of money is being transmitted, there is a substantial incentive to litigate these issues."

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The draft was completed by the National Conference of Commissioners on Uniform State Laws, the organization that drafted the code more than 30 years ago. The nonprofit organization consists of lawyers, judges and academics, many of whom are selected as commissioners by state governors.

Like the other sections of the code, Article 4A will operate as a safety net. It will enable the banks and businesses in most instances to write contracts that differ from the Code. It would generally be applicable in those instances in which there are no contracts or when the contracts are ambiguous.

By adopting Article 4A, the states will enter an area of regulation in which the Treasury Department has also announced its intention to intervene. Earlier this year, the Bush Administration said that to combat the use of the electronic transferring system to launder money to avoid taxes and evade narcotics laws, Treasury regulations would be adopted to make it easier to trace the flow of money through the banking system.

One rule will require that the banks that send and receive transfers keep records, including the name and account of the customer transmitting and receiving the funds. Another rule would require that financial institutions receive more information about the nature of the business of a customer who makes use of international transfers. The Treasury guidelines, which do not appear to pre-empt any move by the states, are expected to go into effect this spring.

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Wholesale Funds Transfers

New Article 4A to the UCC

by Carlyle C. Ring Jr.

Five years ago the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI) began a project to develop a new Article to the Uniform Commercial Code (UCC) to cover wholesale wire transfers.

The UCC is a legal framework adopted by states to govern the legal aspects of business and financial transactions in the United States. Its purpose is, as the name implies, to provide a single, uniform set of rules for business to follow.

The author is vice president and general counsel for Atlantic Research Corporation in Alexandria, Virginia. Mr. Ring also chaired the Article 4A Drafting Committee.

In consultation with bankers and the New York Clearing House, it was determined that comprehensive uniform rules for funds transfers were necessary and desirable. Since most payments are covered by state law under UCC Articles 3 and 4, it was deemed appropriate to draft a UCC amendment.

Article 4A has been approved by NCCUSL and the ALI, and has now been endorsed by the American Bar Association.

Article 4A provides the first comprehensive rules for the rapidly growing wholesale funds transfers, which now average more than $1 trillion daily, with peak days over $2 trillion. The total funds transfers daily is many times greater than the total for all checks, debit and credit cards together. Yet there is no set of comprehensive rules governing the responsibilities, obligations and liabilities in the event of error, mistake, fraud, intervention, or insolvency. It is estimated that, in dollar amounts, less than 10 percent of the transactions are governed by contracts between the parties.

While Federal Reserve rules cover the interbank portion of the Fedwire transactions and the CHIPS rules cover the interbank relationships for that system, there is no set of rules covering the funds transfer from the originator through the banking system to the beneficiary. Article 4A fills that void.

A typical funds transfer is illustrated by the following flow chart.

A "payment order" is an instruction of a sender to a receiving bank to pay or cause another bank to pay a beneficiary. In the flow chart shown there are three payment orders: Niagara to Buffalo Bank; Buffalo Bank to Gotham Bank; and Gotham

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Bank to Fresno Bank. A "funds transfer" means a series of transactions, for the purpose of making payment to a beneficiary, beginning with an originator's payment order and ending when the beneficiary bank accepts a payment order.

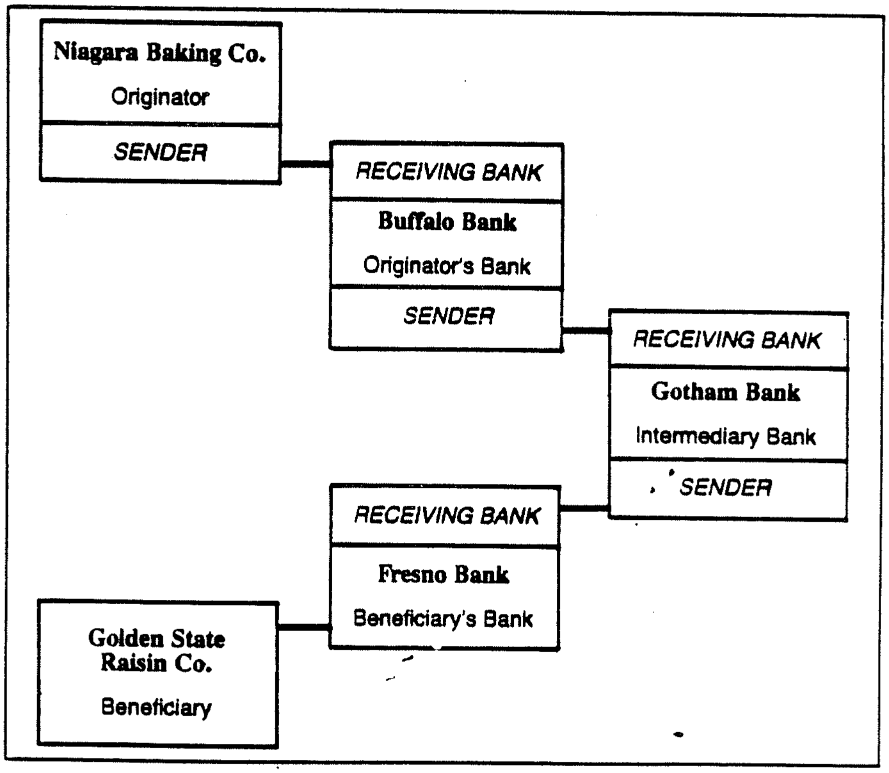
Article 4A covers wholesale funds transfers, including Fedwires, CHIPS, book transfers, and non-consumer ACH credit transfers. It does not pertain to unconditional payment orders transmitted through the banking system and it excludes consumer transactions (e.g. consumer ACH, credit cards, POS), all debit transfers, conditional orders (e.g. payment against release of documents under letters of credit), and transfers outside the banking system (e.g. Western Union).

A payment order is effected when accepted by the receiving bank, generally through execution of the order. Execution occurs when the receiving bank issues a payment order intended to carry out the first payment order it received.

A beneficiary's bank accepts a payment order at the earliest of the following times: when it pays the beneficiary; when it notifies the beneficiary of the receipt of the order for the credit to its account (unless this bank states the credit is not available until it receives payment from its sender); when it receives payment by receipt of final settlement; or at the opening of the next funds transfer business day unless the order is rejected within one hour after the opening of business. When the beneficiary bank accepts the payment order, the underlying obligation between the originator and the beneficiary is discharged.

Unauthorized Payment Orders — One of the key issues addressed by Article 4A is who is responsible for an unauthorized payment order. In effect, Article 4A requires the bank to provide a "commercially reasonable security procedure." "Commercially reasonable" is a question of law (to be decided by the court), taking into account: the wishes of the customer expressed to the bank; the circumstances of the customer known to the bank, including the size, type, and the frequency of the payment orders normally issued by the customer; alternative security procedures issued to the customer; and security procedures in general used by customers in similarly situated receiving banks.

If the bank has complied with the security procedure and written instructions of the customer in good faith, the loss for an unauthorized order falls on the customer, unless the customer proves that his shop was clean. If the customer meets that burden (a pure interloper case), the loss falls on the bank.



23-2/3

Authorized but Erroneous Orders - When a receiving bank accepts an order, it undertakes a duty to properly execute the sender's payment order. That duty is to issue a "payment order complying with the sender's order," which generally covers the amount, beneficiary, and the beneficiary's bank, but may cover the intermediary bank(s), the funds transfer system, the manner of transmission and the time for action. Improper execution may involve errors in amount, wrong beneficiary or wrong beneficiary's bank.

Under Article 4A the bank is obligated to correct such errors and reimburse the originator for expenses in the transfer, incidental expenses and interest losses resulting from the improper execution, but no consequential damages unless there is an "express written contract" covering such damages. Article 4A also imposes a statute of repose of one year.

A more comprehensive summary of Article 4A will be shortly published in the *Business Lawyer* of the ABA.

General Benefits

In summary, Article 4A has the following general benefits to both banks and customers:

- Certainty of result, including ability to assess risks for a cost-benefit analysis in avoidance of litigation;
- Backstop rules filling the gaps in funds transfer agreements and legal framework when agreements cannot be obtained;
- Comprehensive coverage including matters not covered by agreements or system rules, such as discharge of the originator's underlying obligation and limitation of consequential damages;
- Uniformity for the treatment of all funds transfers and standardized terms.

Benefits for Banks

The following are some provisions in 4A that are of particular benefit to banks:

- Banks may rely on an identifying number in the event of names/identifying number inconsistencies;
- Limitation on damages, especially consequential damage recovery;
- Duty of the customer to discover and report unauthorized transfers and erroneous transfers; preclusion to object to debit to account after one year;
- Recognition of multilateral net settlement;
- Right of recovery of CHIPS/ACH payments in the event of settlement failure;
- Right to deduct charges from payment orders.

Customer Benefits

For customers, 4A provides the following benefits:

- Customer is not liable for "interloper fraud";
- Customer has "money-back guarantee" in the event the transfer is not consummated;
- Customer has right to negotiate for increased liability of the banks, although the bank liability generally cannot be reduced;
- Finality of payment;
- Discharge of underlying obligation.

> If the bank has complied with the security procedure and written instructions of the customer in good faith, the loss for an unauthorized order falls on the customer.

Article 4A has passed in Virginia. It has already been introduced into a number of other state legislatures, but of particular importance is New York and California.

It is highly probable that Article 4A will be enacted in both states in 1990, and will become effective in 1991. The choice of law provision permits a funds transfer system to select the law of a particular state to govern transactions through its system. It would be anticipated that CHIPS and Fedwire would by rule choose the law of New York and/or California, once New York and/or California enact Article 4A.

While such action by funds transfer systems would not necessarily remove all uncertainty of the choice of law, for all practical purposes the choice of 4A by the principal funds transfer systems would establish substantially uniform rules throughout the country as well as most international payments as well.

Prompt adoption of 4A by all 50 states, however, is essential to assure certainty and uniformity of the law. Such uniformity is an absolute necessity for funds transfers which involve such huge sums of money that move so quickly, and to preserve the speed, reliability and security of this payment system.

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Sending Large Dollars

U.C.C. Article 4A to Provide Safety Net

Funds transferred by check amount to millions and millions of dollars each year. The legal rules for the check system, although recently somewhat shaken up by federal legislation and regulation CC, basically are well established. Funds transferred by electronic means, including FedWire (operated by the Federal Reserve System) and CHIPS (a funds transfer system operated by the New York Clearing House), often exceed $2 trillion a day. Yet any resulting problems are resolved only to a limited extent by regulation J for FedWire, a few published cases, the Electronic Funds Transfer Act and regulation E for some consumer aspects, and in some cases by the agreements of the parties. In short, the transfers involving the really large dollars, and the most risk if the transfer goes awry, have the least settled guidelines for conduct and for resolving disputes. Uniform Commercial Code article 4A, the U.C.C.'s newest, will fill this void.

As part of the U.C.C., article 4A is the product of the National Conference of Commissioners on Uniform State Laws ("NCCUSL") and the American Law Institute ("ALI"). The drafting committee also was assisted by two Reporters, whose role was to advise the members of the drafting committee as to the pertinent legal issues and what law exists to resolve those issues, and to embody the decisions of the drafting committee in proper statutory form with comments to elaborate on the meaning of the statute. In addition, a number of advisers from the Federal Reserve System, the banking industry, and the businesses that use funds transfers (including banks) worked with the drafting committee. The American Bar Association also appointed an adviser to the drafting committee from the Business Law Section, and members of the Section's Ad Hoc Committee on Payment Systems and its U.C.C. Committee scrutinized and commented on drafts prepared by the drafting committee.

Preparation of article 4A took almost three years. The new article was approved by the ALI at its annual meeting in May 1989 and by NCCUSL at its annual meeting in July–August 1989. Final approval by the ALI is anticipated in December at the latest.

The Council of the Business Law Section has tentatively decided to recommend ABA approval of article 4A when requested by NCCUSL and the ALI. Thus article 4A is ready for enactment by the state legislatures. A number of key commercial states are expected to introduce it soon. Expeditious enactment is contemplated because of the recognized need for greater legal certainty in the governing rules, the general support for article 4A by the interests involved in funds transfers, and the expressed concern of the Federal Reserve System that, unless the states address the significant issues involved in these types of transfers, federal law may become necessary to avoid unacceptable risks to the payment system.

Funds transfers under article 4A

Article 4A creates a series of rules to govern the resolution of legal issues that may arise out of funds transfers. The effect of these rules, like most of those in the U.C.C., may be varied by the agreements of the parties and operating rules of a funds transfer system, with some specific exceptions necessary to protect fundamental policy choices that should not be subject to variance due to fortuitous circumstances of a particular bargain (U.C.C. § 4A-501; *see also* § 4A-107). The ability to vary the effect of the statutory rules allows flexibility and development of new methods, but at the same time, the statutory rules stand as a "safety net" to resolve matters upon which the parties either do not or cannot agree.

Under article 4A, a "funds transfer" (§ 4A-104(1)) is the payment order (§ 4A-103(1)) or series of payment orders by which an originator (§ 4A-104(2)) accomplishes payment to the beneficiary (§ 4A-103(6)) of the originator's order. It can be a very simple transaction in which a corporate originator orders its bank to debit one of its accounts and credit an account of another party at the same bank. In this instance the funds transfer and the payment order are coextensive. If the originator instructs its bank ("originator's bank"—§ 4A-104(3)) to pay a beneficiary that is a customer of another bank, however, that payment order will require the originator's bank, in turn, to issue at least another payment order, perhaps to the beneficiary's bank directly, perhaps over a funds transfer system like FedWire or CHIPS (§ 4A-105(1)(e)), or perhaps to an intermediary bank (§ 4A-104)) that will then issue another order to the beneficiary's bank (§ 4A-103(7)).

Payment orders, unlike checks, do not embody independent rights and liabilities for the payment of money. Rather, the rights and liabilities of the parties to a payment order arise out of the contract formed, generally subject to article 4A and any agreement of the parties, when the payment order is accepted by the receiving bank (§ 4A-103(5)). Apart from contract outside article 4A, a bank has no duty under article 4A to accept a payment order (§ 4A-209). A receiving bank other than the beneficiary's bank accepts a payment order if it executes it (§ 4A-209(1)), and need not reject those orders it does not accept, unless otherwise provided by agreement or the receiving bank had sufficient funds of the sender on hand to cover the order (§§ 4A-210(2), 4A-212).

A receiving bank that accepts a payment order and that is not the beneficiary's bank is obliged to issue a payment order complying with the order of the sender (§ 4A-103(4)) that it accepted and generally to follow any instructions as to routing and method (§ 4A-302). If the resulting payment order does not comply, the sender is not responsible for the error and need not pay the bank other than to the extent of proper execution (§ 4A-303) but, upon learning of improper execution, may have a duty to notify the bank of that fact (§ 4A-304). Indeed, if a funds transfer is not completed by acceptance by the beneficiary's bank of a payment order instructing payment to the beneficiary in accordance with the sender's order, the sender is not obligated to pay for its order, or is entitled to its money back (§ 4A-402(3), (4)).

A beneficiary's bank may accept a payment order in a variety of ways, such as by paying or notifying the beneficiary, and acceptance also may occur when the bank receives payment of the sender's order (§ 4A-403) or by the passage of time if the amount of the sender's order is fully covered by a withdrawable credit balance (§ 4A-209(2)). Acceptance of the order entitles the bank to payment by the sender (§ 4A-402(2)) and generally obliges it to pay the amount of the order to the beneficiary (§§ 4A-404, 4A-405). Failure to do so and to give notice of the receipt of the order may subject the bank to liability. If the beneficiary's bank ac-

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cepts the order, generally at this point the debt of the originator to the beneficiary for which the order was issued is discharged (§ 4A-406).

Scope of article 4A

A payment order can be oral, in writing, or electronic. Like a check, a payment order is an unconditional (except as to timing) instruction to pay a fixed or determinable amount of money to a beneficiary (§ 4A-103(1)). However, a check is not a payment order because a payment order must be transmitted by the sender, not to the payee, but directly to the receiving bank or to an agent, funds transfer system, or communication system for transmittal to the receiving bank (§ 4A-103(1)(c)). For the same reason, the concept of payment order excludes payment by credit card.

VIDEO SEMINAR

Our Section will co-sponsor with the ABA Division for Professional Education "Fundamentals of Asset-Based Financing," to be broadcast via satellite to more than 50 locations nationwide on February 15, 1990, from noon to 4:00 p.m. EST.

Focusing on the basics of asset-based lending, the program will examine the loan from preliminary investigation through closing, including: preparation of loan documents; various types of collateral; guaranties, letters of credit, and debt subordination agreements; relationships between lenders; and usury and regulatory acts.

The program chair is Maury B. Poscover, chair of the Committee on Commercial Financial Services. Other faculty members will include Howard Ruda, Donald Rapson, and E. Carolan Berkley. Registrants at all viewing locations will be able to question the panelists.

The registration fee, which includes study materials, is $135 ($85 for government employees, $65 for law students). To register or to obtain further information, readers should contact Theresa Kittridge, ABA Satellite Seminars, at (800) 621-8986 (outside Illinois) or (312) 988-6200 (within Illinois).

Because payment orders must involve banks (§ 4A-105(1)(b)), funds transfers made by Western Union and the like are excluded; they are sufficiently different from the large, commercial transfers that are the subject of article 4A as to make it inadvisable to employ the same rules. Credit transfers through Automated Clearing Houses ("ACH") are included under article 4A, but ACH debit transfers are excluded, again for the reason they involve sufficiently different considerations (§ 4A-103(1)(b)). Finally, a funds transfer any part of which is governed by the Electronic Funds Transfer Act and its implementing regulation E, which protect consumer rights, is excluded from article 4A to avoid conflicting rules (§ 4A-108). However, a consumer purpose transfer over FedWire, for example, outside of the scope of the federal law could be subject to article 4A.

Salient aspects of article 4A

Three matters in particular are presently a source of litigation concerning funds transfers. These are: responsibility for unauthorized and erroneous orders, liability for damages caused by orders that are improperly executed, and finality of payment. For discussions of the litigation, see the U.C.C. annual surveys at 35 Bus. Law 1129 (1980); 38 Bus. Law. 1130 (1983); 39 Bus. Law 1333 (1984); 41 Bus. Law. 1412 (1986); and 42 Bus. Law. 1291 (1987). Article 4A addresses each of these problem areas.

An authorized payment order may be properly executed by the receiving bank and binds the person identified as the sender. The order may be expressly or impliedly authorized, or the sender may be bound by apparent authority. If the order is not authorized, the bank will have acted improperly in executing the order. However, if a commercially reasonable security procedure (§ 4A-201) was in place, the payment order cleared it, and the bank complied with any instructions of the customer as to a proper account to debit and the like, even an unauthorized order will be effective (§ 4A-202). There is one exception. Even if the order passed an appropriate security procedure, the customer will not bear the loss if the customer proves the order is not attributable to any cause related to the customer's operation (the interloper situation) (§ 4A-203). However, the customer may lose interest owed on any refundable amounts if it does not use ordinary care to detect any unauthorized orders and notify the bank (§ 4A-204).

Payment orders erroneous as to beneficiary, bank, time, amount, or duplicate orders caused by the sender are the sender's responsibility (§ 4A-303). However, such orders only bind the sender as to the intended beneficiary and amount if a security procedure for the detection of error was in effect and the sender complied with it but the bank did not (§ 4A-201). However, again the sender has a duty of ordinary care to discover and report an error (§ 4A-205). A funds transfer or third party communications system to which an order is first transmitted is the agent of the sender; any error made by it is attributed to the sender (§ 4A-206).

Often in fraud schemes or because of mistake, a payment order will identify the beneficiary both by account number and by name, each referring to a different person. Under section 4A-207(2)(a) and (3), the beneficiary's bank is entitled to pay the account if it does not know of the discrepancy and the originator is a bank, or if a nonbank originator received notice that payment might be made by account number even if a name was given. If the bank pays the person identified by name or knows of the discrepancy (§ 4A-402(3)), no person has rights as beneficiary except the person paid by the beneficiary's bank if that person was entitled to payment from the originator. If no person has rights as a beneficiary, acceptance of the order cannot occur (§ 4A-207(2)(b)). If the person paid is not a correct payee, the money back guaranty applies (§ 4A-402(3)). Article 4A also contains provisions resolving situations where the beneficiary's bank or an intermediary bank is misdescribed instead of the beneficiary (§ 4A-208), and governing cancellation (stop payment) and amendment of payment orders (§ 4A-211).

Continued on next page

Sending Large Dollars

Continued from page 7

A funds transfer is used instead of a cashier's or similar check because it is fast and cheap. However, because of the large amounts involved, there is considerable risk if something goes awry; if the banks transmitting the orders had to bear the risk of improper or late execution, funds transfers would cease to be either fast or cheap. Accordingly, absent a contrary agreement, section 4A-305 generally relieves a bank from potential liability for consequential damages because of improper or late execution or the failure to execute a payment order, and provides that for delay, noncompletion, or failure to follow instructions (including the order itself), a bank is liable only for interest losses and expenses, as applicable. Reasonable attorney's fees also are recoverable if a justified demand for compensation is made and refused (§ 4A-305(5)).

Acceptance of a payment order by the beneficiary's bank generally obliges it to pay the amount of the order to the beneficiary (§ 4A-404(1)). However, in some cases the bank itself may not receive settlement for the order. In such event, the obligation of payment and payment are still final as to the beneficiary and any attempt to make it conditional by agreement is ineffective, unless (1) a rule of a funds transfer system used in the funds transfer provides for provisional payment and this rule is accepted by the affected parties after notice before initiation of a transfer, or (2) the order was transmitted over a funds transfer system that has a loss-sharing agreement among participants and nonetheless the system fails to complete settlement under its rules with respect to any payment order in the funds transfer (the "doomsday scenario") (§ 4A-405(3)-(5)).

Conclusion

Article 4A contains a variety of other provisions governing creditor process served on a receiving bank and set-off by the beneficiary's bank (§ 4A-5032); injunctions prohibiting funds transfers (§ 4A-503); preclusion against a customer contesting a payment order made by its bank (§ 4A-505); and the amount of interest payable (§ 4A-506). In addition, section 4A-507 contains rules on choice of law that seek to maximize the certainty of the law governing funds transfers. Indeed, that is the goal of all of article 4A, and its rapid and uniform enactment is necessary to achieve that goal under state law.

Fred H. Miller
Norman, OK

William B. Davenport
Chicago

CALENDAR

1990

Jan. 17–19	*Midwinter* *Committee Meetings:* Corporate Counsel Law & Accounting Partnership & Uninc. Business Orgs. Small Business Santa Fe
Feb. 1–2	Futures Regulation Comm. Puerto Vallarta, Mexico
Mar. 2–3	National Institute: Consumer Fin. Services in the 90's Washington, DC

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A Few Facts About
Revised Article 3 of the UCC

(With Conforming and Miscellaneous Amendments to Articles 1 and 4)

Purpose: To update provisions of the UCC dealing with payment by checks and other paper instruments to provide essential rules for the new technologies and practices in payment systems.

Origin: Completed by the Uniform Law Commissioners, with the American Law Institute, in 1990.

Endorsed by: American Bar Association

State Adoptions:

1991 Introductions:

Arizona
Arkansas
Colorado
Connecticut
Hawaii
Montana
Nevada
New Mexico
North Dakota
Oklahoma
Washington
Wyoming

For any further information regarding Revised Article 3 of the Uniform Commercial Code (with conforming and miscellaneous amendments to Articles 1 and 4), please contact John McCabe or Katie Robinson at 312-915-0195.

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UNIFORM COMMERCIAL CODE
ARTICLE 3 – NEGOTIABLE INSTRUMENTS

– A Summary –

In 1896, four years after the Uniform Law Commissioners (ULC) first organized, they promulgated the Negotiable Instruments Law (NIL). It was adopted in every state in the United States, and was the first successful uniform act. When the Uniform Commercial Code (UCC) was promulgated initially in 1951, the old, venerable NIL was polished up a bit and offered as Article 3 of the new UCC. The old NIL, in either its independent form or as part of the UCC, has governed negotiable instruments in the United States for about 80 years, as its first major revisions are prepared for promulgation by the ULC in the year 1989. Another 80 or so years of service is expected for the revisions.

Negotiable instruments make the economy go around. That is why the law on negotiable instruments is important and why the work of the Uniform Law Commissioners has been lasting and uniformly adopted on this subject. What is a negotiable instrument? It is either a "draft," of which the most common sub–category is the "check," or a "note." A "draft" is merely an order from one person to another to pay money to a third person. A check, as a species of draft, illustrates. A person writes checks on a bank account which the bank maintains on that person's behalf. A check, as a kind of draft, is an order from the person/depositor as "drawer" to the bank/drawee for payment of money to a third person named on the check as "payee."

A "note" is evidence of a debt between the "maker," who promises to pay, and another person. A traditional promissory note is an example. One person borrows money from another person. The borrower signs a piece of paper that obligates him to pay the money back at a time certain. That piece of paper, which evidences the debt, is a "note."

Both notes and drafts can be negotiable or non–negotiable, but negotiability is the issue that makes Article 3 essential. Drafts and notes represent money and have value, based upon that representation. It has long been accepted that drafts and notes can be passed from person to person, well beyond the persons who are parties to the initial transactions represented, almost as easily as money itself is passed from hand to hand. The ability to transfer drafts and notes from person to person, from hand to hand, to "negotiate" them is important to overall economic activity.

That becomes readily apparent when we think about that most common draft, the "check." A "check" is but a draft drawn on a bank. Checks are used to pay for everything, because of their convenience and security. A check has to be negotiable or it simply could not be used for the purposes of paying for nearly everything.

Also, "notes" are bought and sold daily in large quantities on the commercial paper markets in the United States. A person may buy a car or refrigerator on time and sign a note. The dealer will generally negotiate that note to another person in the market for commercial paper, thereby realizing his or her profit and obtaining funds to purchase more inventory to sell. The ability to negotiate these notes, again, is the key to making the market for commercial paper work. The economy needs negotiable instruments, specifically "drafts" and "notes" under Article 3 of the UCC.

"Drafts" and "notes" are "instruments" under Article 3. Besides being orders or promises to pay, they have to have three other characteristics to be instruments subject to Article 3. They must be unconditional orders or promises to pay money on demand or at a certain time. They must be payable to "bearer" or to "order." A bearer instrument simply states that it is

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payable to bearer – no specific payee. Order instruments state the specific person or entity to which payment is to be made. Last, they must promise or order the payment of a fixed amount of money, although this characteristic changes between original and revised Article 3, and that change is described a little later on in this summary.

A negotiable instrument (note or draft) is simply one that a person, called a "holder in due course," who is not one of the persons who created the instrument originally, may negotiate or transfer to another person without difficulty, and who has the power, also, to enforce the instrument according to its terms. If the instrument is a draft, the holder in due course can present it for payment and expect to be paid. If the instrument is a note, a holder in due course can expect to receive payment when the debt is due. The holder in due course can do these things even when the relationship between the original parties to the instrument would preclude their enforcement of the instrument for payment. The holder in due course is the essence of negotiable instruments. Free alienability of these instruments is their important characteristic, and holders in due course are the agents of free alienability.

How does a person become a holder in due course? He or she does so by taking the instrument in good faith from a prior holder for value without knowledge of any defects in the instrument, of any claims against the instrument, or of any defenses that may be asserted against its payment. The holder in due course, therefore, honestly receives the instrument, has paid for it, and can claim innocence with respect to any transactions which may have involved the instrument prior to its coming into his or her possession. The characteristic of innocence is, perhaps, primary.

Negotiation involves a specific sequence of acts that make up the transfer to a holder, and from one holder to another. There are two elements, depending upon the kind of instrument involved. If the instrument is a bearer instrument, delivery of the instrument from one person to another constitutes negotiation. If the instrument is an order instrument, it is negotiated by indorsement of the instrument by the current payee and physical delivery to another person, who becomes a holder.

Some kinds of drafts are bearer instruments, and they are passed from holder to holder just as money is passed. The common check, although it can be made out to bearer, is usually made out to a specific person. That check is an order instrument, and to negotiate it, the payee must indorse it and pass it on to the next holder. If the indorsement is to bearer, the check can be negotiated further simply by delivery to another person who becomes the next holder. If the indorsement is to a specific person, it remains an order instrument, and negotiation requires a further indorsement and physical delivery to another holder. Most of us are familiar with checks and how the rules of negotiable instruments apply to them, so they make good examples for illustrating these rules. It should be recognized that there are other instruments used in varieties of business transactions that are subject to the same general rules.

If negotiable instruments are used handily under current Article 3, why revise it? The basic reason for a revision is the accumulation of decisions based upon current Article 3, some of which have identified problems. It is possible after these many years to respond to these cases in statutory language, correcting the problems that some of the cases reflect. Also, the transactional environment has changed for negotiable instruments. Institutions such as banks, which are heavily engaged in transactions involving negotiable instruments, operate a little differently than they did when the UCC was first promulgated. Technology is a primary factor, along with an imperative need to use it. Check processing is an example of the need to modernize the law of negotiable instruments: Banks need to process checks faster in volume numbers that have grown astronomically. They need to be able to use electronic communications, computers, and visual scanners to process checks. The law of negotiable instruments, and bank deposits must accommodate these kinds of changes.

It is not possible in the context of a short summary to cover every aspect of the revision of Article 3. Remembering that the viability of negotiable instruments was and remains the reason for Article 3, a few of the improvements can be described as examples of the overall revision.

The scope of Article 3 narrows to a degree in the revision. It answers the question of what is a negotiable instrument by admitting, in theory, fewer instruments. Original Article 3 states that is applies to instruments that have certain characteristics of negotiable instruments, except that they are not made out "to order or bearer." Such instruments fall under original Article 3, but no holder of such instruments can be a "holder in due course."

This provision has been viewed as injecting considerable ambiguity into Article 3. Some contracts may have characteristics that make it a question as to whether Article 3 would apply. There may be unanticipated outcomes for parties to such contracts if Article 3 does apply. In revised Article 3, the ambiguity is removed. The only instrument to which Article 3 would apply that is not a bearer or order instrument is a check — an instrument payable at a bank. Checks, whether made out to order to bearer, ought to be treated as negotiable instruments. Holders of such instruments can be holders in due course, also.

Original Article 3 requires that a negotiable instrument state a "sum certain." The requirement of a sum certain is completely eliminated in revised Article 3. Rather than a sum certain, an instrument must show a "readily ascertainable amount of money, with or without interest or other charges described in the promise or order. . . ." Rates of interest may be stated as "fixed or variable."

There is a very specific reason for eliminating the old "sum certain" requirement. Variable rates of interest, pegged to some sort of fluctuating standard rate of interest, are common as they were not in the time Article 3 was originally promulgated. Instruments with variable rates of interest cannot be negotiable instruments with the sum certain requirement, and such instruments should be negotiable instruments. Revised Article 3 assures that variable rate instruments will be negotiable.

Another example of improvements in Article 3 in the new revision is the statement of contribution rules for multiple parties to a draft or notes. If more than one person signs an instrument in the same capacity, Article 3 has always provided that they are jointly and severally liable in that capacity. But revised Article 3 provides further that a party who satisfies an instrument has a right of contribution from co–parties signing the instrument in the same capacity. Further, it deals with contribution when a co–party is insolvent. Contribution is divided between parties who are solvent.

An example for the above rule could involve three persons who co–sign a promissory note as makers. If one of them satisfies the note when it is due, revised Article 3 would permit that person to collect one–third of the payment from each of the co–makers. If one of them is found to be insolvent, the other solvent co–maker would be liable for one–half. The issue of contribution is not addressed in original Article 3.

Original Article 3 provides rules for determining when a cause of action arises or accrues under Article 3. Revised Article 3 adds a statute of limitations. It simply states the time periods within which any action under Article 3 must be brought, as an ordinary statute of limitations provision does.

When an instrument is an order instrument, it requires an indorsement for negotiation. An indorsement is exactly what might be expected, the person to whom payment is ordered signs his or her name on the instrument in the expected place. An indorsed check is a kind of order draft familiar to most people and is an appropriate example.

But indorsements may come with more than the signature. Indorsements that condition negotiation or payment are called restrictive indorsements in original Article 3, because they are intended to restrict the right to negotiate the instrument or to obtain payment. Article 3 has always erred on the side of negotiation.

For that reason, an indorsement that purports to prohibit further transfer or negotiation has been always treated as ineffective.

Certain restrictive indorsements were given effect under original Article 3, however. The "first taker under an indorsement . . . had to apply any value . . . consistently with the indorsement . . . ," for example. Revised Article 3 goes much further in limiting the effect of restrictive indorsements on the right to receive payment. Conditional language does not make an indorsement "restrictive" in revised Article 3. An indorsement conditioning the right to receive payment "does not affect the right of the indorsee to enforce the instrument." A person paying the instrument or taking it for value or collection may disregard the condition and the rights and liabilities of that person are not affected by whether the conditions have been fulfilled." Revised Article 3 errs even further on the side of effective negotiation.

Revised Article 3 follows original Article 3 by honoring certain restrictive indorsements such as "for deposit," "for collection," "pay any bank," and the like. These are restrictive indorsements applicable to instruments that are collected within the banking system. They are indorsements that must be honored, except in the case of intermediary banks or the non–depositary payor bank. While all others who wrongfully pay over such a restrictive indorsement are held for conversion of the instrument, intermediary banks and the non–depositary payor bank are not. Their role as mere conduits to the depositary bank would be impaired if there was liability. Revised Article 3, however, explicitly makes a non–depositary payor bank exempt from liability with intermediary banks, clarifying the position of the non–depositary payor bank as original Article 3 does not.

Revised Article 3 adds indicia of a regularly executed instrument to the other requirements for a holder in due course in original Article 3. If there is "apparent evidence of forgery or alteration" a holder cannot become a holder in due course. To this extent, the notion of holder in due course is a little more limited than in original Article 3, and the notion of innocence is given a little more specificity. However, if an instrument is clearly forged or altered, it is proper to charge the holder with knowledge of that obvious defect, and revised Article 3 does so.

These are examples of the kinds of improvements of Article 3 made in Revised Article 3. Revised Article 3 covers a great many other topics, including liability of parties to instruments, what happens when a negotiable instrument is dishonored, and discharge of instruments. Some of the older mechanical rules pertaining to such matters as presentment of an instrument as a condition to payment are relaxed. But the basic negotiable instrument remains as it was under original Article 3, and under the NIL. The changes in Revised Article 3 are adjustments to the existing act that make it a better one. Revised Article 3 will guarantee the effectiveness of negotiable instruments for the next century.

CONFORMING AND MISCELLANEOUS AMENDMENTS TO UNIFORM COMMERCIAL CODE ARTICLE 4.

– A Summary –

In the Uniform Commercial Code, Articles 3 and 4 are companion articles. Article 3 provides for all negotiable instruments, including checks and certificates of deposit. Article 4 is entitled "Bank Deposits and Collections." Most checks are drawn upon bank accounts, and certificates of deposit are banking instruments. Banks also conduct transactions in other types of negotiable instruments, as well, and are the central institutions for conducting business in instruments. The close relationship between Articles 3 and 4 is, therefore, quite clear.

In 1990, as a revised Article 3 is completed, amendments to Article 4 are also offered. A full revision of Article 4 is not offered. Representatives of the Federal Reserve Board announced in 1990 that it was contemplating the assumption of regulatory control over forward collection of checks, and may extend other regulatory control over bank deposits and collections. The Uniform Law Commissioners and the American Law Institute, therefore, have refrained from major revisions of Article 4, preferring to wait until the scope of the Federal Reserve Board's regulations are determined. The wait may be several years.

However, amendments to Article 4 are offered in conjunction with revised Article 3. These amendments take care of the immediate problems that have developed over the time that Article 4 has been in effect, and update the law pertaining to certain banking practices. It is in the amendments to Article 4 that banks are given the opportunity to utilize the best technology in processing checks, for example.

Article 4 establishes the basic rules by which banks handle checks and other "items" in the process of obtaining payment when presented for that purpose by any holder entitled to such payment. The operative term is "item," a term which covers checks or any instrument handled by a bank for collection or payment. A bank is defined, generally, in Article 1 of the UCC as "any person engaged in the business of banking." One of the amendments to Article 4 sharpens the definition by including "a savings bank, savings and loan association, credit union, or trust company." The broad range of institutions that have customers with accounts and checking privileges clearly become included.

Much of Article 4 concerns the obligations of banks in their varying roles in handling "items." Banks act as "depositary" banks, "payor" banks, "intermediary" banks, "collecting" banks, and "presenting" banks. Much of the transactional environment involves banks dealing with each other in obtaining collection and payment of an "item," and Article 4 reflects this fact.

A "depositary" bank is the bank in which an "item" first appears in the process of obtaining collection and payment. When any person deposits a check, for example, in an account, that person's bank is a "depositary" bank. It is also a "collecting" bank, because its role is to send the "item" on its way to the "payor" bank for payment. It is collecting the value of the check deposited in its customer's account. The last "collecting" bank becomes a "presenting" bank, because it is the bank that delivers the instrument (or its representation) to the "payor" bank for payment. The "payor" bank is the bank in which the person who wrote the check has an account, and against whose account payment will be debited. Any bank in any given situation may perform one or more of these prescribed roles.

The fundamental task is, always, to get the "item" presented by somebcdy's customer to the right bank in a timely manner, so that it can be paid and all participants' books appropriately debited and credited in the process. Article 4, also, deals with the situation in which an "item" is entered into this payment system, and is dishonored. Who carries the loss

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in such a situation? Who warrants what in the process of transferring an "item" from one person or institution to another person or institution? These are the matters that Article 4 addresses. It has provided satisfactory governance for twenty plus years in all states in the United States.

The large share of amendments are for clarification and do not amount to any substantive change in existing sections of Article 4. There are some key amendments to note. Amended Article 4A permits "truncation" agreements, a concept never contemplated in original Article 4. A truncation agreement between a bank and a customer, allows a bank to present an "item" for payment by "transmission of an image of an item or information describing the item ("presentment notice") rather than delivery of the item itself." Rather than deliver the check itself, an image of the check or encoded information of some sort is transmitted. The technology is available to permit such truncation of actual delivery of an instrument. The use of the technology saves time and money. Amended Article 4 allows agreement to use "truncation."

Amended Article 4 has a statute of limitations upon actions to enforce an obligation, duty or right arising under Article 4. The statute of limitations is three years after the cause of action accrues. Original Article 4 has no express statute of limitations, and this surprising omission is corrected in the amended version.

Original Article 4 provides for warranties of customers and collecting banks to a payor of an item. The warranties include good title, lack of knowledge of an unauthorized signature, and no material alteration of the instrument. There are some exceptions if the customer or collecting bank become a holder in due course.

Further, there are warranties from a customer or collecting bank to a subsequent transferee or collecting bank In addition to the warranties mentioned above, the subsequent transferee or collecting bank has the advantage of warranted signatures on the instrument, lack of a defense against payment, and lack of knowledge of insolvency of the maker, acceptor, or drawer of an instrument. These warranties constitute the major obligations of persons and banks under Article 4. Each person or bank has certain responsibilities to the person who takes the instrument offered for the validity of that instrument.

Warranties change to a degree under amended Article 4. Transfer warranties to a subsequent transferee or collecting bank remain much the same. Presentment warranties apply with no exception for holder in due course status. Damages are more specific, as well. The major addition, however, comes with "encoding" and "retention" warranties. These are warranties from one who encodes information with respect to an item that the information is correctly encoded. Retention warranties refer to those who present items pursuant to a truncation agreement and retain the original instrument while transmitting an image of it as presentation for payment. This new warranty notion follows from the concept of truncation agreement in amended Article 4.

Another important amendment to Article 4 takes into account the practice of providing customers an itemized statement of items credited and debited against the customer's account in lieu of providing the actual item to the customer with the statement. Original Article 4 keyed the customer's responsibility to report on altered and/or forged items upon the receipt of the items with the customer's statement. Amended Article 4 permits a sufficiently detailed statement to be notification of altered and/or forged items, and keys the customer's responsibility to report such items upon the receipt of the statement, itself.

However, the bank providing such a statement must keep the items or legible copies for at least seven years, and must supply at least legible copies at the customer's request.

These are examples of the amendments to Article 4 that accompany the revised Article 3. These amendments will assure the utility of the banking system for the long foreseeable future. Perhaps at a future date, depending upon federal action, a fully revised Article 4 will be attempted. But that should not occur for many years. In the meantime the banking system needs these amendments.

Why States Should Adopt Revised Articles 3 and 4 of the UCC

In every state, payment by check and other paper instruments is governed by Articles 3 and 4 of the Uniform Commercial Code., first drafted more than 40 years ago. Article 3 is the most dated article of the UCC. It is merely a revision of the previous uniform act, the Uniform Negotiable Instruments Law, which was drafted in 1896, and is based primarily on 18th and 19th century British case law. Some of the concepts of the concepts of this article are as archaic as the language. Article 4 – based on the Bank Collection Code – was written early in the technological revolution brought on by computers, and substantial changes are now needed to modernize this article. It is evident that revision is needed.

Every state should adopt the Article 3 and 4 Revisions because:

UCC 3 and 4 Needs to be Modernized

Modernization is necessary to accommodate changing business practices. For example, at the time Articles 3 and 4 were drafted, only banks offered checking. Today, banks, savings and loans, credit unions and other brokerage houses offer accounts upon which checks and other payment orders can be drawn, but only banks and checks are clearly governed now.

Much of the language in present Article 3 is unnecessarily technical and archaic. The revisions replace the language with that which can be understood in the 20th century business world. For instance, the present Part 5 on presentment, notice of dishonor, and protest is both confusing and archaic. The revision reorganizes the material in a more logical sequence and significantly modernizes the area.

UCC 3 and 4 Should be Clarified

Revised UCC 3 and 4 will clarify and fix problems that have arisen over the past 40 years of experience with the UCC and negotiable instruments. A principal shortcoming of present Article 3 is its tendency to deal with all instruments in the same way. The revision recognizes that there are two types of instruments – notes and drafts – which usually perform different functions and merit different treatment.

The revised UCC3 also clarifies other provisions in the present article. For instance, cashier's, teller's and certified checks are commonly taken as cash equivalents on the assumption that the obligated bank will pay the check. Revised

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Article 3 makes the obligated bank liable for consequential damages if it refuses to pay. The purpose is to limit consequential damages to cases in which the bank refuses to pay even thought its obligation to pay is clear and it is able to pay.

The Revised Article 4 provides a framework for check truncation, whereby a bank sends forward electronic information rather than the check itself.

Uniformity

The very nature of modern banking and business make it important for every state to adopt Revised Articles 3 and 4. States have interpreted some provisions differently, and a uniform position is needed. If this statute is not kept up–to–date, others will resolve current issues nonuniformly, striking at the long term interest that states have in uniformity.

Conclusion

The goal of the UCC is a uniform law which governs commercial transactions within but also among the states. Uniformity and certainty are necessary to facilitate commerce national in nature. Therefore, it is imperative that states adopt Revised Articles 3 and 4 of the UCC. Uniformity of adoption is as important to Revised Articles 3 and 4 as it was 40 years ago to the original UCC.

Benefits of Revised UCC Article 3

(With Miscellaneous and Conforming Amendments to Articles 1 and 4)

by Carlyle C. Ring, Jr., Chairman, UCC Article 3 Drafting Committee

Revised Article 3 to the Uniform Commercial Code (UCC), with conforming amendments to Articles 4 and 1, constitutes a companion to Article 4A. Both are needed to update the provisions of the UCC to provide essential rules for the new technologies and practices in payment systems since the UCC was promulgated nearly four decades ago. In 1990 the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI) approved revisions to Articles 3 and 4, and they are now offered for enactment in the various states.

When the UCC was first promulgated, three billion checks were handled annually. Currently, over 50 billion checks are processed annually. To handle the increased load with greater reliability, computer and other technologies – such as the MICR line – have made the much needed faster processing possible.

In addition, the Expedited Funds Availability Act of 1987 requires banks to clear checks and to make funds more quickly available. This, too, has accelerated the need for automation and speed in the processing of checks.

The present Articles 3 and 4, written for a paper based system, cannot adequately address issues of responsibility and liability for the new technologies now employed and the procedures required by the Expedited Funds Availability Act and the Regulation CC. While agreements among parties to particular transactions have long provided some relief, such stop gap measures are no longer adequate.

Revised Article 3 is necessary to update, improve and maintain the viability of Articles 3 and 4. Absent such an update, further Federal preemption of state law is even more likely to occur.

Benefits in the Public Interest

Certainty – Revised Articles 3 and 4 remove numerous uncertainties that exist in the current provisions.

Speed and Reliability – The revisions remove encumbrances to use of new technologies of automation, and better conform to Regulation CC to expedite the availability of funds to customers and reduce risks to banks.

Lowers Costs – By providing for the new technologies, lower costs are possible to banks and thus to their customers.

Reduced Litigation – By clarification of troublesome issues – and by the provisions of

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Sections 3–404 through 3–406, which reform rules for allocation of loss from forgeries and alterations — the revisions should significantly reduce litigation.

Benefits to Users

"Good Faith" — The definition of good faith under Sections 3–103(a)(4) and 4–104(c) is expanded to include observance of reasonable commercial standards of fair dealing. This objective standard for good faith applies to performance of all duties and obligations established under Articles 3 and 4, and thus tracks the standard under Article 4A.

Fiduciary Provisions — Section 3–307 protects drawers and persons owed a fiduciary responsibility by imposing stricter standards for obtaining holder in due course rights by a person dealing with the defaulting agent or fiduciary. It also spells out the circumstances under which a person receiving funds has notice of a breach of fiduciary duty, and resulting liability.

Accord and Satisfaction — Under Section 3–311 payees can avoid unintentional accord and satisfactions by returning the funds or by giving a notice that requires checks to be sent to a particular office where such proposals can be handled. On the other hand, the drawer of a full settlement check is protected from the instrument being endorsed with protest and thus losing the money and being liable on the balance of the claim.

Cashier's Checks — Section 3–411 and related provisions considerably improve the acceptability of bank obligations like cashier's checks as cash equivalents by providing disincentives to wrongful dishonor, such as recovery of consequential damages.

Indorser Liability — Section 3–415 gives more time to hold a check before the user loses endorser liability.

Reporting Forgeries — Section 4–406 increases the time a customer has to report forged checks or alterations up to thirty days. It also requires a bank truncating checks to retain the item or the capacity to furnish legible copies for seven years.

Individual Agent and Corporate Liability — Section 3–402, as to corporate instruments signed by agents, (except as against the holder in due course), allows a representative to show the parties did not intend individual liability. It affords full protection to the agent that signs a corporate check, even though the check does not show representative status. Also, Section 3–403(b) makes it clear that a signature of an organization is considered unauthorized if more than one signature is required and it is missing.

Direct Suits — Section 3–420 allows a person whose indorsement is forged to sue the depository bank directly, rather than each drawee of the check involved.

Benefits to Banks

Certainty — Section 3–104 and related provisions clarify what types of contracts are within Article 3, thus promoting certainty of legal rules and reducing litigation costs and risks. Included as fully negotiable are checks that may omit "words of negotiability;" confusion over travelers checks is eliminated; variable rate instruments are included; and there is clarification of the impact of the FTC "Holder" Rule, clarification of the ability of parties to an instrument that is not included in Article 3 to contract for the application of its rules to their contract; and clarification of money orders as checks rather than bank obligations.

"Ordinary Care" – In Sections 3–103(a)(7) and 4–104(c) ordinary care is defined, making clear that financial institutions taking checks for processing or for payment by automated means need not manually handle each instrument if that is consistent with the institutions's procedures and the procedures used do not vary unreasonably from general usage of banks. This clarification is designed to accommodate and facilitate efficiency, thus lowering costs and lowering expedited funds availability risks. The definition of ordinary care relates to those specific instances in the Code where the standard of ordinary care is set forth.

Statute of Limitations – Sections 3–118 and 4–111 include statutory periods of limitations which will make the law uniform rather than leaving the topic to widely varying state laws.

Employee Fraud – Section 3–405 expands a *per se* negligence rule to the case of an indorsement forged by an employee. It also covers that of a faithless employee who supplies a name and then forges the indorsement, but does not require a precise match between the name of the payee and the indorsement.

Bank Definition – The definition of bank is expanded for the purposes of Articles 3 and 4 to clearly include savings and loans and credit unions so that their checks are directly governed by the Code. Section 4–104 clarifies that checks drawn on credit lines are subject to the rules for checks drawn on deposit accounts.

Truncation – Section 4–110 authorizes electronic presentment of items and related provisions remove impediments to truncation. Truncation will reduce risks from mandated funds availability and improve the check collection process. Section 4–406 allows an institution the benefit of its provisions even though it does not return the checks due to truncation. If both the customer and the institution fail to use ordinary care, a comparative negligence standard is used rather than placing the full loss on the institution.

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Article 3 - Negotiable Instruments

TABLE OF DISPOSITION OF SECTIONS IN ORIGINAL ARTICLE 3

The reference to Revised Article 3 is to the revised section that refers to the issue addressed by the Original Article 3 section. If there is no comparable section in Revised Article 3 to a present Original Article 3 section, that fact is indicated by the word "Omitted."

ORIGINAL ARTICLE 3	REVISED ARTICLE 3
3-101	3-101
3-102(1)(a)	3-105(a)
3-102(1)(b)	3-103(a)(6)
3-102(1)(c)	3-103(a)(9)
3-102(1)(d)	Omitted
3-102(1)(e)	3-104(b)
3-102(2)	3-103(b)
3-102(3)	3-103(c)
3-102(4)	3-103(d)
3-103(1)	3-102(a)
3-103(2)	3-102(b)
3-104(1)	3-104(a)
3-104(2)(a)	3-104(e)
3-104(2)(b)	3-104(f)
3-104(2)(c)	3-104(j)
3-104(2)(d)	3-104(e)
3-104(3)	Omitted
3-105(1)(a)	3-106(a)
3-105(1)(b)	Omitted (see Comment 1 to 3-106)
3-105(1)(c)	Omitted (see Comment 1 to 3-106)
3-105(1)(d)	Omitted (see Comment 1 to 3-106)
3-105(1)(e)	Omitted (see Comment 1 to 3-106)
3-105(1)(f)	3-106(b)(ii)
3-105(1)(g)	3-106(b)(ii)
3-105(1)(h)	3-106(b)(ii)
3-105(2)(a)	3-106(a)(ii)
3-105(2)(b)	3-106(b)(ii)
3-106(1)	3-104(a)
3-106(2)	Omitted
3-107(1)	Omitted
3-107(2)	3-107
3-108	3-108(a)
3-109(1)	3-108(b)
3-109(2)	Omitted

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3-110(1)	3-109(b)
3-110(1)(a)	Omitted
3-110(1)(b)	Omitted
3-110(1)(c)	Omitted
3-110(1)(d)	3-110(d)
3-110(1)(e)	3-110(c)(2)(i)
3-110(1)(f)	3-110(c)(2)(iv)
3-110(1)(g)	Omitted
3-110(2)	Omitted
3-110(3)	3-109(b)
3-111(a)	3-109(a)(1)
3-111(b)	3-109(a)(1)
3-111(c)	3-109(a)(3)
3-112(1)(a)	Omitted
3-112(1)(b)	3-104(a)(3)(i)
3-112(1)(c)	3-104(a)(3)(i)
3-112(1)(d)	3-104(a)(3)(ii)
3-112(1)(e)	3-104(a)(3)(iii)
3-112(1)(f)	3-311
3-112(1)(g)	Omitted
3-112(2)	Omitted
3-113	Omitted
3-114(1)	3-113(a)
3-114(2)	3-113(a)
3-114(3)	Omitted
3-115	3-115
3-116(a)	3-110(d)
3-116(b)	3-110(d)
3-117(a)	3-110(c)(2)(ii)
3-117(b)	3-110(c)(2)(i)
3-117(c)	Omitted
3-118(a)	3-104(e) and 3-103(a)(6)
3-118(b)	3-114
3-118(c)	3-114
3-118(d)	3-112
3-118(e)	3-116(a)
3-118(f)	Omitted
3-119	3-117
3-120	4-106(1)
3-121	4-106(2)
3-122	3-118
3-201(1)	3-203(b)
3-201(2)	3-204(c)
3-201(3)	3-203(c)
3-202(1)	3-201(a)
3-202(2)	3-205(a) and (b)
3-202(3)	3-203(d)
3-202(4)	Omitted
3-203	3-204(d)
3-204(1)	3-205(a)
3-204(2)	3-205(b)
3-204(3)	3-205(c)
3-205	Omitted
3-206(1)	3-206(a)

3-206(2)	3-206(c)(4) and (d)
3-206(3)	3-206(b) and (c)
3-206(4)	3-206(d)
3-207(1)(a)	3-202(a)(i)
3-207(1)(b)	3-202(a)(ii)
3-207(1)(c)	3-202(a)(ii)
3-207(1)(d)	3-202(a)(ii)
3-207(2)	3-202(b)
3-208	3-207
3-301	3-301
3-302(1)	3-302(a)
3-302(2)	Omitted See Comment 4 to 3-302
3-302(3)(a)	3-302(c)(i)
3-302(3)(b)	3-302(c)(iii)
3-302(3)(c)	3-302(c)(ii)
3-302(4)	3-302(e)
3-303(a)	3-303(a)(1) and (2)
3-303(b)	3-303(a)(3)
3-303(c)	3-303(a)(4) and (5)
3-304(1)(a)	3-302(a)(1)
3-304(1)(b)	Omitted
3-304(2)	3-307(b)
3-304(3)(a)	3-302(a)(2)(iii); 3-304(b)(i)
3-304(3)(b)	3-304(b)(iii)
3-304(3)(c)	3-304(a)(1),(2),(3)
3-304(4)(a)	Omitted
3-304(4)(b)	Omitted
3-304(4)(c)	Omitted
3-304(4)(d)	Omitted
3-304(4)(e)	3-307
3-304(4)(f)	3-304(c)
3-304(5)	3-302(b)
3-304(6)	Omitted
3-305(1)	3-306
3-305(2)(a)	3-305(a)(1)(i)
3-305(2)(b)	3-305(a)(1)(ii)
3-305(2)(c)	3-305(a)(1)(iii)
3-305(2)(d)	3-305(a)(1)(iv)
3-305(2)(e)	3-601(b)
3-306(a)	3-306
3-306(b)	3-305(a)(2)
3-306(c)	3-305(a)(2); 3-303(b); 3-105(b)
3-306(d)	3-305(c)
3-307(1)(a)	3-308(a)
-307(1)(b)	3-308(a)
3-307(2)	3-308(b)
3-307(3)	3-308(b)
3-401(1)	3-401(a)
3-401(2)	3-401(b)
3-402	3-204(a)
3-403(1)	3-402(a)

3-403(2)(a)	3-402(b)(2)
3-403(2)(b)	3-402(b)(2)
3-403(3)	3-402(b)(1)
3-404(1)	3-403(a)
3-404(2)	3-403(a)
3-405(1)(a)	3-404(a)
3-405(1)(b)	3-404(b)(i)
3-405(1)(c)	3-405(a) and (b)
3-405(2)	3-403(c)
3-406	3-406
3-407(1)(a)	3-407(a)(i)
3-407(1)(b)	3-407(a)(ii)
3-407(1)(c)	3-407(a)(i)
3-407(2)(a)	3-407(b)
3-407(2)(b)	3-407(b)
3-407(3)	3-407(c)
3-408	3-303(b)
3-409(1)	3-408
3-409(2)	Omitted See Comment to 3-408
3-410(1)	3-409(a)
3-410(2)	3-409(b)
3-410(3)	3-409(c)
3-411(1)	3-409(d); 3-414(b); 3-415(d)
3-411(2)	3-409(d)
3-411(3)	Omitted
3-412(1)	3-410(a)
3-412(2)	3-410(b)
3-412(3)	3-410(c)
3-413(1)	3-412; 3-413(a)
3-413(2)	3-414(a) and (d)
3-413(3)	Omitted
3-414(1)	3-415(a) and (b)
3-414(2)	Omitted
3-415(1)	3-419(a)
3-415(2)	3-419(b)
3-415(3)	3-606(g)
3-415(4)	3-419(c)
3-415(5)	3-419(e)
3-416(1)	Omitted
3-416(2)	3-419(d)
3-416(3)	Omitted
3-416(4)	3-419(c)
3-416(5)	Omitted
3-416(6)	Omitted
3-417(1)	3-417
3-417(2)	3-416
3-417(3)	Omitted
3-417(4)	Omitted
3-418	3-418
3-419(1)	3-420(a)
3-419(2)	3-420(b)
3-419(3)	3-420(c)

3-419(4)	3-206(c)(4) and (d)
3-501(1)(a)	3-414(a); 3-502(b)(3),(4)
3-501(1)(b)	3-502(a)(1),(2),(b),(c), (d),(e)
3-501(1)(c)	3-414(e); 3-415(e)
3-501(2)(a)	3-503(a)
3-501(2)(b)	Omitted
3-501(3)	See Comment 1 to 3-414 Omitted
3-501(4)	See Comment to 3-505 Omitted
3-502(1)(a)	3-415(e)
3-502(1)(b)	3-414(e)
3-502(2)	Omitted
3-503	See Comment to 3-505 Omitted
3-504(1)	See Comment to 3-502 3-501(a)
3-504(2)(a)	3-501(b)(1)
3-504(2)(b)	3-501(b)(1)
3-504(2)(c)	3-501(b)(1); 3-111
3-504(3)(a)	3-501(b)(1)
3-504(3)(b)	Omitted
3-504(4)	3-501(b)(1)
3-504(5)	Omitted
3-505(1)(a)	3-501(b)(2)(ii)
3-505(1)(b)	3-501(b)(2)(iii)
3-505(1)(c)	Omitted
3-505(1)(d)	3-501(b)(2)(iv)
3-505(2)	Omitted
3-506(1)	Omitted
3-506(2)	Omitted
3-507(1)	3-502
3-507(2)	Omitted
3-507(3)	3-501(b)(2)(v)
3-507(4)	Omitted
3-508(1)	3-503(b)
3-508(2)	3-503(c)
3-508(3)	3-503(b)
3-508(4)	Omitted
3-508(5)	Omitted
3-508(6)	Omitted
3-508(7)	Omitted
3-508(8)	3-503(b)
3-509(1)	3-505(b)
3-509(2)	3-505(b)
3-509(3)	3-505(b)
3-509(4)	Omitted
3-509(5)	Omitted
3-510(a)	3-505(a)(1)
3-510(b)	3-505(a)(2)
3-510(c)	3-505(a)(3)
3-511(1)	Omitted
3-511(2)(a)	3-504(a)(v)

3-511(2)(b)	3-504(a)(ii), (v) and (b)
3-511(2)(c)	3-504(a)(i)
3-511(3)(a)	3-504(a)(ii)
3-511(3)(b)	3-504(a)(ii)
3-511(4)	3-502(f)
3-511(5)	Omitted
3-511(6)	Omitted
3-601(1)	3-601(a)
3-601(2)	3-601(a)
3-601(3)	Omitted
3-602	3-601(b)
3-603(1)	3-602(a) and (b)
3-603(1)(a)	3-602(b)(2)
3-603(1)(b)	3-206(c)(1),(2),(3)
3-603(2)	Omitted
3-604(1)	3-603(c)
3-604(2)	3-603(b)
3-604(3)	3-603(c)
3-605(1)(a)	3-604(a)(i)
3-605(1)(b)	3-604(a)(ii)
3-605(2)	3-604(b)
3-606(1)(a)	3-605(b)
3-606(1)(b)	3-605(d)
3-606(2)	Omitted
3-701(1)	Omitted
3-701(2)	Omitted
3-701(3)	Omitted
3-801(1)	Omitted
3-801(2)	Omitted
3-801(3)	Omitted
3-801(4)	Omitted
3-802(1)(a)	3-310(a) and (c)
3-802(1)(b)	3-310(b) and (c)
3-802(2)	Omitted
3-803	3-119
3-804	3-309
3-805	Omitted See Comment 2 to 3-104

THE APPROACH OF REVISED UCC ARTICLES 3 AND 4 TO CONSUMER ISSUES

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There are many provisions in Revised Article 3, and in amended Article 4, that affect both commercial parties and consumers alike, such as liability for unauthorized instruments. For the most part, these Articles continue the Uniform Commercial Code (UCC) approach of not differentiating the rules between commercial and consumer transactions. Four reasons exist for this posture.

First, the debate over consumer provisions may preclude or destroy the necessary consensus on the commercial law. The early history of the project to revise Article 3 and amend Article 4, when a "New Payments Code" that included consumer protection provisions, such as limitation of the ability to vary the effect of statutory provisions by agreement, limitation of due course rights, and an error resolution procedure, was the focus, demonstrates this proposition; that effort had to be abandoned. Thus it makes sense to deal with each set of problems separately.

Second, the UCC is not a regulatory statute for the most part. Consumer provisions are regulatory in nature, cannot be made subject to variation by agreement, and require sanctions for violation to insure compliance. Precluding changes in the effect of statutory provisions by agreement generates a rigidity, and sanctions which increase liability exposure produce a quest for certainty, that are particularly inappropriate in a statute like the UCC that needs flexibility to accommodate evolving and changing practices, procedures and technology. Indeed, as many have pointed out, it was the ability to vary the effect of Article 4 provisions by agreements and rules that enabled that statute, promulgated at the beginning of the machine processing of checks, to survive without pressing need for amendment for over 30 years.

Third, a review of state law also will demonstrate that consumer law in relation to Articles 3 and 4 has grown outside of the UCC and as a appendage to it in the area of commercial paper. As a result, state consumer law relating to drafts and notes largely is not uniform across the country. Some states have more consumer protection provisions, and some have less. In these circumstances, a statute to be enacted nationally like the UCC which contained extensive consumer provisions, assuming consensus could be reached on what they should be, could serve well enough in the states with little prior protective legislation, if the provisions chosen were

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perceived to be an appropriate balance for that jurisdiction, but would be unlikely to be accepted in lieu of the established provisions in the states where extensive provisions already had been negotiated, since at the very least the new provisions would unsettle the law and upset old balances long struck.

Finally, it is widely perceived that Articles 3 and 4 must facilitate and not hamper the nationwide check system in functioning at maximum efficiency for the benefit of all its users and in minimizing financial institution risk. Most consumer type provision are inconsistent with this design, since they generally promote the individual customer's interest over the interest of the system and its users as a whole. In doing so, by removing or reducing loss with respect to a customer and shifting it to the institution, such provisions increase costs, which in turn are recovered by the institution by spreading the cost of the loss over the institution's customers. A perfect example of the difference in approach exists in Article 4A with respect to consequential damages. Article 4A rejects placing the liability for such damages on financial institutions in favor of keeping funds transfers rapid and inexpensive. Less dramatic but nonetheless similar policy choices were made in Articles 3 and 4. To illustrate, suppose the law were allowed to impede the market development of check truncation or the automated processing of checks, something present Articles 3 and 4 would do were the effect of their provisions not subject to variation by agreement, in order that customers could be assured of continuing to receive canceled checks and of having their checks and accounts handled by non-automated means to better preserve the stop payment process, a maximum period for allowing a covering deposit to arrive, and the like. Such an approach would slow down funds availability for all users or, given present law on funds availability, elevate financial institution risk. It also would keep costs up and by law deprive users who would like a cheaper service of that option. If "consumer protection" requires an institution to still furnish returned checks, to furnish information on account statements that is not machine readable, and to manually check drawer's signatures and accounts to obtain the preclusion of UCC Section 4–406 and to avoid liability for wrongful dishonor, then lower costs, and speeding up check collection to mitigate financial institution risk stemming from mandated availability times (another "consumer protection"), through check truncation and the automated machine processing of checks, will not be available, or fully available.

This should not be taken to mean that consumer protection provisions are repudiated, however. Rather the judgment with respect to Revised Article 3 and amended Article 4 is that if extensive consumer provisions are deemed desirable after careful consideration of a proper balance in a particular jurisdiction, separate provisions should be enacted. This has been the tested historical approach of the UCC.

This also is not to say that Revised Article 3 and amended Article 4 do not contain provisions that benefit the users of negotiable instruments, which includes consumers as well as commercial users. Some of the more important benefits over what present law provides include:

1. The concepts of good faith under Sections 3–103(a)(4) and 4–104(c) are expanded to include the observance of reasonable commercial standards of fair dealing. This makes it harder for the holder of a note or a check to enforce its

obligation when the maker of the note or the drawer of a check has a good reason not to make payment such as fraud, want of consideration or breach of warranty.

2. Money orders are classified as ordinary checks so as to preserve the right to stop payment if the instrument is lost or there is a problem in the transaction. The experience in states now holding this view suggests this type of instrument will continue to be viable for persons who do not have checking accounts and because the insufficient funds risk of normal checks is mitigated.

3. Section 3–117 expands the ability to use evidence of an agreement made when a note or check is taken to modify, supplement or nullify the obligation represented by the note or check and thus the revision better recognizes the entire agreement of the parties.

4. Section 3–118 clarifies when time will run out for enforcement of "family notes" not really intended to be enforced, and when outstanding bank obligations like cashier's checks, which are often held as a form savings, can no longer be enforced.

5. Section 3–302 explicitly subjects holder in due course rights under Article 3 to consumer protection rules arising in cases or statutes outside of Article 3.

6. Section 3–305 clarifies what sorts of claims which are not defenses to payment nonetheless can be used to offset the obligation to pay against a non–holder in due course, and what defenses, other than surety defenses, that a party like a guarantor has (e.g., what defenses a guarantor can use of the principal debtor's).

7. Section 3–307 better protects drawers and persons owed fiduciary responsibilities by imposing stricter standards for obtaining holder in due course rights by a person dealing with a dishonest agent or fiduciary.

8. Section 3–310 protects the drawer of a check which has been stolen from a payee against suit on both the instrument and the underlying obligation, allowing only the former which requires protection from double liability by bond.

9. Section 3–311 protects the drawer of a full settlement check from it being indorsed with protest and thus losing the money and still being liable on the balance of the claim.

10. Section 3–402, except as against a holder in due course, allows an employee to show that the parties did not intend the employee to be personally liable on an instrument he or she signs, and affords full protection to an employee signing a corporate check who does not show agency status.

11. Section 3–404, as in present law, places the risk of indorsements by imposters and those of dishonest employees who are allowed to sign checks on the drawer or employer, but it does not ignore any negligence of the person or bank that takes the check.

12. Section 3–405 clarifies and limits the scope of the per se negligence rule which imposes on employers the risk of forged indorsements by faithless employees

who supply names of payees, and makes relevant the negligence of the person or bank who later takes the instrument.

13. Section 3–411 and related provisions considerably improve the acceptability of bank obligations like cashier's checks as cash equivalents to close deals and pay off loans, by allowing compensation to the holder in the case of wrongful dishonor by the bank.

14. Section 3–420 clarifies that a person whose indorsement is forged, such as a payee whose check is stolen, can sue one depository bank with which the culprit dealt, rather than having to sue each drawee of the checks involved.

15. Section 3–605 expands the inclusion of suretyship law in Article 3 to modifications of the instrument; eliminates the ability to hold a guarantor by merely reserving rights without notice to the guarantor; and clarifies what constitutes impairment of collateral and that impairment furnishes a defense even to a principal who is jointly and severally liable, thus benefitting guarantors and comakers.

16. Section 4–110 and related provisions remove obstacles to check truncation which can reduce the costs of having a checking account and thus may allow more persons to have accounts at a lower cost than otherwise.

17. Section 4–401 relieves a joint account customer from liability for an overdraft drawn by the other customer unless otherwise agreed or unless the customer benefitted from it. It also gives a customer a clear way to protect against the early cashing of a postdated check, or a clear right of recovery if the bank pays the check after notice to it by the customer.

18. Section 4–403 allows any customer on an account to stop payment or to close the account and clarifies that damages for failure to obey a valid stop include damages for the wrongful dishonor of later items that are dishonored because the stop order was ignored and the earlier check was paid.

19. Section 4–406 increases the outside time a customer has to report forgeries or alterations by the same wrongdoer to 30 days. It also requires item retention or the capacity to furnish legible copies for seven years in the case of truncation.

ANALYSIS OF NEW UCC ARTICLES 3 AND 4

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A. OVERVIEW OF NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS AND AMERICAN LAW INSTITUTE REVISION PROJECT OF UNIFORM COMMERCIAL CODE ARTICLES 3 AND 4 (NEGOTIABLE INSTRUMENTS AND BANK COLLECTIONS)

This is a dual project: Part 1 updates Article 3 for technological developments and changes in business practices, resolves divisions of authority, and modernizes language.

Part 2 updates Article 4 to conform to changes in Article 3 and as feasible to accommodate the impact of Regulation CC, 12 C.F.R. pt. 229. Also Article 4, Parts 1 and 4, have been substantially revised to correct problems and deficiencies, but Parts 2 and 3, which are heavily impacted by Regulation CC, are largely left alone and retained for non-preempted provisions and for items other than checks.

B. ANALYSIS OF BENEFITS OF REVISIONS OF ARTICLES 3 AND 4 TO FINANCIAL INSTITUTIONS

1. "Ordinary care" defined in 3-103(a)(7) and 4-104(c) makes clear that financial institutions taking checks for processing or payment by automated means need not manually handle the instrument if that is consistent with the institution's procedures and does not vary unreasonably from general usage designed to accommodate and facilitate efficiency, lowering

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costs, and lowering expedited funds availability risks. See Rhode Island Hospital Trust National Bank v. Zapata Corp., 848 F.2d 291 (1st Cir. 1988): bank examined all checks over $1000, signatures on lesser checks if it suspected a problem, and made a random check on 1% of all checks for less than $1000; testimony of similar practices by other banks in region and of recommendations of banking experts, also no evidence of increase in forgery losses. Compare Medford Irrigation Dist. v. Western Bank, 676 P.2d 329 (Ore. App. 1984) (failure to examine not ordinary care) with Rhode Island Hospital Trust National Bank v. Zapata Corp., 848 F.2d 291 (1st Cir. 1988) and Wilder Binding Co. v. Oak Park Trust and Savings Bank, 10 UCC Rep. Serv. 2d 916 (Ill. 1990) (commercially reasonable practices do not require examination of all checks).

2. 3-104 and related sections clarify the types of contracts within Article 3, thus promoting certainty of legal rules and reducing litigation costs and risks. Included are: (a) checks that may omit "words of negotiability" (compare present §3-805); (b) elimination of confusion over traveler's checks (compare Xanthopoulos v. Thomas Cook, Inc., 629 F.Supp. 164 (S.D.N.Y. 1985) (traveler's check is like note with second signature similar to indorsement which, if forged, denies holder status) with Thomas C. Cook, Inc. v. Rowhanian, 700 S.W.2d 672 (Tex.App. 1985) (stolen checks without second signature not subject to Article 3); (c) inclusion of variable rate instruments thus overruling Taylor v. Roeder, 360 S.W.2d 191 (Va. 1987), Doyle v. Trinity Sav. & Loan Ass'n, 869 F.2d 558 (10th Cir. 1989), and like cases. See also §3-112: (d) clarification of the impact of the FTC Holder rule; (e) clarification of the ability of parties to an instrument that is not included in Article 3 to contract for the application of its rules to their contract; and (f) classification of money orders as checks rather than bank obligations to clear up a split in the cases (compare Unger v. NCNB National Bank, 540 S.2d 246 (Fla. App.

1989) (akin to cashier's check) with Duggan v. State Bank, 540 N.E.2d 1111 (Ill. App. 1989), appeal denied 545 N.E.2d 108 (Ill. 1989) (treated as ordinary check).

3. Clarification of language and rules generally to make the law more understandable and thus easier of application, and to resolve divisions of authority and ambiguities. For example, the warranty provisions of 4-207 and 4-208.

4. Updating of the rules generally to reflect current technology and accepted business practices. For example, the dishonor rules of 3-502.

5. 3-118 includes statutory periods of limitation which will make this law uniform rather than leaving the topic to widely varying state law.

6. 3-110(d) puts the risk of ambiguity as to whether an instrument's terms make it payable in the alternative or jointly on the issuer rather than on the institution. See C.H. Sanders Construction Co. v. Bankers Trust Co., 1 U.C.C. Rep. Serv. 2d 1563 (N.Y. 1986).

7. 3-302 clarifies that a holder who has not paid or performed the full consideration for an instrument has a pro rata right as a holder in due course. See Korzenik v. Supreme Radio, Inc., 197 N.E. 2d 702 (Mass. 1964) (note taken for partially performed legal services). See also 3-303(b).

8. 3-305 clarifies what sorts of claims can be used in offset against a non-holder in due course. See e.g., Goldberg v. Rothman, 332 N.Y.S.2d 931 (N.Y. Civ. Ct. 1971) (set off not a "defense"). It also eliminates the vague limitation on holder in due course rights that one "has not dealt with party having the defense."

9. 3-311 protects a corporate payee from inadvertently losing its claim due to mechanical processing of a full settlement check. This section follows the line of cases that hold

the law of accord and satisfaction is not displaced by §1-207. Compare Hearst Corp. v. Lauerer, Markin & Gibbs, Inc., 524 N.E.2d 193 (Ohio App. 1987) (no displacement) with Horn Waterproofing Corp. v. Bushwick Iron & Steel Co., 488 N.E.2d 56 (N.Y. 1985) (§1-207 alters common law). To take care of the lock-box arrangement, §3-311 allows the creditor to require any accord and satisfaction attempt to be sent to a particular office or to return the money within 90 days.

10. 3-404 as in present law, places the risk of indorsements by imposters, and those of dishonest employees of drawers, on drawers, but does not require strict conformity with the payee's name to get the benefit. In present §3-405 cases, some deviation in the indorsement from the name of the payee in the check may be fatal. See, e.g., Consolidated Public Water Supply District No. C-1 v. Farmers Bank, 686 S.W.2d 844 (Mo. App. 1985) (deviation from "Layne Western Co." to "Layne Western"). The revision permits a substantially similar name. The revision also will cover the "double-forgery" case and produce the result reached in Perini Corp v. First National Bank of Habersham County, 553 F.2d 398 (5th Cir. 1977) and National Credit Union Administration v. Michigan National Bank, 771 F.2d 154 (6th Cir. 1985) (root cause of loss is forgery of drawer's signature and not that of payee's indorsement).

11. 3-405 expands a per se negligence rule to the case of an indorsement forged by an employee, and in that case and that of the faithless employee who supplies a name and then forges the indorsement does not require strict conformity to the name to place the loss on the employer. Who is within the rule as a "supplier" also is clarified. See e.g., Danje Fabrics Division v. Morgan Guaranty Trust Co., 409 N.Y.S.2d 565 (N.Y.Sup.Ct. 1978). In these cases any negligence of the bank will be taken into account and a comparative negligence standard

adopted instead of the present absolute rule.

12. 3-406 is revised so that negligence of the financial institution does not prevent it from asserting the preclusion, and comparative negligence is the rule. Compare Kuwait Airways Corp. v. American Security Bank, 890 F.2d 456 (D.C. Cir. 1989) (negligence of bank prevented it from asserting §3-406 defense).

13. 3-411 gives a financial institution both clearer guidance with respect to, and a better excuse not to, dishonor its obligation. The section provides for recovery by the holder of a cashier's, certified or teller's check if payment is refused, which recovery can include expenses and consequential damages, and limits the circumstances under which a refusal to pay is a valid defense. As such the revised provision is consistent with the approach in Yukon National Bank v. Modern Builders Supply, 686 P.2d 307 (Okla. App. 1984) and Hotel Riveria, Inc. v. First National Bank & Trust Co., 768 F.2d 1201 (10th Cir. 1985).

14. §§3-416, 3-417. These sections replace present §3-417 and provide for a defense if prompt notice of breach of transfer and presentment warranties is not given. They also disallow disclaimer of warranties with respect to checks. A drawee who seeks recovery for breach of warranty is subject to the defense the indorsement is effective or that the drawer is precluded from raising the alteration or forged indorsement.

15. 3-418 clarifies when payment or acceptance in mistake cases can be recovered or revoked from one not a holder in due course or a reliance payee.

16. 3-420 clarifies that a payee who never received the check cannot sue a depository bank for dealing with a check with a forged indorsement. See Lund v. Chemical Bank, 665 F.Supp. 218 (S.D.N.Y. 1987) so allowing. Moreover what a joint payee can recover is clarified

in missing endorsement cases. See Stapleton v. First Security Bank, 711 P.2d 1364 (Mont. 1985) (one payee allowed to recover full amount of check). A depository bank is made liable in conversion for acting inconsistently with the owner's rights when an indorsement is unauthorized, but the revision blocks suit by the drawer. This settles a major controversy. Compare, Sunbelt Factors, Inc. v. Bank of Gonzales, 481 So. 2d 648 (La. App. 1985) (drawer has no basis for suit) and with Wymore State Bank v. Johnson International, Inc., 873 F.2d 1082 (8th Cir. 1989) (drawer may sue), and Peerless Insurance Co. v. Texas Commerce Bank, 791 F.2d 1177 (5th Cir. 1986) (payee can sue depository bank) with Knesz v. Central Jersey Bank & Trust Co., 477 A.2d 806 (N.J. 1984) (payee cannot hold depository bank). But compare Insurance Co. of State of Pa. v. Citibank (Del.), 9 U.C.C. Rep. Serv. 2d 620 (N.Y. App. Div. 1989), appeal den. 543 N.E.2d 746 (N.Y. 1989) (drawer of forged checks paid over unauthorized restrictive indorsements not allowed to sue depository bank) with Olean Camp Fire Council, Inc. v. Olean Dresser Clark Federal Credit Union, 9 U.C.C. Rep. Serv. 2d 625 (N.Y. App. Div. 1989) (contra).

17. 3-605 clarifies who has the impairment of collateral defense (it is both sureties and makers) (see Crimmins v. Lowry, 691 S.W.2d 582 (Tex. 1985) (co-maker with right of recourse included) and what constitutes impairment of collateral. But see, e.g., Wisconics Engineering, Inc. v. Fisher, 466 N.E. 745 (Ind.App. 1984) (decline in fortunes of company when secured party voted the collateral stock). The defenses are extended to include modifications and may be limited to the extent of actual prejudice.

18. Credit and debit card slips are clearly excluded from Article 4 leaving them governed by system rules but free of issues like stop payment and the like.

19. The definition of "bank" is expanded for the purpose of Articles 3 and 4 to clearly

include S & L's and credit unions so that their checks are directly governed by the Code. 4-104(1)(a) also will include checks on credit lines.

20. 4-106 clarifies that a bank named on a draft drawn on a non-bank drawee is a collecting bank and not a co-drawee subject to the midnight deadline. See Reynolds-Wilson Lumber Co. v. Peoples National Bank, 699 P.2d 146 (Okla. 1985), which held a bank named along with a non-bank drawee was a co-drawee, is overturned.

21. 4-109 clarifies that failure of equipment or interruption of computer facilities may be an excuse with respect to the midnight and other deadlines. See Port City State Bank v. American National Bank, 486 F.2d 196 (10th Cir. 1973), construing present §4-108 to extend to computer failure.

22. The process of posting is eliminated as a point of payment or cut-off for stops, garnishment and the like as inconsistent with automated processing, but 4-303 allows the bank to set a cutoff hour by agreement for checks before its midnight deadline. This would change the analysis in Merrill Lynch, Pierce, Fenner & Smith v. Devon Bank, 832 F.2d 1005 (7th Cir. 1987), cert. den. 108 S.Ct. 1473 (1988), where the bank having posted the check on August 2 was not allowed to dishonor the check on August 3 (the midnight deadline was 11:59 p.m. on August 3) when it learned a check deposited in the account has been dishonored.

23. 4-110 authorizes electronic presentment of items and related provisions remove impediments to truncation to reduce risk from mandated funds availability and improve the check collection process.

24. 4-205 is clarified to allow a depositary bank to become a holder without obtaining a customer's actual physical endorsement. See Bowling Green, Inc. v. State Street Bank and

Trust Co., 425 F.2d 81 (1st Cir. 1970).

25. §4-209. Provides warranties by the depository bank against misencoding errors. These provisions will deal with underencoding as in SOS Oil Corporation v. Norstar Bank, 548 N.Y.S.2d 308 (N.Y. App. Div. 1989) ($255,000 item encoded for $25,000) and Azelea City Motels, Inc. v. First Alabama Bank, 551 So. 2d 967 (Ala. 1989) ($100,000 item encoded for $10,000) (payor accountable for full amount), and with overencoding as in the Port City, case, supra ($72 check encoded for $72,000).

26. 4-214 clarifies that a collecting bank that goes beyond its midnight deadline does not lose chargeback but only is responsible for resulting loss. See Appliance Buyers Credit Corp. v. Prospect National Bank, 708 F.2d 290 (7th Cir. 1983). On the right to charge-back even after funds availability under Regulation CC, see Coffee Trade Servs., Inc. v. First Fidelity Bank, N.A., __ F.Supp. __ (D.N.J. 1989) and Reg. CC Commentary ¶229.32(b).

27. §4-302 codifies the line of cases that excuse delay beyond the midnight deadline where the person presenting was attempting to defraud the bank. See, e.g., Bank Leumi Trust Co. v. Bally's Park Place, Inc., 528 F. Supp. 349 (S.D.N.Y. 1981) (holder of check known to be drawn on insolvent estate not entitled to enforce liability for late return of check).

28. §4-401 clarifies the liability of a joint account holder for an overdraft (see, e.g., Williams v. Cullen Center Bank, 685 S.W. 2d 311 (Tex. 1985), (no liability absent contract, benefit or ratification), as well as the post dated check problem where the check is presented and paid before its date (the check is properly payable unless notice of it is given to the bank).

29. 4-402 is revised to eliminate the trader rule. See Elizarraras v. Bank of El Paso, 631 F.2d 366 (5th Cir. 1980) (trader rule not abolished). It also allows a bank to check the

account balance once within its midnight deadline and not be liable if it dishonors on that basis and a later credit comes in; this brings the law into line with practice in dealing with checks by automated means and confirms agreements that so provide.

A comment will clarify that §4-402 does not displace theories outside of Article 4 that may allow a non-customer to recover. C.f. Thrash v. Georgia State Bank, 375 S.E. 2d 112 (Ga. App. 1988) (president of closely held corporation could not recover damages for wrongful dishonor).

30. §4-406. The revised section authorizes a descriptive bank statement to facilitate truncation and permits as little information as item number, amount, and date of payment. The bank, as discussed previously with respect to the duty of care, does not fail to exercise ordinary care merely because it does not examine every item. If both it and its customer fail to exercise ordinary care, a comparative negligence standard prevails. The outside time for a customer to report successive forgeries or alterations is increased to 30 days.

C. SIGNIFICANT OTHER PROVISIONS OF REVISED ARTICLES 3 AND 4

Article 3

1. §3-103(a)(4). Good faith is defined as honesty in fact and the observance of reasonable commercial standards of fair dealing.

2. §3-307. In Smith v. Olympic Bank, 693 P.2d 92 (Wash. 1985), the court held that a bank which allows a guardian to deposit a check payable to him as guardian in his individual account is not a holder in due course. See as contra Knox v. Colum bia Banking Federal Sav. & Loan Ass'n, 477 N.E.2d 448 (N.Y. 1985) (bank that cashed check payable to guardian not

liable when money deposited to individual's account). The revision follows the Smith case. The revision also would deny holder in due course status to a payee who knowingly takes a corporate check made out to it in payment of the personal debt of a corporate employee, overruling to that extent Eldon's Super Fresh Stores, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 207 N.W.2d 282 (Minn. 1973). But note Hartford Acc. & Indem. v. American Express, 542 N.E.2d 1090 (N.Y. 1989): "it is common practice in the business world for corporate checks to be used to pay employee expenses."

3. §3-310. Under present law if a bank instrument is taken the underlying obligation is discharged unless there is recourse on the instrument against the remitter. §3-802(1)(a). The revision will discharge the obligation but keep recourse on the instrument.

Under present law it is unclear whether the drawer of a check on which the indorsement of the payee is forged and which is paid is discharged. Under the revision, the drawer is discharged on the obligation but may be sued by the payee on the instrument under §3-309 (which replaces §3-804).

4. §3-402. The revision always allows, except as to a holder in due course, an agent to try to prove his or her signature was made in a representative capacity no matter the form of the instrument, thus changing §3-403(2)(a). Compare United Burner Serv., Inc. v. George Peters & Sons, Inc., 5 U.C.C. Rep. Serv. 383 (N.Y. Sup. Ct. 1968) (individual liability even if plaintiff knew intent to sign as agent). In addition, the provision denies agent liability on a check written on a corporate account, overruling cases like A.L. Jackson Chevrolet, Inc. v. Oxley, 564 P.2d 633 (Okla. 1977).

5. §4-111. A three year statute of limitations to enforce an obligation or duty under

Article 4 is created.

6. §4-207 and §4-208. Conform Article 4 transfer and presentment warranties to the changes in the comparable Article 3 provisions.

7. §4-403. Clarifies that any person authorized to draw can stop payment of any item. The revised provision, however, does little to clarify the rule in Staff Service Associates v. Midlantic National Bank, 504 A.2d 148 (N.J. Super. 1985) (stop order 60¢ off valid; disclosure that all information had to be accurate not enough to properly warn customer) and in Parr v. Security National Bank, 680 P.2d 648 (Okla. App. 1984) (stop payment order 50¢ off valid even though computer needed exact amount) as to what constitutes a proper stop order.

PO Box 37347
Washington, DC 20013

Freddie
Mac

November 1, 1990

Dear State Legislator:

The Federal Home Loan Mortgage Corporation, more commonly known as Freddie Mac, asks that you support the passage into law of Revised Article 3 of the Uniform Commercial Code (UCC) proposed by the National Conference of Commissioners of Uniform State Laws (NCCUSL). In particular, Freddie Mac asks that you adopt Sections 3-104 and 3-112 of Revised Article 3 which would permit adjustable rate mortgages ("ARMs") to be included within the definition of "negotiable instruments".

By way of background, Freddie Mac was created by Congress in 1970 to increase the supply of money which primary mortgage lenders can make available to home buyers nationwide. Freddie Mac fulfills its Congressional mandate by purchasing investment quality mortgages from primary lenders, packaging the mortgages as securities, and selling the securities to investors. In this way, Freddie Mac facilitates the flow of affordable mortgage funds from investors to borrowers. Since its inception in 1970, Freddie Mac has assisted in the financing of one in eight American homes.

Under current UCC guidelines, to be a negotiable instrument a note must, among other things, contain a promise to pay a "sum certain" in money. If a negotiable instrument is transferred in compliance with Section 3-302 of the current UCC, the transferee who (1) pays value for it (2) in good faith and without notice that the note is overdue and without notice of any other claim to the note, can become what is known as a "holder in due course" of the note. The transfer under Section 3-302 of a note that is non-negotiable will not give the transferee holder in due course status.

Several courts have reasoned that since an ARM note refers to an outside index from which adjustments in the interest rate are determined, it is not possible to calculate from the face of an ARM note the amount of the principal and interest to be paid on the note. Thus, courts have found that an ARM note is not for a "sum certain" and, therefore, is not a negotiable instrument. Consequently, according to some courts, a transferee of an ARM note is not a holder in due course.

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Attaining the status of a holder in due course is important because, when a negotiable instrument is in the hands of a holder in due course, the holder takes the instrument free of certain defenses that might have been asserted against the transferor by a prior party. In other words, in the event of a foreclosure action or any other legal dispute, if the plaintiff is not a holder in due course, the plaintiff may be defeated by any defense, real or personal, which the defendant can establish to avoid payment of the note. On the other hand, if the plaintiff is a holder in due course, the plaintiff will cut off any personal defenses of any other party on the instrument with whom the holder in due course has not dealt. A holder in due course also cuts off claims of ownership or other claims.

Since the UCC protections available to holders of negotiable instruments (such as fixed rate notes) do not currently extend to ARMs, investments in ARMs are certainly more risky than investments in fixed rate mortgages. Because of the volume of ARMs purchased by Freddie Mac, if ARMs continue to be excluded from the definition of negotiable instruments, ARMs may have to be priced higher to cover the additional investment risk.

At least 13 states have already passed laws to address the ARM negotiability problem and the NCCUSL has obviously recognized the importance of adopting a uniform law which permits ARMs to be treated as negotiable instruments. For the reasons set forth above, Freddie Mac urges you to adopt the NCCUSL revisions to Article 3 of the UCC which would make ARMs negotiable instruments and permit the holders of those notes to claim the status of a holder in due course. If you have any questions, please feel free to call me at (202) 789-4586.

Sincerely,

Lauren W. Meservey
Manager, State Government Relations

THE IMPORTANCE OF THE UNIFORM COMMERCIAL CODE

Beginning in 1991, the National Conference of Commissioners on Uniform State Laws, celebrates the 100th birthday of its founding. At 100 years, the Conference may look back on an illustrious record: the successful promulgation of many uniform and model acts; achievement of uniformity in a diverse portfolio of acts; a prestigious membership; and an unbroken record of service to state government.

It is fitting to pause a moment to reflect on that 100 years at the mid–point of an effort to update what is perhaps the most important effort of the Conference – the Uniform Commercial Code (UCC). The Conference focused on commercial law almost from the beginning: the Uniform Negotiable Instruments Law was promulgated in 1896, only four years after its first annual meeting.

For those interested in historic conjunctions, William Jennings Bryan made his "Thou shalt not crucify this nation on a cross of a gold" speech in that year, reacting to the depression precipitated by President Grover Cleveland's withdrawal of the silver standard in 1893. These are events lost in a mythic past, but perhaps they should inform us as we enter the decade of the 1990s – with not only a new Article 3 as a second generation successor to the Uniform Negotiable Instruments Law, but also updates of other UCC Articles and completely new Articles to serve in what may be perilous economic times.

The issue is fundamentally the same. Can we create law for a viable, functioning community in a federal system of government? Twice in history the legal profession, the financial institutions, the citizens of the United States and state government have answered yes. The Uniform Negotiable Instruments Law and other uniform commercial acts like the Uniform Sales Act were uniformly adopted. So was the original Uniform Commercial Code – even for the most part in Louisiana, which recently adopted Article 9 because people interested in doing business in Louisiana demanded law that they were familiar with. Uniform commercial law is good for business. But it will be interesting to see if widespread enactment of necessary revisions can be done uniformly.

The National Conference is a unique institution. Uniform law commissioners are all lawyers by the rules of the Conference and by the tradition governing their appointment. They are also state officials, though unpaid state officials, and regard state government as a kind of client for their wares – the uniform and model acts. So commissioners have both a double identity and a double obligation – they are part of the spectrum of organizations of the legal profession and part of the spectrum of organizations representing state governmental interests.

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The Conference began in true grassroots fashion. State commissions began to form in 1889, following resolutions passed by the state legislatures. In 1892, there were seven such commissions, enough to hold the first national conference in the suite of one of the commissioners at Saratoga Springs, New York, just following the American Bar Association meeting of that year. The entire uniform law movement grew from that modest beginning, sustained by the states to this day.

What is even more remarkable than the grassroots quality of its origin, is the everpresent "against the grain" orientation of its activities. This is a profession enamored with the common law in its training and traditions, notwithstanding the intentions of our forefathers (and probably some mothers, too), who seemed to regard law-making as a legislative activity. The 19th century scholastic battles between "common law" and "statute" mostly were won by common law, at least in academic circles. Statutes and legislation continued to be virtually ignored. The Conference, in the profession and among its own academic members, remains a kind of vestige, in the minority, in the image of David Dudley Field, the great 19th century proponent of statute.

But the UCC may be seen in our time as a watershed event. For here is the monumental distillation of the common law, modified for sound economic reasons, into statute. It was unprecedented, and is extraordinarily successful. It should be regarded as a triumph of democratic processes, and should commend those processes to the ever skeptical legal profession as we enter a new phase of the UCC — that of revising it to meet modern business practices and technologies.

The success of the UCC is rooted in a very simple proposition. It is a proposition that should give pause to significant areas of common law persistence. Further, it is a proposition that has nothing to do with sustaining a federal system of government. This proposition is that the common law is inadequate to govern any complex transactional environment. The UCC reflects commercial necessity. The alternative simply costs too much. The law must emanate from the legislatures, and there must be uniformity — meaning a common language of the law upon which both business and the legal profession can rely. This is the simple truth about the Uniform Commercial Code, a truth that the business and financial world instinctively understood, and so it became a reality in the time of economic expansion following World War II.

The uncertainty of the common law makes it an unreliable source for complex transactional environments. But private law, with its inherent complexities, requires refined legislative development. It requires institutions with the capacity to do the careful work in the policy arena coupled with devotion to careful drafting. This is a combination of policy and craft. The institutions must be situated within the broader boundaries of the legislative branch of government, if they are to function adequately, and if thcy are to reflect the norms of a democratic society.

When we look at government in the United States at any level, we find very little commitment to the development of such institutions. The federal government has none at all. At the state level, there are several law revision commissions which have some of the essential characteristics. But despite the excellence of some of the work in these state institutions, their influence ends at the borders of the states that have created them. For the development of national legislation, and for the advocacy of uniformity, there is only one institution — the National Conference of Commissioners on Uniform State Laws. If there were no Conference, it would have to be invented. This is a necessity in a democratic society with a federal system of government.

The devotion of the Conference to the UCC, then, should come as no surprise. It is the institution charged by state government with the responsibility for private law development and for the promotion of uniformity. It was natural for it to take up the responsibility for commercial law development as business and the legal profession found the common law inadequate for the task. The need for craftsmanship, for a studied, non–partisan approach to development of the law, all these factors led the Conference to the field. After half a century of individual commercial acts, some of them more successful than others, the leadership of the Conference steered it towards the Uniform Commercial Code. They got it drafted and they got it adopted. There was virtually no other institution with the position, the opportunity and the ability to get the job done.

Today the task is somewhat different. The UCC is simply the familiar landscape which is a background for business and the practice of law. We are three and four generations of commercial lawyers removed from its founders, and are confronted with the problem of maintaining the commercial law, much in the image that the founders cast it, while updating it for utility into the next century. It is a much larger commercial world than existed in the formative period after World War II. There is a commercial bar that did not exist in the time of its founding, and that would not exist but for the UCC. The specter of federal preemption does not abate, but continues to grow as the United States approaches this final decade of the 20th century, our gay '90s — or so we hope it is reported when the annals are written.

But the principal task is much the same. The need for an institution that can carefully and expeditiously carry out the codification of private commercial law remains, as it must remain in a diverse, federal system of government. It now must reestablish the Uniform Commercial Code as revised and updated. Uniformity must be reestablished within a reasonable timeframe. The functioning of the financial community depends upon the swift action on the part of the legislatures.

Everybody should take into account the question: what happens if this enterprise of revision does not succeed? Can we rely upon the federal government? There is no agency with the tradition, experience or mission in the federal government that can be identified. Further, the development of such an institution is more than highly unlikely. In the matter of reliance over time, there is no alternative to the Conference and the state legislatures.

The prospect suggests substantial reliance upon the institutions — the National Conference in partnership with the American Law Institute — that have promulgated these revisions. Reliance and forbearance must be the watchwords. We must allow uniformity to become a primary value in evaluating the work of the revision of the UCC. Otherwise, the unthinkable may be thought, and the commercial law be uniform no more.

Reliance and forbearance and relinquishment of some of our common law orientation are the needs of our time. We must bring ourselves to rely upon the process that brings these acts into being. We must forbear when they are presented to the various legislatures from unnecessary and delaying amendments. And we must adopt an analytic approach to statute–making that looks for essential policy. Once that essential policy is articulated within the process of the institution that develops that legislation, we must rely upon the chosen language unless that language is so faulty as to defeat the policy entirely.

In 1991, the Conference embarks upon its 100th year of advocacy for uniform acts, and most particularly its advocacy of the Uniform Commercial Code. After 100 years, there is much to be done. The Conference invites the legal profession to join it in that celebration by recreating uniformity in commercial law as soon as possible.