Chapter 3.
Uniform Commercial Code (UCC)

After reviewing this chapter, you should be able to:

1. Describe how contracts governed by Article 2 differ from those governed under the common law of contracts
2. Understand the various ways of entering into sales contracts
3. Describe the UCC Statute of Frauds
4. Understand transfer of title and risk of loss
5. Understand bulk sales transfers
6. Understand the nature of a negotiable instrument
7. Identify the different kinds of commercial paper and the formal requirements of negotiability
8. Define a “holder in due course”

Laws relating to the sale of goods (sales law) have their origin in the common-law principles of contracts (basic contract law). However, Article 2 of the Uniform Commercial Code (UCC), which governs sales law, has made changes that meet the needs of merchants and consumers who deal with each other contractually in a modern business world. In effect, the UCC has relaxed the rules relating to sales transactions by removing many of the technical requirements found in basic contract law. Under the UCC, it is now easier to form a binding sales contract. In fact, a sales contract may be made in any manner sufficient to show that the parties intended to be bound, even though essential terms such as price, quantity, place and time for delivery, and terms of payment are missing. These missing terms can be added later by the parties or supplied under other provisions of the Code. To offset these relaxed rules, however, the Code does insist that the parties perform in good faith (honestly) and that the dominant party deal fairly with the other party to the sales transaction.

The UCC defines a sale as a contract that transfers ownership of goods from the seller (vendor) to the buyer for a price. Under the UCC, goods are defined as tangible personal property. The term goods also includes other items such as growing crops and timber to be cut, minerals (including gas and oil), and structures – if severance is to be made by the seller – money bought and sold as a commodity, the unborn young of animals, items specially manufactured for a buyer, and items that are attached to real property that can be easily removed without doing material harm. The term goods does not include intangible personal property such as shares of stock.
Article 2 generally applies to all sellers and buyers, whether they are merchants or nonmerchants. In a few limited provisions of Article 2, some special rules apply only to sales contracts between merchants. A merchant is a professional. He or she either sells goods of the type involved in the sales contract or has specialized knowledge of the goods by virtue of his or her profession. A nonmerchant is defined as a casual seller.

Article 2 of the UCC has made substantial changes to basic contract law in the areas of offer and acceptance and consideration. An action for breach of contract under the Code must be brought within four years of the breach. Under the most current version of the UCC statute of frauds, most contracts for the sale of goods costing $5,000 or more must be in writing to be enforceable; however, it may be years before all states have increased the amount from the old $500 limit to the new $5,000. Under the Code, courts can now deal directly with unconscionable contracts – that is, contracts that are unfair.

The parties to a sales contract do not always specify in the contract when title and risk of loss are to pass from seller to buyer. In such cases, rules under Article 2 of the UCC will apply.

In a sale by a merchant to a consumer at the merchant’s place of business, risk of loss passes to the buyer when the buyer takes physical possession of the goods. If the seller is not a merchant, the risk of loss passes when the seller has tendered delivery.

If the seller is to ship the goods (Free on Board or Freight on Board [FOB] shipping point), risk of loss passes from the seller to the buyer on proper delivery of the goods to an independent carrier. If the seller is to deliver the goods (FOB destination), risk of loss passes after the goods have been delivered to the destination point.

In a sale on approval, risk of loss and ownership remain with the seller until the buyer accepts the goods by approval. In a sale and return, the buyer accepts risk of loss and ownership of the goods at the time of the sale; both the risk and title will revert to the seller if the buyer returns the goods.

A bulk transfer is the sale of all or a major part of the stock of merchandise, materials, supplies, or other inventory at one time and not during the ordinary course of business. The bulk-transfer law protects creditors by giving them the right to void a bulk sale (within six months) if the bulk-sale buyer does not notify them before the sale takes place.

A buyer generally obtains no better title to goods than the seller had. A person who has no title cannot pass a title on. Thus, a thief cannot pass legal title on to a good faith purchaser. The UCC allows at least two exceptions to this general rule: 1) a buyer with a voidable title can transfer a valid title to a third party who obtained the goods for value and in good faith, and
2) any merchant who is given temporary possession of goods can transfer a valid title to those
goods to a buyer in the ordinary course of business.

The seller performs the sales contract by delivering conforming goods; the buyer performs by
accepting and paying for these goods, assuming, of course, that there has been a proper delivery
by the seller and that the goods do conform to the contract. The UCC governs performance unless
the seller and the buyer make other arrangements in the sales contract. If either the goods or the
delivery does not conform to the contract, the seller has the right to correct the defect in certain
circumstances. If the seller does not correct the defect or is not allowed to, then the buyer may
reject the goods, in effect canceling the contract. If after a reasonable inspection the buyer accepts
nonconforming goods, however, he or she may no longer reject them.

Remedies available to the buyer for breach of a sales contract by the seller are: 1) suing for
breach of warranty, 2) canceling the contract, 3) canceling the contract and suing for damages,
and 4) suing to obtain the goods. The buyer may exercise more than one of these remedies,
depending on the individual case.

Remedies available to the seller if the buyer breaches the sales contract are 1) canceling the
contract, 2) reselling the goods and suing for damages, 3) suing the buyer to recover the purchase
price, 4) suing the buyer to recover damages for nonacceptance, 5) withholding delivery of the
goods, and 6) reclaiming the goods from the buyer.

Article 2 of the UCC provides for two types of warranties made by sellers: express warranties
and implied warranties. Express warranties can arise in several ways. The seller may make a
factual statement or a promise about the product, may describe the goods to the buyer, or may
show the buyer a sample of the item being sold. To constitute an express warranty, the statement,
description, or sample must be part of the basis of the sale. The two types of implied warranties
are the implied warranty of merchantability and the implied warranty of fitness for a particular
purpose. Another type of warranty that exists under the Code is the implied warranty of title.
Express warranties can be excluded from sales contracts by using clear, specific language that
meets the requirements of the UCC, or by simply refraining from using language, descriptions, or
samples that induce people to purchase the goods. The expressions “as is” and “with all faults”
exclude all implied warranties except the implied warranty of title. The implied warranty of title
is excluded only if the seller specifically states that no warranty of title is given or if the buyer
realizes, or should realize, that the seller does not own the goods. If the buyer examines the
goods, sample, or model or has refused to do so after a demand by the seller, there is no implied
warranty as to the defects that were or should have been obvious.
Commercial paper is governed by the provisions of Article 3 of the UCC and consists of written documents or instruments that are available in the business world and that can be used as a substitute for money or a means of extending credit. There are two types of commercial paper: promises to pay and orders to pay. Promissory notes and certificates of deposit are promises to pay. Drafts and checks are orders to pay. Notes have two parties. The maker is the person making the promise to pay, and the payee is the person to whom the note is payable. Drafts and checks have three parties. The party issuing the draft or check is the drawer, the party to whom the instrument is payable is the payee, and the party ordered to pay is the drawee. A check is a type of draft in which the drawee is always a depository institution and the drawer is the depositor. Instruments that serve as commercial paper may be either negotiable or nonnegotiable, depending on the language used in the instrument.

To be negotiable, commercial paper must meet the following requirements: 1) be in writing, 2) be signed, 3) contain a promise or order to pay, 4) contain an unconditional promise to pay, 5) be payable in a “sum certain,” 6) be payable on demand or sight or at a defined time, 7) be payable to order or to bearer, and 8) designate a drawee or place of payment with certainty.

In terms of commercial paper, to negotiate means to transfer title or ownership to another person or party in return for value received. How commercial paper can be negotiated depends on whether the instrument is an order instrument or bearer instrument. Order instruments are negotiated by endorsement and delivery, and bearer instruments are negotiated by delivery. There are four basic endorsements: blank, special, restrictive, and qualified. A blank endorsement consists only of the signature of the endorser and makes an instrument payable to the bearer. A special endorsement names the person who is to receive the instrument and includes the signature of the endorser: “Pay to the Order of . . . .” A restrictive endorsement limits what the party to whom the instrument is transferred may do with the instrument: “For Deposit Only.” A qualified endorsement “without recourse” relieves the endorser from future liability if the instrument is not paid by the maker or drawee when presentment is made.

Commercial paper can be discharged by five means: payment, alteration, the statute of limitations, bankruptcy, or cancellation. When the party who is liable for payment of the instrument pays the amount to the holder, the instrument will normally be discharged. If the holder of commercial paper alters it in any significant and/or fraudulent manner, the obligation of any party whose liability has been changed by the alteration will be discharged. If commercial paper is not paid on time, the statute of limitations begins to run from the due date of the instrument. The instrument will be discharged if suit is not brought within the statutory period (usually six years). Discharge through bankruptcy of a debt evidenced by commercial paper will also discharge the instrument. A cancellation is any act that indicates that the obligation is ended and the commer-