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Source: Business Law/California UCC Sales and Leases/Preface

Preface

California UCC Sales and Leases is the successor to Sales & Leases in California Commercial Law Practice, published by CEB in 1993. It represents nearly ten years' worth of legal developments in the field of commercial sales, leases, and related matters governed by California's version of the Uniform Commercial Code. Each of the chapters in this new edition has been reviewed by attorneys specializing in commercial law to ensure that it reflects current law and practice.

Like its predecessor, this book contains several features that will make the practice of commercial law easier, including the following:

- *Options and remedies table.* Appendix C presents in outline form the options and remedies available to a seller or buyer under the Commercial Code when a problem develops in a sales transaction. The table describes troublesome situations that the client is likely to encounter (*e.g.,* the goods are delayed in shipment) and, for each situation, lists the client's choices and possible relief. Cross-references in the table direct the attorney to specific Commercial Code sections and extensive discussion of the subject in the book.

- *Forms and drafting tips.* Form clauses appear throughout the text of the book, with comments about their proper use. In addition, highlighted "Drafting Considerations" draw attention to legal principles that might affect how the attorney drafts a particular document or provision.

- *Agreement checklists.* Appendixes A and B contain detailed checklists of provisions that the attorney may want to include in an agreement for the sale or leasing of goods. Because of the enormous variety of goods encompassed by Commercial Code Divisions 2 and 10, the editors felt that a form agreement would be of little use to the practitioner. More often than not, the sale or leasing transaction would have requirements that a single form could not anticipate. Consequently, the checklist approach was adopted. Each checklist serves as a reminder of issues that the attorney may want to address in the transaction documents.

- *Practice tips.* This highlighted feature draws the attorney's attention to issues that he or she may wish to consider in planning strategy or making a choice between two courses of action.

- *Tables.* Tables are provided throughout the book to illustrate how Commercial Code rules operate in a variety of situations. For example, chapter 8 contains tables showing when title to the goods passes and when the risk of their loss shifts from the seller to the buyer under various circumstances.

- *Up-to-date case law.* This book contains the latest California commercial law authorities. It also includes federal and state authorities from other jurisdictions when California has no case law dealing with the issue in question.

We owe much to every author who contributed to this book, as well as to those who contributed to previous editions. Each author is experienced in commercial law practice and has given generously of his or her knowledge and specialized skills. See "About the Authors" on page xv for biographical information.

David Peyerwold was project manager of this book. Legal editors were Margaret Cloudt, Robert Denham, Debra Landis, and Dave Ng. Legal research assistance was provided by Jill Culbert, Alan Flatt, Kim Harris, Eleni Konstantaras, Alice Kostin, Shawn Ridgell, and Andy Rosner. Richard Dempewolf handled copyediting and production.

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December 2009 Update

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Source: Business Law/California UCC Sales and Leases/About the Authors

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December 2009 Update

Status of Revisions to UCC Articles 2 and 2A and a Note About Citations to "Official Comments"

The National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI) approved extensive revisions to UCC Articles 2 and 2A in 2003. However, no state has yet adopted those revisions and, according to the NCCUSL's website (http://www.nccusl.org), no state introduced legislation in 2009 to enact the revised articles.

The adoption of revised Articles 2 and 2A has made citation to "Official Comments" throughout this book somewhat tricky. The drafters' Official Comments are an invaluable guide for interpreting UCC provisions. They provide the legal background for specific rules and explain the purpose and intent of each provision, in many cases explaining why the drafters used certain terms

or approaches rather than others. When Articles 2 and 2A were revised, many of the original Official Comments were retained, but in some instances were amended or renumbered. Given the uncertain future of the 2003 revision effort, we have elected to retain the citations to the original Official Comments, but for ease of reference, have added in parentheses any change in numbering resulting from the NCCUSL/ALI revision.

In *Wall St. Network, Ltd. v New York Times Co.* (2008) 164 CA4th 1171, 80 CR3d 6, in a case of first impression, the court decided that a contract to solicit subscribers through "pop-up" ads on Internet websites was essentially a contract for services, rather than goods; thus, the acceptance rules of Com C §2606(1) did not apply. See §1.9.

In *Pacific Sunwear, Inc. v Olaes Enters.* (2008) 167 CA4th 466, 84 CR3d 182, the court of appeal clarified what is a "rightful" claim of infringement under Com C §2312(3), the Commercial Code's warranty against patent or trademark infringement. See §3.44.

A buyer may not recover both a civil penalty under CC §1794(c) (part of the Song-Beverly Consumer Warranty Act) and punitive damages under CC §3294 for the same willful, oppressive, and malicious acts. *Ortega v Toyota Motor Sales, USA, Inc.* (SD Cal 2008) 572 F Supp 2d 1218, 1221. See §3.90.

In *Cardinal Health 301, Inc. v Tyco Electronics Corp.* (2008) 169 CA4th 116, 130, 87 CR3d 5, the court held that a warranty that a spring probe connector would have a "mechanical life" of 50,000 cycles was not a warranty extending to future performance, and thus did not extend the statute of limitations period beyond 4 years. See §3.103.

Vertical privity between the plaintiff and defendant is still a requirement for actions based on breach of the implied warranties of merchantability and fitness, in which the damages are for purely commercial or economic losses arising from the defective quality of the goods. *Clemens v DaimlerChrysler Corp.* (9th Cir 2008) 534 F3d 1017. See §3.121.

An exception to the privity requirement may be allowed when the parties have extensive "direct dealings" with each other, even though they do not have a formal contractual relationship. See *Cardinal Health 301, Inc. v Tyco Electronics Corp.* (2008) 169 CA4th 116, 87 CR3d 5. See §3.121.

If a distribution contract provides for successive performances but is indefinite in duration, the contract is valid for a reasonable time; however, unless otherwise agreed, it may be terminated at any time by either party. See *Unterberger v Red Bull N. Am., Inc.* (2008) 162 CA4th 414, 75 CR3d 368; §4.79.

In determining the applicability of a particular statute of limitations, courts will look to the nature of the rights sued on rather than to the form of the action. Additionally, a specific statute of limitations will prevail over a more general statute. Under these principles, a breach of contract claim based solely on a breach of warranty is governed by Com C §2725(2). *Cardinal Health 301, Inc. v Tyco Electronics Corp.* (2008) 169 CA4th 116, 134, 87 CR3d 5. See §18.68.

A finance lessor receives special benefits relating to warranties. Although the lessor does not escape liability for any express warranties created by the lessor's conduct or representations, a finance lessor will not be held to have made any implied warranties of merchantability (Com C §10212(a)), fitness for a particular purpose (Com C §10213), or freedom from infringement (Com C §10211(b)). *Arriaga v CitiCapital Commercial Corp.* (2008) 167 CA4th 1527, 85 CR3d 143; see §19.32.

CEB published a new edition of Jefferson's California Evidence Benchbook in 2009. All citations to that work have been updated.

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Cutoff Dates and CEB Citation

Cutoff Dates

We completed legal editing and analysis of authorities cited in this publication as of September 15, 2009, and monitored developments through October 1, 2009.

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1

Introduction and Key Principles

Wayne H. Thomas

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§1.1 I. INTRODUCTION TO COMMERCIAL CODE

The California Uniform Commercial Code (the "Commercial Code," "California UCC," or "Com C") consists of 11 substantive divisions. Most of this book deals with Division 2, which governs transactions in goods. The outline of Division 2 is presented in §1.25. A table of terms used in Division 2 is provided in §1.26. Letters of credit are governed by Division 5. See chap 13. Bulk transfers are governed by Division 6. See chap 14. Warehouse receipts, bills of lading, and other documents of title are governed by Division 7. See chap 15. Leases of personal property are governed by Division 10. See chap 19. The attorney should always be conscious of the possible application of Division 9 on secured transactions, even if the text does not specifically refer to that division. See Secured Transactions in California Commercial Law Practice (2d ed Cal CEB 2001).

Division 2 provides the fundamental rules of contract for the sale of goods. With key exceptions, such as good faith and reasonableness, the rules of Division 2 are default rules that may be waived or modified by agreement. The rules provide for each stage of a contractual relationship, from formation to performance. Included are provisions governing implied and express warranties, risk of loss, statute of frauds and extrinsic evidence, interpretation, auction sales, "gap-filling" terms that apply when parties fail to reach agreement, breaches of contract, and remedies for breaches of contract.

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§1.2 A. Uniform Commercial Code

California Uniform Commercial Code Divisions 2, 5, 6, 7, and 9 are based on Articles 2, 5, 6, 7, and 9, respectively, of the Uniform Commercial Code (UCC). California Uniform Commercial Code Division 10 is based on UCC Article 2A. California's version of the UCC became effective on January 1, 1965. California adopted the 1999 revision of UCC Article 9 effective July 1, 2001. It adopted the 2001 revision of UCC Article 1 and the 2003 revision of UCC Article 7 effective January 1, 2007. California has not adopted the recommended repeal of UCC Article 6.

In enacting the official text of the UCC, the California Legislature adopted numerous amendments. As a result, some UCC sections or subsections do not appear in the California UCC, and other UCC sections have been modified for California practice. Therefore, the Official Comments that accompany and explain each section of the UCC may not apply exactly to the section that was adopted in California. In addition, although commercial cases from other states may be useful in interpreting and applying California's Commercial Code in the absence of California case authority, the attorney should bear in mind that the version of a UCC section adopted in another state may differ from the version adopted in California. Nevertheless, a key goal in enacting the Uniform Commercial Code was to create a fair and efficient statutory scheme for transactions involving personalty and fixtures (*Ford & Vlahos v ITT Commercial Fin. Corp.* (1994) 8 C4th 1220, 36 CR2d 464), and a high degree of uniformity among the states furthers that goal. Therefore, when a provision of the California UCC is identical (or at least very similar) to a provision in the uniform version, Official Comments to the UCC and decisions of courts in other states are helpful authority for determining its application in California. See *Porter v Gibson* (1944) 25 C2d 506, 154 P2d 703 (decision under former Uniform Sales Act).

NOTE: Both the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute approved amendments to UCC Articles 2 (on Sales) and 2A (on Leases) in 2003. Basically, these amendments update the articles to accommodate electronic commerce and to reflect developments in business practices, changes in other law, and interpretive difficulties of practical significance. The most current drafts of Articles 2 and 2A are available from the NCCUSL website at http://www.nccusl.org. **No state has yet adopted either revised Article 2 or 2A.** When Articles 2 and 2A were revised, nearly all of the original Official Comments were carried over, but in many instances were renumbered. Given the uncertain future of the 2003 revision effort, we have elected to retain the original cite, and to indicate in parentheses where appropriate its "revised" number.

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§1.3 B. Rules of Construction

The California Uniform Commercial Code provides the following rules concerning its construction:

- The Commercial Code must be liberally construed and applied to promote its underlying purposes and policies, which are (Com C §1103(a)(1)-(3)):
- To simplify, clarify, and modernize the law governing commercial transactions;
- To permit the continued expansion of commercial practices through custom, usage, and agreement of the parties; and
- To make uniform the law among the various jurisdictions.
- Unless displaced by particular provisions of the Commercial Code, the principles of law and equity (including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, and other validating or invalidating cause) supplement its provisions. Com C §1103(b).
- The remedies provided in the Commercial Code must be liberally administered to put the aggrieved party in as good a position as if the other party had fully performed. Com C §1305(a).
- Commercial Code provisions are severable. Com C §1105.

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II. SCOPE OF DIVISION 2

§1.4 A. Application to Transactions in Goods

Commercial Code Division 2 applies to transactions in goods. Com C §2102; 4 ALR4th 85 (discussing what constitutes a "transaction"). See §§1.5-1.8. Division 2 does not apply to transactions in services. *Expeditors Int'l, Inc. v Official Creditors Comm. of CFLC, Inc. (In re CFLC, Inc.)* (9th Cir 1999) 166 F3d 1012. For the application of Division 2 to transactions involving both goods and services, see §1.9. For the application of Division 2 to sales of business assets including goods and non-goods, see §1.10.

PRACTICE TIP: Even if the transaction is predominantly for services, or includes predominantly non-goods, the attorney may want to argue that particular provisions should apply by analogy.

Division 2 does not apply to transactions intended to operate only as security transactions. Com C §2102. Security transactions are governed by Division 9.

Division 2 also generally does not apply to leases of goods, which are governed by Division 10. See §1.11. For the application of Division 2 to other transactions, see §§1.12-1.14. On the relation of Division 2 to Division 9, see §1.15. On the relation of Division 2 to other laws, see §§1.16-1.18.

The Commercial Code distinguishes an "agreement" from a "contract." The former is the "bargain of the parties in fact as found in their language or by implication from other circumstances, including course of dealing, usage of trade, and course of performance." Com C §1201(b)(3). "Contract" means "the total legal obligation that results from the parties' agreement as affected by this code and any other applicable rules of law." Com C §1201(b)(12).

The Commercial Code also distinguishes between a "contract to sell" and a "contract for sale." A "contract for sale" includes "both a present sale of goods and a contract to sell goods at a future time." Com C §2106(1). Comment 1 to that subdivision states that "contract for sale" is used generally throughout Article 1, but the parties' rights are not determined by whether the sale is a present sale or a contract to sell in the future, except where Article 1 expressly so provides.

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§1.5 1. Definition of "Goods"

Because Division 2 governs transactions in "goods," the meaning of that term is of critical importance. The general test is that goods are "all things … which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities … and things in action." Com C §2105(1).

For specifically included transactions, see §1.6. For specifically excluded transactions, see §§1.7-1.8.

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§1.6 a. Included Transactions

Expressly included. The following are expressly included in the definition of "goods" (Com C §§2105(1), 2107):

- Specially manufactured goods (Com C §2105(1)) (*i.e.*, those made to the special design or requirements of a buyer). See §7.19 for a discussion of the statute of frauds in transactions involving such goods.
- The unborn young of animals (Com C §2105(1)).
- Minerals or the like (including oil and gas), or a structure or its materials to be removed from the realty, if the contract provides for the seller rather than the buyer to sever such items (Com C §2107(1)).
- Growing crops and "other identified things" not described in Com C §2107(1) that are attached to real property but capable of severance without material harm to it (Com C §§2105(1), 2107(2)).
- Timber to be cut (Com C §2107(2)).

A contract providing for severance by the buyer (but not the seller) of things described in Com C §2107(1), *e.g.,* minerals or a structure, is one affecting real property and is not subject to Division 2. Official Comment 1 to UCC §2-107. In addition, until severance, the goods cannot be the subject of a present sale; a purported present sale may be effective only as a contract to sell. Com C §2107(1). In contrast, the parties can by identification effect a present sale of such things as crops or timber before severance of the goods. Com C §2107(2).

Transactions found to involve "goods." In *Pierce v Pacific Gas & Elec. Co.* (1985) 166 CA3d 68, 82, 212 CR 283, the court held that the supply of electricity by a utility was a sale of "goods." See also *Fong v Pacific Gas & Elec. Co.* (1988) 199 CA3d 30, 245 CR 436. Water provided by a local government utility was also held to be "goods" in *Gall v Allegheny County Health Dep't* (Pa 1989) 555 A2d 786, and similarly, by implication, in *Voth v Wasco Pub. Util. Dist.* (1976) 56 CA3d 353, 128 CR 608.

Software developers or owners usually attempt to license the right to use their software rather than sell it, but courts nevertheless tend to treat at least some aspects of such transactions as a sale of goods for purposes of the Commercial Code. See, *e.g., RRX Indus., Inc. v Lab-Con, Inc.* (9th Cir 1985) 772 F2d 543, 546. Applying California law, the term "goods" was held to be broad enough to include computer programs in *In re Amica, Inc.* (Bankr ND Ill 1992) 135 BR 534. But see *Pearl Invs. LLC v Std. I/O, Inc.* (D Me 2003) 257 F Supp 2d 326, which held that software developed "from scratch" was not a "good." If the software is determined to be a "good," Division 2 will apply to the transaction, in particular with respect to implied warranties (see chap 3) and remedies (see chap 18). See §§2.50G-2.50I for further discussion of the sale/license of software, "shrink-wrap," "click-wrap," and "browse-wrap" licenses. For an extended discussion of developer/owner exposure to Commercial Code requirements (notwithstanding a purported license), see Phillips, *When Software Fails; Emerging Standards of Vendor Liability Under the Uniform Commercial Code*, 50 Bus Law 51 (Nov. 1994).

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§1.7 b. Excluded Transactions

The following are expressly excluded from the definition of "goods" (Com C §2105(1)):

- The money with which the price is paid. Money sold as a commodity (*e.g.,* foreign currency), however, is a "good." Official Comment 1 to UCC §2-105.
- Investment securities (as defined in Division 8).
- Things in action, *i.e.,* rights to recover money or other personal property by judicial proceedings. CC §953.

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§1.8 2. Future Goods

Goods must be both existing and identified before any interest in them can pass. Com C §§2105(2), 2401(1). For discussion of identification, see §§8.28-8.29.

Goods not meeting these requirements are "future goods." There can be no present sale of future goods; a purported present sale of such goods or any interest in them operates only as a contract to sell. Com C §2105(2).

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B. Mixed Transactions

§1.9 1. Transactions Involving Both Goods and Services

When a transaction includes both the sale of goods and the rendition of services, California courts follow the majority rule and generally determine that the entire transaction is either inside or outside of Division 2, depending on whether the goods aspect or the services aspect is the predominant feature of the transaction. When a transaction is predominantly the rendition of services, the incidental sale of goods does not bring the contract under the Commercial Code. Compare *Filmservice Labs., Inc. v Harvey Bernhard Enters., Inc.* (1989) 208 CA3d 1297, 256 CR 735 (contract with film processing laboratory to produce copies of motion picture from negatives was essentially agreement for provision of services, not sale of goods), with *RRX Indus., Inc. v Lab-Con, Inc.* (9th Cir 1985) 772 F2d 543 (contract to supply computer software system was treated as sale of goods because service aspects, including employee training, system upgrading, and repair services, were incidental to sale of system, and court looks to "the essence of the agreement" to determine whether transaction will be governed by Commercial Code) and *U.S. ex rel Bartec Indus., Inc. v United Pac. Co.* (9th Cir 1992) 976 F2d 1274, modified (9th Cir 1994) 15 F3d 855 (contract to manufacture and paint steel for construction project that did not require manufacturer to assist on project site was sale of goods).

In *Wells v 10-X Mfg. Co.* (6th Cir 1979) 609 F2d 248, the court held that a contract for the manufacture of shirts from materials provided was essentially a contract for services and was not a contract for the sale of specially manufactured goods, because the contract was merely to provide the labor and machine capabilities for the shirts.

The issue of mixed goods and services often arises in the context of transactions involving software. Because software packages vary depending on the needs of the individual consumer, courts apply a case-by-case analysis. *RRX Indus., Inc. v Lab-Con, Inc. supra*. See *Tk Power v Textron* (ND Cal 2006) 433 F Supp 2d 1058, 1061 (although purchase order covered production of mechanical items, cost was mostly for development of software code and beta testing of prototype units, so contract was essentially for services and UCC did not apply; however, subsequent mass production of units would be subject to UCC); *Colonial Life Ins. Co. v Electronic Data Sys. Corp.* (D NH 1993) 817 F Supp 235 (license of computer software governed by UCC); *Data Processing Servs., Inc. v L.H. Smith Oil Corp.* (Ct App Ind 1986) 492 NE2d 314 (plaintiff agreed to develop computer software, data processing system, and accounting system to meet defendant's specific needs; defendant bargained for plaintiff's knowledge and ability, not prepackaged software product, so UCC did not apply). See also *Wall St. Network, Ltd. v New York Times Co.* (2008) 164 CA4th 1171, 80 CR3d 6 (contract to solicit home delivery subscribers for newspaper through "pop-up" ads at Internet websites was contract for services that did not involve sale of goods).

The predominant feature test can be useful to either party. For example, a seller may want to argue that the contract was predominantly for services to avoid the Commercial Code's implied warranties of merchantability and fitness for a particular purpose (see, *e.g., Milau Assocs. v North Ave. Dev. Corp.* (1977) 398 NYS2d 882, 368 NE2d 1247), to avoid the Commercial Code's statute of frauds (see, *e.g., Advent Sys. Ltd. v Unisys Corp.* (3d Cir 1991) 925 F2d 670), or to invoke other provisions of the Commercial Code (see, *e.g., Wall St. Network, Ltd. v New York Times Co.* (2008) 164 CA4th 1171, 80 CR3d 6, in which the plaintiff argued that newspaper subscriptions captured through website "pop-up" ads were goods, so that the acceptance rules of Com C §2606(1) would apply, thus creating a triable issue of fact about whether acceptance had occurred). A buyer may want to argue that the contract was predominantly for services to escape the effect of the Commercial Code's 4-year statute of limitations. See, *e.g., Filmservice Labs., Inc. v Harvey Bernhard Enters., Inc., supra*; *Alesayi Beverage Corp. v Canada Dry Corp.* (SD NY 1996) 947 F Supp 658, aff'd without published opinion (2d Cir 1997) 122 F3d 1055. See §18.68 for a further discussion of statute of limitations issues.

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§1.10 2. Sales of Business Assets Including Goods and Non-Goods

The applicability of the Commercial Code to sales of business assets may depend on whether goods or non-goods predominate in terms of the total consideration paid. In *Dehahn v Innes* (Me 1976) 356 A2d 711, for example, the court held that Maine's version of Article 2 (essentially identical to California's version in applicable respects) applied to the sale of a road-building business, including heavy equipment and a gravel pit, because the gravel pit (the only portion of the business that was real property) represented only 5 percent of the consideration paid. In *De Filippo v Ford Motor Co.* (3d Cir 1975) 516 F2d 1313, the court held that a contract for the sale of an automobile dealership was subject to the statute of frauds under Pennsylvania's version of UCC §2-201 (essentially identical to California's version in applicable respects) because the value of movables, including inventory, to be sold was more than three times the value of assets not properly classified as goods. In *Monarch Photo, Inc. v Qualex, Inc.* (D ND 1996) 935 F Supp 1028, however, the court held that North Dakota's version of Article 2 (essentially identical to California's version in applicable respects) did not apply to the sale of a business in which the service-related provisions, such as customer lists and a noncompetition agreement, totaled $1 million of the contract, whereas equipment and inventory accounted for only $250,000.

In *Kazerouni v De Satnik* (1991) 228 CA3d 871, 279 CR 74, the court declined to apply the express warranty provisions of Com C §2313 to a contract for the sale of a business, because the representations by the seller did not relate to the assets involved in the sale. The court did not consider whether goods or non-goods predominated.

Another approach, adopted in a minority of other jurisdictions, is to apply the UCC to the "goods" aspect of the transaction but not to the "non-goods" aspect. See *Foster v Colorado Radio Corp.* (10th Cir 1967) 381 F2d 222 (notice of resale required for goods included in transfer of radio station but not required for non-goods such as radio license, goodwill, real estate, studios, and transmission equipment). But see *Field v Golden Triangle Broad., Inc.* (Pa 1973) 305 A2d 689 (seller's right to demand adequate assurance of performance for sale of goods did not apply to physical assets, including nonmovables, that represented only 4.6 percent of total purchase price in sale of two radio stations).

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C. Particular Transactions

§1.11 1. Leases

Commercial Code Division 2 generally does not apply to leases, which are governed by Division 10 (see chap 19). See *Kimco Leasing Co. v Lake Hortonia Props.* (Vt 1993) 640 A2d 18 (implied warranties of merchantability and fitness for particular purpose under UCC §§2-314-2-315 did not apply to exercise equipment purchased and then leased by financier). A lease intended (or deemed intended) as a security transaction is governed by Division 9. See *In re Pacific Sunwest Printing* (Bankr SD Cal 1980) 6 BR 408 (Division 9 applies because of option to purchase for nominal price at end of term); *In re Eureka S. R. R., Inc.* (Bankr ND Cal 1987) 72 BR 813 (lessee/debtor bore all costs and risks of ownership). See also Com C §1203, which provides tests for determining whether a transaction in the form of a lease creates a security interest as well as a general rule that the answer is determined by the facts of each case.

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§1.12 2. Franchises and Distributorships

Broad interpretation of the term "transactions in goods" has resulted in the application of the Uniform Commercial Code to franchising and distributorship agreements. Although those agreements might not require a specific purchase of goods and typically require the assumption of numerous service responsibilities, many courts have reasoned that, because the service aspects of the agreements are aimed at increasing the market for products sold by the franchise or distributorship, the sale of goods aspect of the contracts is predominant. See, *e.g., Sally Beauty Co. v Nexxus Prods. Co.* (7th Cir 1986) 801 F2d 1001; *Paulson, Inc. v Bromar, Inc.* (D Haw 1991) 775 F Supp 1329; *Aronowicz v Nalley's, Inc.* (1972) 30 CA3d 27, 106 CR 424 (applying Division 2 to food distributorship without discussion). But see *Zeno Buick-GMC, Inc. v GMC Truck & Coach* (ED Ark 1992) 844 F Supp 1340, aff'd without published opinion (8th Cir 1993) 9 F3d 115 (automobile dealer sales and service agreement was personal services contract even though sale of goods was a result). See also *Coca-Cola Bottling Co. v Coca-Cola Co.* (D Del 1988) 696 F Supp 57, 84, aff'd in part and rev'd in part on other grounds (3d Cir 1993) 988 F2d 386.

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§1.13 3. Bailments

Some courts have applied the "transactions in goods" language to bailments; other courts have refused to do so. If a transferee obtains goods after promising to pay for them but also has an option to return them, the transaction will be a sale unless the option is exercised. If a transferee acquires goods with an option to buy them but without the promise to pay, then that transaction will be a bailment. In *Mieske v Bartell Drug Co.* (Wash 1979) 593 P2d 1308, 6 ALR4th 923, a home movie was delivered to a retail store for editing, and the retailer's processing agent lost the film. The court held that bailments arising from service transactions were transactions in goods. In *Indemnity Marine Assur. Co. v Lipin Robinson Warehouse Corp.* (Mich App 1980) 297 NW2d 846, the plaintiff delivered goods to the defendant (without passing title) for disposition in accordance with the plaintiff's instructions. The defendant improperly stored and handled the goods. The court held that the bailment was not a transaction in goods. By holding that the 4-year statute of limitations in Com C §2725 applied to a defendant's failure to return plaintiff's property rather than the shorter limitations period for the tort of conversion, the court in *H. Russell Taylor's Fire Prevention Serv., Inc. v Coca Cola Bottling Corp.* (1979) 99 CA3d 711, 160 CR 411, may have impliedly considered the transaction to be a "transaction in goods."

NOTE: Division 7 also may apply to bailments. The scope of Division 7 includes warehouse receipts, bills of lading, and other documents of title. See *Georgia Ports Auth. v Servac Int'l* (Ga App 1992) 415 SE2d 516.

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§1.14 4. Installation, Service, and Repair Contracts

In contracts to install or maintain equipment, no clear line can be drawn between transactions that are subject to Division 2 and those that are not. The test is whether the contract is predominantly one for goods or services. See §1.9.

On the one hand, installation and servicing of a burglar alarm system (see *Feary v Aaron Burglar Alarm, Inc.* (1973) 32 CA3d 553, 108 CR 242) and installation and maintenance of heating and air-conditioning systems (see *Mingledorff's, Inc. v Hicks* (Ga App 1974) 209 SE2d 661) have been held *not* to be transactions in goods.

On the other hand, an unsigned contract for the sale and installation of carpeting was held unenforceable under Colorado's Commercial Code statute of frauds (essentially identical to California's in applicable respects) because the majority of the contract price was for the cost of the carpeting rather than the labor needed for its installation. *Colorado Carpet Installation, Inc. v Palermo* (Colo 1983) 668 P2d 1384, 45 ALR4th 1113. Similarly, a contract for the sale and installation of windows created a transaction in goods under Georgia's Commercial Code (essentially identical to California's in applicable respects). *J. Lee Gregory, Inc. v Scandinavian House* (Ga App 1993) 433 SE2d 687.

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§1.14A 5. Consignment

If a contract calls for a true consignment as defined in Division 9, title to the goods will not transfer until the consignor has sold the goods. However, if a contract ambiguously (see, *e.g.,* *Chastain v Belmont* (1954) 43 C2d 45, 271 P2d 498) or deceptively (see, *e.g.,* *Shafford v Otto Sales Co.* (1953) 119 CA2d 849, 260 P2d 269) purports to create a consignment agency, the transaction may instead be considered a sale and not a consignment. See §§12.56-12.67 for a discussion of how Division 9 applies to consignments.

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§1.15 D. Relation to Division 9

Commercial Code Division 9 applies to "a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract." Com C §9109(a)(1). A transaction that is intended *only* to create a security interest is not covered by Division 2. Com C §2102. Division 2 also may apply, however, if the transaction includes a sale of goods as well as the creation of a security interest. See *Steiner v Mobil Oil Corp.* (1977) 20 C3d 90, 98 n3, 141 CR 157 (Division 2 applied to transaction that included certain security agreements as well as agreement on sale of gasoline, *i.e.*, goods, where agreement regarding sale of goods could be enforced without invoking security agreements). See also *Stillwater Nat'l Bank & Trust Co. v CIT Group/Equip. Fin., Inc.* (10th Cir 2004) 383 F3d 1148, holding that a transfer of equipment between two parties was a secured financing and not a sale. Factors favoring a sale included the use of a "bill of sale." Factors favoring a secured transaction included the presence of a granting clause (granting a security interest to the "purchaser" and stating "Title… shall remain in the Assignor and is not transferred to Assignee for any purpose") and the requirement of a mandatory repurchase by the "seller" at the end of the transaction (thus eliminating any risk of loss for the "buyer").

Division 2 provides for the creation of security interests in certain situations, *e.g.,* the seller's reservation of title to goods shipped to the buyer (Com C §§2401(1), 2505; see §§8.21-8.24) and the buyer's security interest in certain rejected goods (Com C §2711(3); see §§17.71-17.74). The seller also has rights of stoppage and resale (Com C §§2703, 2705-2706; see §§17.14-17.22, 17.38-17.47) that are similar to a secured party's rights under Division 9.

Security interests in favor of either sellers or buyers as described in the previous paragraph are subject to Division 9. Com C §9110. However, until the debtor (*i.e.,* the buyer in the case of security interests under Com C §2401 or §2505, or the seller in the case of Com C §2711(3)) obtains possession of the goods, the security interests are enforceable regardless of whether the requirements of Division 9 have been met (*e.g.,* filing of a financing statement). Com C §9110. Until possession of the goods shifts, Division 2 security interests exist by operation of law; thus, no security agreement is necessary, filing rules do not apply, and rights on default are governed by Division 2, not Division 9. Com C §9110(1)-(3). Moreover, until the debtor obtains possession of the goods, a Division 2 security interest has priority over a conflicting Division 9 security interest. Com C §9110(4). Official Comments 3 and 4 to UCC §9-110.

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§1.16 E. Relation to Other Laws

The Commercial Code does not deal comprehensively with all areas of law to which it relates. For example, Com C §§2613-2615 (dealing with casualty to identified goods, substituted performance, and excuse by failure of presupposed conditions) set forth rules that by no means cover all possible factual situations.

Even in areas of law that the Commercial Code purports to cover, some gaps inevitably exist. To fill these gaps, the Commercial Code recognizes that the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, and bankruptcy continue to apply unless displaced by particular provisions of the Code. Com C §1103(b).

Division 2 also does not impair or repeal any statute regulating sales to "consumers, farmers or other specified classes of buyers." Com C §2102. The attorney should therefore keep in mind other statutory enactments that might apply specifically to the transaction, such as laws governing consumer transactions. See §1.17. Special rules also may apply to international transactions. See §1.18.

Finally, in situations involving interstate commerce, federal law may control. See, *e.g., King Jewelry v Federal Express Corp.* (9th Cir 2003) 316 F3d 961 (under Airline Deregulation Act of 1978 (49 USC §41713), federal common law governs contractual clauses that limit interstate carriers' liability for damage to goods shipped by air); *BII Fin. Co. Ltd. v U-States Forwarding Servs. Corp.* (2002) 95 CA4th 111, 115 CR2d 312 (Federal Bills of Lading Act (49 USC §§80101-80116) preempts Division 7 of California Commercial Code in application to interstate and foreign commerce traveling through state).

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§1.17 1. Consumer Transactions

The following statutes, among others, may apply to consumer transactions:

- The Consumers Legal Remedies Act (CC §§1750-1784);
- The Consumer Credit Reporting Agencies Act (CC §§1785.1-1785.36);
- The Song-Beverly Consumer Warranty Act (CC §§1790-1795.8);
- The Information Practices Act of 1977 (CC §§1798-1798.78), governing the maintenance and dissemination of personal information;
- The Consumer Contract Awareness Act of 1990 (CC §§1799.200-1799.207);
- The Unruh Act (CC §§1801-1812.20), governing retail installment sales;
- The Rees-Levering Motor Vehicle Sales and Finance Act (CC §§2981-2984.4);
- The Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (Lemon Law) (15 USC §§2301-2312);
- CC §§1689.5-1689.14, governing door-to-door sales;
- Bus & P C §§17538-17538.3, governing telephone, Internet, mail order, and catalog sales; and
- Bus & P C §§17511-17513, governing telephonic sellers.

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§1.18 2. International Transactions

If the sale of goods is between parties whose places of business are in different nations, the United Nations Convention on Contracts for the International Sale of Goods (CISG), sometimes referred to as the Vienna Sales Convention (see 15 USC App), may apply. The parties to an international sale of goods may select the law to govern the transaction, but silence in the agreement regarding the governing law may result in application of the CISG. Among other things, such an application may determine whether an oral contract may be formed (*i.e.,* not be barred by the statute of frauds) or the remedies for breach. See Kraw, *The Convention for International Sale of Goods: New Rules for International Sales Contracts*, 4 CEB Cal Bus L Prac 66 (Spring 1989); M. Sandstrom and D. Goldsweig, *Negotiating and Structuring International Commercial Transactions*, (2d ed 2003, American Bar Association Section of International Law and Practice).

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III. KEY PRINCIPLES AND POLICIES OF DIVISION 2

§1.19 A. Contract Formation

An attorney who is unfamiliar with Commercial Code Division 2 may be surprised to learn how easily a contract may be formed under its rules. For example:

- An offer may be binding even though no consideration has been given. Com C §2205.
- A contract may be created even though the acceptance attempts to change the terms of the sale. Com C §2207.
- A contract may be created even though terms are left open. Com C §2204(3).

Omitted terms such as price, place for delivery, or time for shipment will be filled in according to what is provided in the Commercial Code or what is reasonable under the circumstances. If the parties so intend, they can conclude a contract for sale even though the price is not settled, and a reasonable price will be determined. Com C §§2305, 2308-2309. No contract is formed, however, if the parties intend not to be bound unless the price is agreed on, and no agreement on the price is reached. Com C §2305(4).

NOTE: However, common law and statutory contract principles are not irrelevant. For example, the basic requirement of privity will not be ignored. See *All W. Electronics, Inc. v M-B-W, Inc.* (1998) 64 CA4th 717, 75 CR2d 509. A contract or clause may not be enforced, or its application may be limited, if the court finds that it was unconscionable at the time it was made. CC §1670.5. The requirement that contractual terms may not be unconscionable protects parties from bargaining abuses that are not otherwise regulated by the doctrines of fraud, duress, or mistake. See §§18.69-18.71.

The terms of a contract include those specifically agreed on by the parties, plus those implied by the parties' prior dealings, their manner of performance, and practices prevalent in their trade. Com C §§1201(b)(3), 1303, 2207(3). See §1.22. For more detailed discussion of contract formation, see chaps 2-5.

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§1.20 B. Variation by Agreement

Unless prohibited to do so in a particular section, the parties may vary the effect of Commercial Code provisions by agreement. Com C §1302(a). The parties may not, however, disclaim the obligations of good faith, diligence, reasonableness, or care. Com C §1302(b). The parties are also limited in their choice of applicable law. Com C §1301. See §18.59. Additionally, the Commercial Code specifies that a liquidated damages clause in an agreement governed by the Commercial Code will be subject to and must comply with CC §1671. Com C §2718. See §§18.51-18.52.

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§1.21 C. Good Faith

There is an obligation of good faith in the performance or enforcement of every contract or duty under the Commercial Code. Com C §1304. "Good faith" is defined as "honesty in fact and the observance of reasonable commercial standards of fair dealing." Com C §1201(b)(20). The implied covenant of good faith rests on the existence of a specific contractual obligation. It protects a contract's express covenants or promises; it does not protect a general public policy interest not tied to the contract's purpose. *Racine & Laramie, Ltd. v Department of Parks & Recreation* (1992) 11 CA4th 1026, 14 CR2d 335.

NOTE: Although the parties are ordinarily free to vary the effect of Commercial Code provisions by their agreement, the obligation of good faith may not be waived or disclaimed. Com C §1302(b). See §1.20.

The obligation of good faith is not a separate contractual duty that can be independently breached. Official Comment 1 to UCC §1-304. Stated another way, there is no remedy for bad faith alone; a cause of action must have a basis in the contractual expectations of the parties, not merely in the failure to meet the standard of good faith. For example, at least in the absence of agreement to do so, parties do not have a good faith obligation to negotiate an agreement to conclusion, and even taking an arbitrary stance does not breach an obligation of good faith. See *Copeland v Baskin Robbins U.S.A.* (2002) 96 CA4th 1251, 117 CR2d 875; *Racine & Laramie, Ltd. v Department of Parks & Recreation, supra.*

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§1.22 D. Course of Performance, Course of Dealing, and Usage of Trade

The parties' conduct during the course of performing their contract (course of performance) may be relevant to interpretation of the contract. Com C §1303(d). Course of performance also may modify or waive a provision in the contract that is inconsistent with that performance. Com C §1303(f).

The parties' prior conduct (course of dealing) and the customs of their business (usage of trade) also may be relevant to interpretation of their contract. The express terms of an agreement, course of dealing, and usage of trade shall be construed as consistent wherever reasonable. When such a construction is unreasonable, the express terms control both course of dealing and usage of trade. Course of dealing controls usage of trade. Course of performance controls both course of dealing and usage of trade. Com C §1303(e)(2).

For discussion of course of performance, see §§4.94-4.97. For discussion of course of dealing, see §§4.98-4.99. For discussion of usage of trade, see §§4.100-4.103.

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§1.23 E. Passing of Title

With the adoption of Commercial Code Division 2, few questions turn on the passing of title. Passing of title still has significance in some situations, such as the application of sales tax and property tax and the determination of ownership at the time of theft or for insurance coverage. Rules for determining who has title are provided in Com C §2401. For discussion of title, see chap 8.

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§1.24 F. Merchants

Most provisions of Commercial Code Division 2 apply equally to merchants and nonmerchants. In some situations, however, different or higher standards apply to merchants. For example:

- A merchant's written offer may be treated as irrevocable (Com C §2205(a)).
- Merchants may be held to an implied warranty of merchantability (Com C §2314(1)).
- Merchants have greater power to transfer good title (Com C §2403(2)).
- Merchants may be bound by written confirmations if not objected to within 10 days (Com C §2201(2)), or by written acceptances that contain different terms (Com C §2207(2)).

A party to a sale of goods may be considered a "merchant" either by being a dealer in the goods or, by his or her occupation, purporting to have certain knowledge or skill peculiar to the practices or goods in the transaction. Com C §2104(1).

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§1.25 IV. OUTLINE OF DIVISION 2

The seven chapters of Commercial Code Division 2 are arranged in order of the formation and performance of the contract for sale, as follows:

- Chapter 1: Short Title, General Construction, and Subject Matter
- Chapter 2: Form, Formation, and Readjustment of Contract
- Chapter 3: General Obligation and Construction of Contract
- Chapter 4: Title, Creditors, and Good Faith Purchasers
- Chapter 5: Performance
- Chapter 6: Breach, Repudiation, and Excuse
- Chapter 7: Remedies
- Chapter 8: Retail Sales

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§1.26 V. TABLE: TERMS USED IN DIVISION 2

The Commercial Code relies heavily on special definitions. The following table lists alphabetically the terms that are defined for purposes of Division 2 and the sections in which the definitions appear. These definitions include those generally applicable to all divisions of the Commercial Code (see Com C §1201), those found in Division 2 (see Com C §§2103(1), 2104-2106, 2319-2326), and those from other divisions of the Commercial Code that are incorporated by reference in Com C §2103(2)-(3).

Defined Term	*Com C §*
acceptance of goods	2606
action	1201(b)(1)
aggrieved party	1201(b)(2)
agreement	1201(b)(3)
bank	1201(b)(4)
banker's credit	2325(b)(3)
bearer	1201(b)(5)
between merchants	2104(3)
bill of lading	1201(b)(6)
branch	1201(b)(7)
burden of establishing a fact	1201(b)(8)
buyer	2103(1)(a)
buyer in ordinary course of business	1201(b)(9)
cancellation	2106(4)
check	3104(f)
C.I.F. and C. & F. (cost, insurance, and freight; cost and freight)	2320(1)
commercial unit	2105(6)
confirmed credit	2325(3)
conforming (or conform) to contract	2106(2)
consignee	7102(a)(3)
consignor	7102(a)(4)
conspicuous	1201(b)(10)
consumer goods	9102(a)(23)
contract	1201(b)(12)
contract for sale	2106(1)
course of dealing	1303(b)
course of performance	1303(b)
cover	2712(1)
creditor	1201(b)(13)
defendant	1201(b)(14)
delivery	1201(b)(15)
delivery "ex ship"	2322(1)
dishonor	3502
document of title	1201(b)(16)
draft	3104(e)
entrusting	2403(3)
F.A.S. (free alongside ship)	2319(2)
fault	1201(b)(17)
financing agency	2104(2)
F.O.B. (free on board)	2319(1)
fungible	1201(b)(18)
future goods	2105(2)
genuine	1201(b)(19)
good faith	1201(b)(20)

goods	2105(1), 2800 (see also CC §§1761(a), 1802.1)
guarantor (surety)	1201(b)(39)
holder	1201(b)(21)
identification	2501(1)
insolvency proceedings	1201(b)(22)
insolvent	1201(b)(23)
installment contract	2612(1)
knowledge/know	1202(b)
letter of credit	2325(3)
lot	2105(5)
merchant	2104(1)
money	1201(b)(24)
no arrival, no sale	2324
notice	1202(a)
notifies	1202(d)
organization	1201(b)(25)
overseas	2323(3)
party	1201(b)(26)
person	1201(b)(27)
person in position of seller	2707(1)
present sale	2106(1)
present value	1201(b)(28)
purchase	1201(b)(29)
purchaser	1201(b)(30)
reasonable time	1302(b)
receipt of goods	2103(1)(c)
receive notice	1202(e)
record	1201(b)(31)
remedy	1201(b)(32)
representative	1201(b)(33)
right	1201(b)(34)
sale	2106(1)
sale on approval	2326(1)(a)
sale or return	2326(1)(b)
security interest	1201(b)(35)
seller	2103(1)(d)
send	1201(b)(36)
signed	1201(b)(37)
state	1201(b)(38)
surety	1201(b)(39)
term	1201(b)(40)
termination	2106(3)
unauthorized signature	1201(b)(41)
usage of trade	1303(c)
value	1204
warehouse receipt	1201(b)(42)
writing; written	1201(b)(43)

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2

Formation of Sales Contracts: Express Terms

Wayne H. Thomas

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§2.1 I. SCOPE OF CHAPTER

The attorney analyzing a client's rights under a purported contract must consider first whether a contract exists. The Commercial Code makes several changes in the law of contract formation as it relates to the sale of goods. This chapter discusses the Commercial Code provisions that govern formation of the contract of sale.

Problems that arise when sales contracts omit terms are mentioned only in brief in this chapter. For detailed discussion, see chap 4.

The Commercial Code's statute of frauds (Com C §2201) and parol evidence rule (Com C §2202) play a role in formation of enforceable contracts and proof of their terms. See chap 7.

Auction sales present special issues relating to offer and acceptance. See §§2.51-2.59.

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II. BASIC PRINCIPLES

§2.2 A. Ease of Contract Formation

The basic philosophy of contract formation under Commercial Code Division 2 is simple: Practical business people cannot be expected to govern their actions with reference to legal formalisms. *Kleinschmidt Div. of SCM Corp. v Futuronics Corp.* (1977) 395 NYS2d 151, 363 NE2d 701. Goods are purchased and sold by a variety of methods, including purchase orders, acknowledgment or acceptance forms, letters, telephone conversations, e-mail exchanges, and handshakes on the street. Some of these methods memorialize the terms of sale more completely than others.

PRACTICE TIP: Often, a formal written sales agreement between the seller and buyer is not negotiated. The attorney may initially draft the sales or purchase order forms, but thereafter the client and other parties will exchange these forms (whether their terms match or not), accept and pay for goods, and expect that their bargain will be enforced. In fulfilling this expectation, Division 2 supersedes many of the contract formation rules of common law.

To facilitate the ability of parties to enter into contracts on whatever terms they choose, a great many sections in Division 2 begin "Unless otherwise agreed…." The Commercial Code recognizes contracts that are written, oral, or created by conduct alone. Com C §§2204(1), 2207(3). See *Steiner v Mobil Oil Corp.* (1977) 20 C3d 90, 141 CR 157; *National Controls, Inc. v Commodore Bus. Machs., Inc.* (1985) 163 CA3d 688, 209 CR 636. See also *Arizona Cartridge Remanufacturers Ass'n, Inc. v Lexmark Int'l, Inc.* (9th Cir 2005) 421 F3d 981 (language on outside of printer cartridge package specified terms under which consumer could use purchased item; consumer could read conditions on box before deciding whether to accept them or to opt for other cartridges sold without restrictions).

Although it may be difficult under some circumstances to identify the "offer," the "acceptance," or the time when the deal was struck, the Commercial Code validates the contract nevertheless, providing that "a contract for sale may be found even though the moment of its making is undetermined." Com C §2204(2). A case on the enlarged concept of agreement is *Nanakuli Paving & Rock Co. v Shell Oil Co.* (9th Cir 1981) 664 F2d 772.

The fundamental contract formation rule of Division 2 is that if the parties intended to make a contract and "there is a reasonably certain basis for giving an appropriate remedy," a contract will be found to exist despite the fact that its terms are indefinite. Com C §2204(3).

> [T]his provision states that a court, if it is to enforce a contract, must first make two findings. Initially, the court must find some basis for concluding that the parties engaged in a process of offer and acceptance, rather than inconclusive negotiations. Second, the court must find that it possesses sufficient information about the parties' incomplete transaction to apply the provisions of the California Uniform Commercial Code which fill in the gaps in parties' contracts.

Steiner v Mobil Oil Corp. (1977) 20 C3d 90, 105, 141 CR 157. As stated in Official Comment to UCC §2-204 (Official Comment 3 to UCC §2-204 (2003)):

> If the parties intend to enter into a binding agreement, this subsection recognizes the agreement as valid in law, despite missing terms, if there is any reasonably certain basis for granting a remedy based on commercial standards of indefiniteness. Neither certainty for what the parties were to do nor a finding of the exact amount of damages is required. Neither is the fact that one or more terms are left to be agreed upon enough by itself to defeat an otherwise adequate agreement. This Act makes provision elsewhere for missing terms needed for performance, open price, remedies and the like. The more terms the parties leave open, the less likely it is that the parties have intended to conclude a binding agreement, but their actions may be conclusive on the matter despite the omissions.

For example, precision in the statement of quantity is not essential. Courts have held that the following contracts meet the Commercial Code test for definiteness: a contract to buy all the hemlock logs in a given area (see *Fort Hill Lumber Co. v Georgia-Pacific Corp.* (Or 1972) 493 P2d 1366), a contract to purchase all the cotton produced on a given acreage during one specified crop year (see *Riegel Fiber Corp. v Anderson Gin Co.* (5th Cir 1975) 512 F2d 784), and a contract to purchase a quantity of sand measured by the capacity of a truck (see *Blue Rock Indus. v Raymond*

Int'l, Inc. (Me 1974) 325 A2d 66).

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§2.3 B. Open Terms

The Commercial Code's "gap-filler" provisions, Com C §§2305-2310, are used to supply terms left open by the parties, unless the parties intended that no contract would arise until they agreed on the open terms. Assuming that the parties intended to form a binding contract, it will consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of the Commercial Code. Com C §2207(3). For example, if the price of the goods is left open, a court will deem the agreed price to be a "reasonable price" at the time for delivery. Com C §2305(1). If the time or place for delivery or the time for payment are left open, the Commercial Code will fill in the gaps. See Com C §§2308-2310.

Quantity is an essential term (Com C §2201), but a contract can be formed if quantity can be determined outside the agreement. See, *e.g., Sanmina Corp. v BancTec USA, Inc.* (ND Tex 2001) 43 UCC Rep Serv 2d 1088, aff'd in part and vacated in part on other grounds (5th Cir 2004) 94 Fed Appx 194. Although quantity is an essential term, a contract that measures the quantity to be sold by the output of the seller or the requirements of the buyer is enforceable. Com C §2306. See §§4.22-4.38.

For discussion of these "open terms" and others, see chap 4.

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§2.4 C. Formation Issues

Formation issues may arise in a variety of circumstances. The client may ask the attorney to evaluate existing practices and establish procedures for future transactions. The attorney may be required to determine whether actions by the client have already created a contract. In approaching these problems, the attorney should consider the following:

- The subject matter of the contract may not be simply "goods." See Com C §2105.
- The subject matter of the contract may be governed by special laws that are not preempted by the Commercial Code. Com C §2102. For example, see the Unruh Act (CC §§1801-1812.20) governing retail installment sales, the Rees-Levering Motor Vehicle Sales and Finance Act (CC §§2981-2984.5), the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8), the Convention for the International Sales of Goods (see §§2.12, 9.1), and the Perishable Agricultural Commodities Act (PACA; 7 USC §§499a-499s).
- Non-Commercial Code concepts may apply. Com C §1103(b). For example, the contract may be vitiated for mistake (CC §§1577-1578), unlawful (CC §§1596, 1598), or impossible to perform (CC §1597). Fraud may be present. CC §§1571-1573.
- For some extrinsic reason, a court may not hold what appears to be a valid, complete contract to be valid and complete. For example, the contract may be subject to the approval of a third person, or the parties may have agreed that the contract would not be binding until a certain time or the occurrence of a certain event.
- The statute of frauds or the parol evidence rule may apply to the transaction. See Com C §§2201-2202; chap 7.
- The parties may have shown agreement even though they did not enter into a formal or conventional contract. Alternatively, a party who denies that any contract was made may have conducted itself in a manner that recognizes the contract's existence. See Com C §2207(3).
- The parties may have left terms open by express provision or by not mentioning them. The attorney should check for the following terms:
- *Price*. See Com C §2305. See also §4.3.
- *Quantity*. On contracts for output, for requirements, or for exclusive dealing, see Com C §2306. See also §§4.21-4.55. A quantity term is required in contracts subject to the statute of frauds. Com C §2201.
- *Delivery*. See Com C §§2307-2308. See also §§4.56-4.70.
- *Time requirement*. See Com C §2309. See also §§4.62, 4.77, 4.79.
- *Payment or credit*. See Com C §2310. See also §4.76.
- The parties may have left so many terms open that a court would conclude that they did not intend to make a contract. See §4.2.
- There may not be a "reasonably certain basis for giving an appropriate remedy." Com C §2204(3). Note that Com C §1201(b)(32) includes self-help in its definition of "remedy." Remedies are provided for in Com C §§2701-2725. See also chaps 17-18.

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§2.5 D. Formation Problems Not Covered by Commercial Code

The Commercial Code does not contain specific provisions regarding certain matters that may bear on whether a contract was formed by the parties. However, the Commercial Code expressly incorporates the principles of law and equity, including the law merchant and the law as to capacity to contract, principal and agent, estoppel, fraud and misrepresentation, duress, coercion, mistake, and bankruptcy. See Com C §1103(b).

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III. THE OFFER

§2.6 A. What Constitutes an Offer?

"Offer" is not defined by the Commercial Code. Thus, courts must apply general contract law principles to determine whether a party has made an offer. See Com C §1103(b). An offer is the manifestation of willingness to enter into a bargain, so made as to justify another person in understanding that assent is invited and will conclude the bargain. Restatement (Second) of Contracts §24 (1981).

The principal distinction to be made is between offers and preliminary negotiations. Advertisements, price lists, circulars, catalogs, or quotations may be invitations to make an offer rather than offers themselves. See 1 Witkin, Summary of California Law, *Contracts* §§130, 132 (10th ed 2005). See also *Brown v California State Lottery Comm'n* (1991) 232 CA3d 1335, 284 CR 108 (advertisements ordinarily are not offers but merely invitations to bargain). This approach has been criticized on the grounds that it is inconsistent with the ordinary expectations of consumers and leads to haphazard results. See Eisenberg, *Expression Rules in Contract Law and Problems of Offer and Acceptance*, 82 Cal L Rev 1127, 1166 (1994). See also *Donovan v RRL Corp.* (2001) 26 C4th 261, 109 CR2d 807 (Veh C §11713.1 requires auto dealers to sell vehicles at advertised prices; therefore, advertisement for specific vehicle should not be considered mere request for offers from consumers or invitation to negotiate, but rather must be deemed operative offer that is accepted when consumer tenders advertised price).

A manifestation of willingness to enter into a bargain is not an offer if the person to whom it is addressed knows or has reason to know that the person making it does not intend to conclude the bargain without further manifestation of assent. See Restatement §26.

Thus, one underlying principle is the intent to conclude a bargain. Another principle is certainty. An offer must be sufficiently definite, or must call for such definite terms in the acceptance, that the performance promised is reasonably certain. See *Foremost Pro Color, Inc. v Eastman Kodak Co.* (9th Cir 1983) 703 F2d 534, disapproved on other grounds in *McMahon v Televents, Inc.* (9th Cir 1997) 1997 US App Lexis 30158 (buyer/offeror could not recover from seller for alleged untimely delivery because purchase orders were merely offers to buy inviting acceptance; because there was no promise to ship, no contract was formed until seller actually shipped, so no late delivery). See also *Beard Implement Co. v Krusa* (Ill 1991) 567 NE2d 345 (no contract where seller's purchase order "unambiguously" required signature of seller's "dealer," who did not sign); 1 Witkin, Summary, *Contracts* §137.

Restatement §33 sets forth the rule as follows:

> (1) Even though a manifestation of intention is intended to be understood as an offer, it cannot be accepted so as to form a contract unless the terms of the contract are reasonably certain.
>
> (2) The terms of a contract are reasonably certain if they provide a basis for determining the existence of a breach and for giving an appropriate remedy.
>
> (3) The fact that one or more terms of a proposed bargain are left open or uncertain may show that a manifestation of intention is not intended to be understood as an offer or as an acceptance.

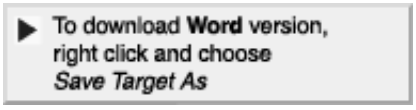
An apparent offer may not be an offer for other reasons.

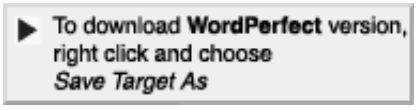
EXAMPLE: An "offer" may be a sham or a joke that justifiably should not be taken seriously, or it may be contingent on an event that has not yet occurred such as approval by a third party.

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Source: Business Law/California UCC Sales and Leases/2 Formation of Sales Contracts: Express Terms/§2.7 1. Form: Quotation

§2.7 1. Form: Quotation





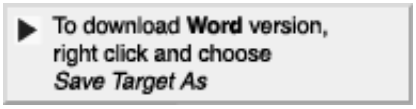
2.7-1 Quotation

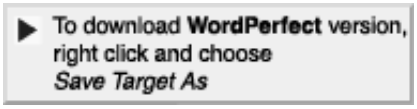
This list represents our current prices and inventory. Because our own supply situation changes, however, we cannot guarantee either availability or price. Please call first to confirm that we can accept your order.

Comment: Whether a communication naming a price is a quotation or an offer depends on intention, manifested by the facts and circumstances of each particular case. *R.E. Crummer & Co. v Nuveen* (7th Cir 1945) 147 F2d 3. Although the favored construction is that an advertisement or published price list is a mere invitation to enter into a bargain rather than an offer (see Restatement §26, comment b), it is best not to leave the matter open to dispute. See *Donovan v RRL Corp.* (2001) 26 C4th 261, 109 CR2d 807 (holding that licensed automobile dealer's advertisement regarding particular vehicle at specific price constituted an offer because failure to sell at advertised price is illegal under Vehicle Code). See also *Chang v First Colonial Sav. Bank* (Va 1991) 410 SE2d 928. The language in the form makes it clear that inquiries are being invited and that no contract will arise unless an order is "accepted" by the seller.

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§2.8 2. Form: Noncontractual Intent





2.8-1 Noncontractual intent

This writing is intended for discussion purposes only. It is not an agreement, a memorandum of an agreement, or an offer to enter into an agreement. Neither of the parties is obligated in any way to the other until a formal agreement is executed by an authorized officer or representative of each of them.

Comment: Business people sometimes exchange documents termed "letters of intent" or "terms of agreement" that, despite their characterization, are merely negotiating positions expressed in writing. The risk of such writings is illustrated in *Graulich Caterer Inc. v Hans Holterbosch, Inc.* (NJ Super Ct 1968) 243 A2d 253, 258, in which the writing exchanged by the parties contained the following sentence in a rider to a detailed agreement:

> It is understood that this letter indicates intent only and that a detailed contract will be drawn as soon as possible which will contain complete and detailed specifications on quality and quantity of food and details of service.

The court held that the quoted language did not adequately show an intent not to enter into a contract. In reaching this result, the court relied on a New Jersey statute identical to Com C §2204 (regarding contract formation).

DRAFTING CONSIDERATIONS: Because the Commercial Code liberalizes the rules of contract formation, any document that is intended to be only a memorandum of terms for negotiating purposes should clearly state this intention.

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§2.9 B. Revocability and When "Firm"

Under common law and by statute (CC §1586), an offer may be revoked until it is properly accepted, except in limited situations, such as these:

- When consideration had been given to keep the offer open (see *Torlai v Lee* (1969) 270 CA2d 854, 76 CR 239; see also 1 Witkin, Summary of California Law, *Contracts* §§168, 170 (10th ed 2005));
- When the offeree of a unilateral contract had begun performance (see *Lyon v Goss* (1942) 19 C2d 659, 123 P2d 11; *Edgar Rice Burroughs, Inc. v Commodore Prods. & Artists* (1959) 167 CA2d 463, 334 P2d 922 (part performance by promisee furnishes valid consideration and cured lack of mutuality, if any, that existed originally)); or
- When the offeree had relied on the offer to the extent that the offeror was estopped from revoking it (see *Drennan v Star Paving Co.* (1958) 51 C2d 409, 333 P2d 757; but see *C.R. Frederick, Inc. v Borg-Warner Corp.* (9th Cir 1977) 552 F2d 852, where statute of frauds made an agreement unenforceable notwithstanding offeree's reliance on offeror's oral promise).

Division 2 has changed the common law and statutory rule regarding revocability with respect to certain offers made by merchants (called "firm offers"); there are also special rules applicable to contractors (see §2.16).

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1. Requirements of Firm Offer

§2.10 a. Offer Made by Merchant

In contracts governed by Commercial Code Division 2, a merchant's offer may be binding without consideration for a limited time under certain circumstances. An offer by a merchant to buy or sell goods in a signed writing that by its terms gives assurance that it will be held open is not revocable, for lack of consideration, during the time stated, or, if no time is stated, for a reasonable time. In neither event may this period exceed three months. Any such term of assurance on a form supplied by the offeree must be separately signed by the offeror. Com C §2205(a). Such an offer by a merchant is also known as a "firm offer."

Only a merchant can make a firm offer (although the offer can be made *to* anyone), and the offer must be for the purchase or sale of goods. Com C §2205(a). Offers made by other persons or in other types of transactions are governed by non-Code law.

A merchant is defined for purposes of the Commercial Code as a person who deals in goods of the kind in the transaction or who by occupation holds himself or herself out as having knowledge or skill peculiar to the practices or goods involved in the transaction, or to whom such knowledge or skill may be attributed by employment of an agent or broker or other intermediary who so holds himself or herself out. Com C §2104(1).

PRACTICE TIP: The attorney should ensure that the business person in the particular transaction is acting as a merchant. If, for example, a seller who deals only in household furnishings wants to sell a forklift that is part of the seller's equipment and not inventory, the seller would not be acting as a "merchant" for purposes of Com C §2205.

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§2.11 b. Assurance That Offer Will Be Held Open

An offer is not "firm" unless by its terms it gives assurance that it will be held open. Com C §2205(a). The clearest assurance would be an express statement that the offer will be held open, but less explicit language (such as a request for reply by a certain date) or use of the term "firm offer" would likely be sufficient.

In *E.A. Coronis Assoc. v M. Gordon Constr. Co.* (NJ Super Ct 1966) 216 A2d 246, a subcontractor's letter to a general contractor offered to sell structural steel. The letter was phrased "We are pleased to offer" and "Thank you very much for this opportunity to quote." When the general contractor did not accept the subcontractor's offer for a two-week period, the subcontractor withdrew the proposal. The court found that the letter contained no assurances that the offer would be held open; therefore, the offer was revocable by the subcontractor.

In *Ivey's Plumbing & Elec. Co. v Petrochem Maintenance, Inc.* (ND Miss 1978) 463 F Supp 543, the seller quoted prices for compressors but, before the buyer accepted, issued a revised quotation at a substantially higher price. The court determined that, because the original estimate contained no assurance that the quotation would be held open for any period of time, it was subject to revocation by the seller unless previously accepted by the buyer. The court rejected the buyer's contention that a firm offer could arise by implication or through the buyer's reliance on the offer to its detriment.

The Commercial Code does not specify whether a rejected firm offer nevertheless remains open until the end of the indicated period. Arguably, a firm offer should be treated like any offer without consideration for this purpose, because an offeror is likely to rely on the rejection. Thus, the offer would be terminated by offeror's receipt of the offeree's rejection. See Restatement §40; 1 Witkin, Summary of California Law, *Contracts* §163 (10th ed 2005).

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§2.12 c. Signed Writing

For an offer to be binding without consideration, it must be in writing and signed by the merchant making it. Com C §2205(a). Two definitions in the Commercial Code make this formality (a substitute for the safeguard of consideration) easier to comply with than might at first appear.

"Signed" includes any symbol executed or adopted by a party with the present intention to adopt or accept a writing. Com C §1201(b)(37). Examples of what may be a "signing" for purposes of making an offer irrevocable include:

- A formal signature;
- Initials or thumbprints;
- A handwritten memorandum, subscribed or not, on the writer's letterhead, confirming a firm offer already made;
- An authorized telegram, even though the original contained only a typewritten signature; or
- Any reasonable symbol that is printed, stamped, or written on any part of the document, executed or adopted by a party with present intention to authenticate the writing. "Written" or "writing" includes printing, typewriting, or any other intentional reduction to tangible form. Com C §1201(b)(43).

Much modern commercial communication is by e-mail. The Commercial Code does not directly address whether an e-mail constitutes a "signed writing" from the sender for purposes of Division 2. Decisions concluding that e-mail is a signed writing include *Donovan v RRL Corp*. (2001) 26 C4th 261, 109 CR2d 807 (noting with apparent approval that other states had relaxed requirement for signed writing to satisfy statute of frauds to include e-mails) and *Lamlie v Mattel, Inc.* (Fed Cir 2005) 394 F3d 1355 (applying California law to conclude that pre-2000 e-mail satisfied signature requirement of statute of frauds). But see *Toghiyany v Amerigas Propane, Inc.* (8th Cir 2002) 309 F3d 1088, 1091 (stating, without discussion, that e-mails are not "signed" for purposes of Missouri statute of frauds). See also §2.50B for a discussion of electronic signatures in contracts governed by the Electronic Signatures in Global and National Commerce Act (ESIGN) (15 USC §§7001-7031).

In contrast to e-mail, a document with a name imprinted automatically on each page by a fax machine will probably not be considered a "signed writing." See, *e.g., Parma Tile Mosaic & Marble Co. v Estate of Short* (1996) 640 NYS2d 477, 663 NE2d 633 (automatic imprinting of name does not demonstrate sender's intention to authenticate document).

As noted in §§1.18 and 9.1, international sales of goods may be governed by the United Nations Convention on Contracts for the International Sale of Goods (CISG; sometimes referred to as the Vienna Sales Convention; see 15 USC App). Under the CISG, a firm offer need not be in writing. The CISG allows an oral, unlimited firm offer to exist (1) when the offeror states that the offer is irrevocable or (2) when the offeree reasonably relies on the offer as being irrevocable. See CISG, art 18. See §9.1 about the applicability of the CISG to a particular transaction.

DRAFTING CONSIDERATIONS: When the definition of "written" or "writing" is read in conjunction with the definition of "signed," it becomes clear that it is not difficult to furnish a signed writing complying with Com C §2205. A merchant may distribute printed or typewritten quotations or price lists with language indicating duration; if these are construed to be offers (see §2.7), the language indicating duration may make them firm offers. The attorney should review all such documents to determine whether they could be considered offers. If a court might hold them to be offers, contrary to the client's wishes, the attorney should add qualifying language to the documents, such as: "This is a quotation only and not an offer." See §2.8 for appropriate qualifying language.

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Source: Business Law/California UCC Sales and Leases/2 Formation of Sales Contracts: Express Terms/§2.13 2. Form Supplied by Offeree

§2.13 2. Form Supplied by Offeree

A provision in a form supplied by the offeree that an offer will be held open (for example, "All offers are irrevocable for 30 days") must be separately signed by the offeror. Com C §2205(a). The intent of this requirement is to protect the offeror against "boilerplate" firm offers that the offeror does not want to make.

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§2.14 3. Period of Irrevocability

A merchant's offer qualifying as a "firm offer" cannot be revoked for lack of consideration during the period stated in the writing. If no time is stated, the offer remains open for a reasonable time. In neither event may the period of irrevocability be longer than 3 months. Com C §2205. If the writing states that the offer will remain open for 4 months, it will bind the offeror only for the first 3 months of the period. Official Comment 3 to UCC §2-205.

If the offer is supported by consideration, it may remain open for as long as the parties specify. The 3-month maximum period applies only to firm offers not supported by consideration. Com C §2205.

What will be considered a "reasonable" time depends on the nature of the business and the circumstances of the offer. Conceivably, the period could be much shorter than the 3-month maximum provided in Com C §2205, especially during a rapidly rising or falling market. See Official Comment 3 to UCC §2-205.

Even though there is no agreement at the offer stage, a court probably will examine the parties' course of dealing and the usages of their trade in measuring a reasonable time for the life of a firm offer. On course of dealing and usage of trade, see §§4.98-4.104. The court also will consult outside law for supplementary principles. See Com C §1103(b). For example, under CC §1587(2) an offer is revoked by the lapse of a reasonable time when there is no communication of its acceptance.

The period of irrevocability recited in the writing need not be expressed in units of time. Official Comment 3 to UCC §2-205. If an offeror withdraws a firm offer before it has expired (by its terms or by law), the offeree may have a cause of action for breach of contract, and the remedy may be damages or specific performance. See *Sashti, Inc. v Glunt Indus*. (D Ohio 2001) 140 F Supp 2d 813.

EXAMPLE: A merchant's offer stating that it will remain firm until the cost of certain raw materials increases would not be revocable until that contingency occurred (or until 3 months had elapsed, whichever came first).

EXAMPLE: A seller/offeror sent a "proposal" for sales of goods which included a provision that more than 45 days' notice would be given before a price increase. The proposal did not include quantity or durational terms, and the buyer/offeree neither assented nor rejected. However, the buyer sent several purchase orders over a period of more than 3 months that the seller/offeror filled. After 3 months, the seller raised the price for the goods, effective immediately, and buyer contested the no-notice increase. Held: the parties had not entered into a "requirements contract" (see §§4.22-4.30), so each purchase order began a separate transaction. The "proposal" was a "firm offer" that commenced when the offeror delivered the "proposal," and this was irrevocable for just 3 months. Therefore, the increased price was enforceable. *Mid-South Packers, Inc. v Shoney's, Inc.* (5th Cir 1985) 761 F2d 1117.

It is not clear whether a firm offer becomes effective when it is sent by the offeror or when it is received by the offeree. The effective date becomes important if the offer is open for a specific period only, or if it has no lapse date and therefore lasts for three months. The general rule that an offer must be communicated to be effective (Restatement (Second) of Contracts §23, comment a (1981)) would imply that the offeree's receipt is the starting point. However, the rule in California is that an acceptance is effective on deposit "in the course of transmission to the proposer" (CC §1583). Therefore, the offeror should avoid uncertainty about duration by making the offer run until a certain date rather than for a given period.

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§2.15 4. Limited Effect of Com C §2205

A firm offer is not a special kind of offer; Com C §2205 merely removes the offeror's power of revocation for lack of consideration for a limited time. Properly interpreted, §2205 is simply an additional, formal method to create an option.

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Source: Business Law/California UCC Sales and Leases/2 Formation of Sales Contracts: Express Terms/§2.16 5. Firm Offer to Contractor

§2.16 5. Firm Offer to Contractor

A merchant's offer to supply goods to a licensed contractor may be made irrevocable as provided under Com Code §2205(b):

- The merchant's offer may be either oral or written.
- The contractor must be licensed under the applicable California Business and Professions Code provisions or a similar contractor's law of another state.
- The merchant must have actual or imputed knowledge that the offeree is a licensed contractor and that the contractor will rely on the offer in the submission of a bid for a construction contract with a third party.
- If the contractor relies on the offer, it is irrevocable for 10 days after the contract is awarded to the contractor, but not for more than 90 days after the date on which the offer was tendered by the merchant.
- The merchant may provide that the offer will be held open for less than the time specified in the statute.
- If the offer is oral and for $2500 or more, it must be confirmed in writing by the contractor within 48 hours after it is tendered. The contractor's failure to confirm releases the merchant from the offer.

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§2.17 C. Drafting Considerations

A client may prefer an offer that definitely is or is not firm or an offer that is firm but limited in some way. The client's preference may depend on whether it is a buyer or seller or whether the goods are unique or fungible and easily obtained elsewhere.

The attorney should first determine whether the offeror is a merchant and whether the subject of the sale is goods. If the answer to either question is "no," Com C §2205 does not apply and the matter is governed by other Commercial Code provisions.

If Com C §2205(a) does apply, the client must decide how long the offer should be kept open. The time will depend on the nature of the goods, the nature of the market, and the expectations of customers. If a firm offer is not supported by consideration and the three-month period of irrevocability provided by Com C §2205(a) is too long, a time for the expiration of the offer should be specified. If the client wants a form for repeated use, the time provision may be left incomplete, but the attorney should alert the client to the reasonable period applicable.

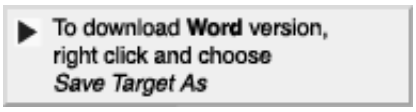
A firm offer may be as simple as a fax or e-mail from the offeror stating: "Offer to sell sugar ten cents. Firm through June 13." Such language, however, fails to deal with many problems that may attend a firm offer, *e.g.*:

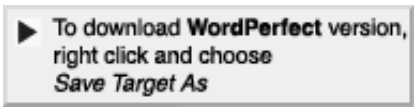
- The provision does not specify the manner of acceptance. This may be important if the offeree takes more time to accept the offer than the offeror expects.
- The provision does not clearly specify what happens if the cutoff date arrives and the offeree has not accepted the offer. The language should specify either that the offer then terminates or that the offer will remain open subject to revocation.
- The provision does not specify any contingencies that may revoke the offer. For example, the offeror's supply or price might be subject to war or weather.

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Source: Business Law/California UCC Sales and Leases/2 Formation of Sales Contracts: Express Terms/§2.18 1. Form: Revocable Offer

§2.18 1. Form: Revocable Offer





2.18-1 Revocable offer

This _ _[*offer/order*]_ _ may be revoked at any time. If we have not previously revoked it, the _ _[*offer/order*]_ _ will terminate if we do not receive your acceptance or notice of acceptance in our office at _ _[*address*]_ _ on or before _ _[*date*]_ _.

Comment: A seller may want the offeree to accept or reject an offer promptly so that it may offer the goods elsewhere. The attorney should scrutinize any order or offer form to ensure that it cannot be construed as a firm offer. This clause makes it clear that the offer terminates if the offeror does not receive acceptance of the offer by a given date. It is generally good practice to specify the manner of acceptance.

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Source: Business Law/California UCC Sales and Leases/2 Formation of Sales Contracts: Express Terms/§2.19 2. Form: Firm Offer for Specified Period

§2.19 2. Form: Firm Offer for Specified Period

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2.19-1 Firm offer for specified period

This is a firm offer that we assure you will be held open until _ _[*date*]_ _. For this offer to be effective, we must receive your written acceptance of it at _ _[*address*]_ _ no later than that date; if not received by that date, the offer will terminate automatically.

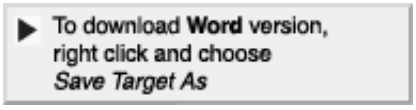
[*Add if appropriate*]

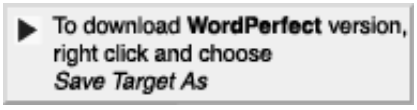
We reserve the right to revoke this offer earlier if, in our judgment, we are required to do so because of natural disasters, acts of governments, or other causes beyond our control.

Comment: This clause should eliminate problems relating to the manner and time of acceptance. The risks of transmission are shifted to the offeree. See §2.34. The provision that the acceptance must be received by the cutoff date causes the offer to be revoked automatically if the offeror does not receive it. If the offeror desires to condition the offer by allowing for revocation in the event of labor disputes, shortages, fire, flood, or other contingencies, the attorney should add language to that effect.

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§2.20 3. Form: Firm Offer Subject to Contingencies





2.20-1 Firm offer subject to contingencies

This is a firm offer that we assure you will be held open until _ _[*e.g., the price of raw materials reaches _ _*[*specify*]*_ _/present stock in inventory is sold*]*_ _ _ _*[*but no later than _ _*[*date*]*_ _*]*_ _*. **For this offer to be effective, we must receive your written acceptance of it at _ _**[*address*]*_ _* **no later than that date. We will advise you in writing if _ _**[*the terminating event*]*_ _* **occurs, and that the offer is terminated.**

Comment: In this clause, the firm offer may terminate on the occurrence of a contingency. See Official Comment 3 to UCC §2-205. If no cutoff date is given, the offer will remain firm for a reasonable period, not to exceed three months. The attorney should specify the terminating event to minimize the possibility that an offeree will claim detrimental reliance on the offer's remaining open.

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§2.21 4. Form: Firm Renewable Offer

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2.21-1 Firm renewable offer

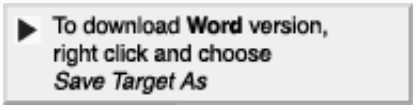
This offer will be kept open for a period of 3 months from its date. Unless we inform you otherwise in writing at least _ _[*e.g., 10*]_ _ days before this or any subsequent 3-month period expires, this offer is automatically renewed from each 3-month period to the next succeeding 3-month period.

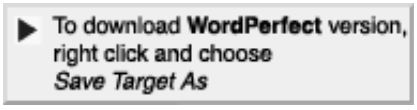
Comment: This clause is an attempt to alter the Commercial Code limitation of 3 months for a firm offer when no consideration is received. A longer time limitation may be advisable if goods are purchased over an extended period and the purchaser wishes some assurance about the terms of the offer. An option agreement with some consideration may be preferable, however, because such an agreement is more likely to be enforceable. See form in §2.23.

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Source: Business Law/California UCC Sales and Leases/2 Formation of Sales Contracts: Express Terms/§2.22 5. Form: Firm Offer in Form Supplied by Offeree

§2.22 5. Form: Firm Offer in Form Supplied by Offeree





2.22-1 Firm offer in form supplied by offeree

This offer is a firm offer to furnish the goods at the prices specified above, made to _ _[*buyer/seller*]_ _ **by** _ _[*seller/buyer*]_ _**. The offer will be held open until** _ _[*date*]_ _**, after which it** _ _[*may/will]* **be revoked.**

Date: _ _ _ _ _ _ __[*Signature of offeror*]__

Comment: A buyer soliciting a bid might add this clause to its bid request form. The clause might also be useful to a seller who wishes to obtain firm orders before producing a new item. Note that the clause must be separately signed by the offeror. See Official Comment 4 to UCC §2-205. For convenience and conspicuousness, the attorney should place this clause near the signature spaces toward the end of the form.

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§2.23 6. Form: Firm Offer by Nonmerchant

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2.23-1 Firm offer by nonmerchant

I offer to _ _[*buy from you/sell to you*]_ _ _ _[*identify goods*]_ _ **for** _ _[*dollar amount*]_ _**. In consideration of the payment to me of** _ _[*dollar amount*]_ _**, receipt of which I acknowledge, you may have** _ _[*for example, ten days*]_ _ **in which to act on this offer.**

Date: _ _ _ _ _ _ __[*Signature of offeror*]__

Comment: Commercial Code §2205 applies exclusively to an offer by a "merchant." Therefore, an offer made by a nonmerchant may be revoked at any time before acceptance, even though the offeror specifies that the offer will remain open, unless the offeror has received consideration for not revoking the offer or the offeree has detrimentally relied on the offer remaining open and its reliance was reasonably foreseeable by the offeror.

Revocation is effected by the communication of notice of revocation by the offeror to the offeree, in the manner prescribed by CC §§1581 and 1583 (*i.e.,* in the manner required for communication of acceptance). CC §1587(1). Literally applied, CC §1587(1) prevents formation of a contract if a notice of revocation is posted before the posting of a notice of acceptance, even though the notice of revocation reaches the offeree after acceptance. See 1 Witkin, Summary of California Law, *Contracts* §160 (10th ed 2005).

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IV. ACCEPTANCE

§2.24 A. When No Means or Manner Specified

Commercial Code requirements differ from common law rules for contract acceptance. Common law distinguished between offers for unilateral contracts and offers for bilateral contracts. An offer for a unilateral contract could be accepted only by performance. An offer for a bilateral contract could be accepted only by promise. Generally, any acceptance in derogation of these principles was ineffective. See Corbin on Contracts, chap 3 (rev ed 1993). For general common law rules of acceptance, see 1 Witkin, Summary of California Law, *Contracts* §§180-201 (10th ed 2005). In addition, the acceptance under common law had to be communicated in the same manner as the offer (*e.g.,* an offer made by telegram had to be accepted by telegram). See Corbin on Contracts, 3 (rev ed 1993).

In contrast to these common law rules, Com C §2206(1)(a) provides that unless otherwise unambiguously indicated by the language or circumstances, an offer to make a contract must be construed as inviting acceptance in any manner and by any medium reasonable under the circumstances.

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§2.25 B. Specifying Means or Manner of Acceptance

The offeror may prescribe the form that the acceptance must take. The manner of acceptance, however, must be "unambiguously indicated." Com C §2206(1). See, *e.g., Great W. Sugar Co. v Lone Star Donut Co.* (ND Tex 1983) 567 F Supp 340, aff'd (5th Cir 1983) 721 F2d 510.

See §§2.50G-2.50H for a discussion of click-wrap, browse-wrap, and shrink-wrap licenses, including acceptance of offers and enforceability of the license agreement.

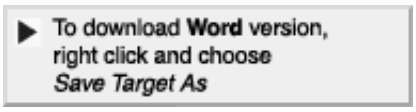
An offeror may want to require a particular manner of acceptance for various reasons. For example, the offeror may want to:

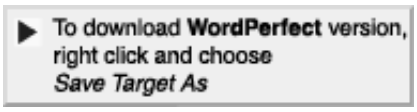
- Reduce the number of personnel required to process orders;
- Simplify its bookkeeping procedures;
- Conclude transactions more quickly to facilitate cash flow;
- Avoid being left in the dark about whether an offer will be accepted so that it may place its own orders; and
- Minimize the potential for litigation.

WARNING: Unless the offeror is very clear about the manner of acceptance, the terms of the offer may be construed as merely suggestive and a method of acceptance unsuited to the offeror's needs may be considered reasonable.

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§2.26 1. Form: Acceptance by Return of Form





2.26-1 Acceptance by return of form

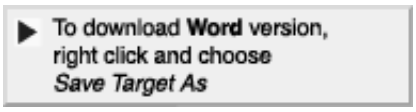
To accept this offer, you must sign the enclosed form, which we must receive at _ _[*address*]_ _ no later than _ _[*date*]_ _. No other form of oral or written acceptance will be valid or binding.

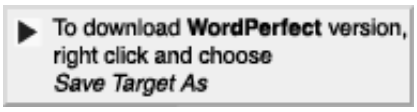
Comment: The attorney may use this clause when it is important that the contract be on the terms set out in the offeror's form. The clause reduces the risk that the offeree's acceptance will contain additional or different terms. The clause also eliminates problems of processing personal, telephone, e-mail, or fax acceptances.

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Source: Business Law/California UCC Sales and Leases/2 Formation of Sales Contracts: Express Terms/§2.27 2. Form: Acceptance by Performance

§2.27 2. Form: Acceptance by Performance





2.27-1 Acceptance by performance

To accept this offer, you must ship via _ _[*specify method of shipment*]**_ _ no later than _ _**[*date and time*]**_ _. In addition, we must receive written notice of your shipment at _ _**[*address*]**_ _ within 24 hours after you ship. Unless these conditions are met, this offer will lapse, but in any event, on _ _**[*e.g., 1 day after the last date for shipping*]**_ _. A promise to ship will not be an acceptance of this offer.**

Comment: This clause takes away the offeree's choice under Com C §2206(1)(b) to accept an order for prompt or current shipment by a promise to ship. See §2.36. The only way for the offeree to accept under this clause is to ship within the time given and send a notice that it has done so. On notice of acceptance, see §§2.28-2.31.

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C. Notices of Acceptance

§2.28 1. Code Requirement of Reasonable Time

When the beginning of a requested performance is a reasonable mode of acceptance, an offeror who is not notified of acceptance within a reasonable time may treat the offer as having lapsed before acceptance. Com C §2206(2). See *Petersen v Thompson* (Or 1973) 506 P2d 697 (because notice not given, offer deemed lapsed even though offeree had begun performance).

What will be considered a "reasonable" time depends on the circumstances of the transaction and is subject to agreement. Com C §§1205(a), 1302(b). At one extreme, an immediate shipment might arrive as soon as a notice of acceptance. Under this circumstance, no notification is required. At the other extreme, an offeree who is required to make extensive drawings or cost studies may expect the offer to remain outstanding for a considerable time before a notice of acceptance is required.

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§2.29 2. Effect of Performance Alone

If the offeree does not notify the offeror that performance has begun, might the commencement of performance nevertheless prevent the offeror from revoking the offer? Under Official Comment 3 to UCC §2-206, the issue is left to outside law. The Comment states that (a) for the protection of both parties, it is essential that notice follow in due course to constitute acceptance; and (b) nothing in UCC §2-206 bars the possibility that, under the common law, performance begun may have an intermediate effect of temporarily barring revocation of the offer.

Restatement (Second) of Contracts §45 (1981) adopts the following approach (emphasis added):

> (1) Where an offer invites an offeree to accept by rendering a performance and does not invite a promissory acceptance, *an option contract is created* when the offeree tenders or begins the invited performance or tenders a beginning of it.
>
> (2) The offeror's duty of performance under any option contract so created is conditional on completion or tender of the invited performance in accordance with the terms of the offer.

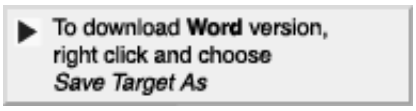
See also 1 Witkin, Summary of California Law, *Contracts* §166 (10th ed 2005).

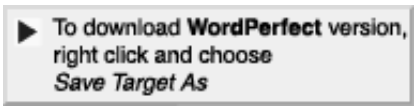
Comment f to Restatement §45 indicates that, to preclude revocation, what is begun or tendered must be part of the actual performance invited, but preparations to perform may constitute justifiable reliance sufficient to make the offeror's promise binding.

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3. Forms

§2.30 a. Form: Notice of Acceptance by Performance





2.30-1 Notice of acceptance by performance

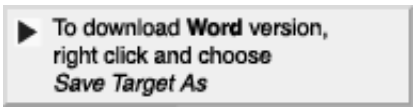
Thank you for your offer of _ _[*date*]**_ _. We have begun _ _**[*describe performance begun, for example, manufacture of item*]**_ _ and expect to complete performance by _ _**[*date*]**_ _.**

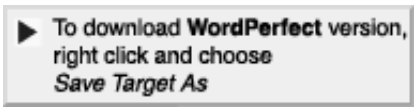
[*Add other details if appropriate, for example, shipping information*]

Comment: To constitute acceptance, the offeree's acts must "unambiguously express" the intention to perform as required. The performance may be as simple as shipping or may involve more complicated initial steps such as the preparation of drawings. The purpose of describing the performance is to make it clear to the offeror that the offeree has done enough to form a contract binding the offeror. Shipping information and other details may be added for the offeror's convenience. To avoid the danger of misjudging what is a reasonable time, the offeree should transmit the notice of acceptance as quickly as circumstances permit.

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§2.31 b. Form: Offeror's Waiver of Notice of Acceptance





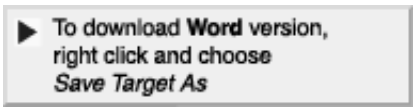
2.31-1 Offeror's waiver of notice of acceptance

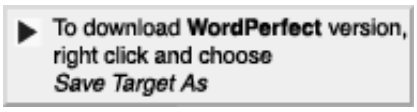
_ _[*Name of offeror*]_ _ **expressly waives the necessity of a notice of acceptance and agrees that acceptance will be complete when** _ _[*name of offeree*]_ _ **begins performance.**

Comment: Offerees may solicit offers on their own forms. By making the beginning of performance a complete acceptance, this clause eliminates the need for sending the offeror a notice of acceptance. Ordinarily, unless an offeree gives notice of acceptance, the offeree who begins performance runs the risk that the offeror may treat the offer as lapsed. Official Comment 3 to UCC §2-206 (UCC §2-206(2) (2003)). The notice requirement of the Commercial Code may be waived by agreement. See Com C §1302(a).

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§2.32 c. Form: Notice That Offer Has Lapsed





2.32-1 Notice that offer has lapsed

On _ _[*date*]_ _, we ordered _ _[*describe goods*]_ _. Because we have not received your notice of acceptance, we assume that you do not intend to fill the order. This is to advise you that our offer has lapsed and is revoked.

Comment: By advising that the offeree can no longer accept the offer, this clause minimizes the danger of leaving an offer outstanding and subject to acceptance. The Commercial Code does not state when this notice will be considered effective. Presumably, a court will treat it the same as a revocation. See §2.9.

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§2.33 D. Withdrawal of Acceptance

An acceptance is complete when sent in conformity with CC §1582 (CC §1583), and the offeree cannot withdraw the acceptance before it reaches the offeror. The offeree is not permitted to speculate at the offeror's expense during the time required for the acceptance to arrive. See 1 Witkin, Summary of California Law, *Contracts* §200 (10th ed 2005).

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§2.34 E. Failure in Transmission of Acceptance

Under certain circumstances, an offeree's notice of acceptance may fail to be transmitted to the offeror either before or after performance. Although the Commercial Code does not specify when an acceptance is effective, it puts the risk of the nondelivery of the notice on the offeror. Under Com C §1202(d), a person notifies another by taking such steps as may be reasonably required to inform the other in ordinary course, whether or not the other actually comes to know of it.

See also CC §1583, which provides that consent is deemed to be fully communicated between the parties as soon as the party accepting a proposal has put his or her acceptance "in the course of transmission" to the proposer. See *Gibbs v American Sav. & Loan Ass'n* (1990) 217 CA3d 1372, 266 CR 517 (deposit with postal service, rather than office mail clerk, required for "in the course of transmission").

PRACTICE TIP: The notice provision of the Commercial Code can be changed by agreement. Com C §1302(a). To prevent the offer from lapsing, the offeror should provide in the offer that it must actually receive a notice of acceptance. See §2.35.

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Source: Business Law/California UCC Sales and Leases/2 Formation of Sales Contracts: Express Terms/§2.35 F. Form: Requirement of Notice of Acceptance by Given Date

§2.35 F. Form: Requirement of Notice of Acceptance by Given Date

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2.35-1 Requirement of notice of acceptance by given date

If we do not receive your notice of acceptance by _ _[*date and time*]**_ _, this offer will lapse.**

Comment: This clause shifts the risk of communication failure to the offeree and defines the time within which notification of acceptance must be made.

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G. Prompt or Current Shipment: Acceptance by Promise or Performance

§2.36 1. The Rule

When a buyer orders goods for "prompt" or "current" shipment (or words to that effect), the seller may form a contract either by shipping promptly or currently or by making a prompt promise to ship. Com C §2206(1)(b).

Unless the manner of acceptance is specified, a buyer that orders goods for prompt shipment does not know whether the seller will ship the goods or merely make a prompt promise to ship them. The buyer and seller may not have the same notion of "prompt" or "current." If these matters are important, the buyer should specify in the order (a) whether the buyer wants actual shipment or a prompt promise to ship and (b) the latest date allowed for receipt of shipment. See §§2.25-2.27.

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2. Acceptance by Promise

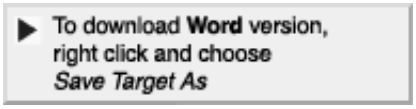
§2.37 a. The Rule

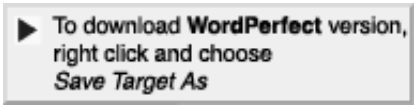
The fact that a seller can accept an offer for prompt shipment by a prompt promise does not mean that the time for the seller's performance is extended. In whatever manner the contract is formed, the seller must perform it according to its terms; if the seller fails to ship promptly or currently, the seller is in breach of contract.

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Source: Business Law/California UCC Sales and Leases/2 Formation of Sales Contracts: Express Terms/§2.38 b. Form: Requirement of Acceptance by Promise to Ship

§2.38 b. Form: Requirement of Acceptance by Promise to Ship





2.38-1 Requirement of acceptance by promise to ship

If we do not receive your promise to ship by _ _[*date and time*]_ _, this offer will lapse.

Comment: This clause makes it clear that the buyer wants a timely commitment that the seller will ship. The offer may also specify the time for performance. Note that under this clause the promise to ship must be received by the buyer rather than merely sent by the seller.

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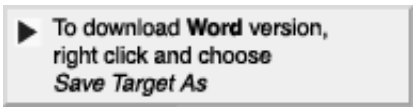
3. Acceptance by Performance

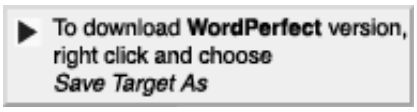
§2.39 a. The Rule

If the seller elects to accept by performing, the acceptance will be ineffective unless the seller's performance is prompt or current. To protect itself, the seller should send a notice of acceptance. See §2.30.

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§2.40 b. Form: Requirement of Acceptance by Performance





2.40-1 Requirement of acceptance by performance

I order _ _[*identify goods*]_ _ as quoted in your letter of _ _[*date*]_ _, on the condition that prompt shipment is made to me at _ _[*address*]_ _. This offer can be accepted only by shipment made no later than _ _[*date*]_ _.

Comment: This clause specifies what the offeror considers "prompt" shipment to be. Providing a deadline for shipment eliminates any dispute between the offeror and offeree about whether shipment of the goods was prompt enough to constitute an acceptance.

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§2.41 4. What Is Prompt or Current?

The Commercial Code does not define "prompt" or "current." It is not clear whether "current" means the same as "prompt" or "in the regular course of business." If the latter is the intended meaning, "current" could apply to present orders for goods to be manufactured in the future but shipped immediately after manufacture (*e.g.,* magazines that are shipped as published) or to goods that must be ordered a long time in advance. What is "prompt" or "current" presumably depends on the nature of the business and the goods involved. Promptness in shipping hammers for a hardware store would not be the same as promptness in shipping roses for Valentine's Day. If time of performance is important, the offeror should indicate how promptly performance is expected.

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H. Acceptance by Shipping Nonconforming Goods

§2.42 1. Meaning of "Nonconforming"

"Goods or conduct including any part of a performance are 'conforming' or conform to the contract when they are in accordance with the obligations under the contract." Com C §2106(2). Consequently, "nonconforming" describes (a) goods that deviate from the specifications of the order or (b) "conforming" goods shipped in the wrong quantity or at the wrong time.

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§2.43 2. Shipment of Nonconforming Goods May Be Acceptance and Breach

If a buyer asks for prompt shipment of goods, but the seller ships goods that differ from those ordered, the shipment of nonconforming goods may be considered an acceptance by the seller. An order or other offer to buy goods for prompt or current shipment will be construed as inviting acceptance either by a prompt promise to ship or by the prompt or current shipment of conforming or nonconforming goods. Com C §2206(1)(b). Shipment of nonconforming goods thus creates a contract, even though it is one that the seller has breached. The statute precludes an unscrupulous seller that has provided nonconforming goods from asserting the defense that no contract had been formed because the performance was not the act called for.

The Commercial Code recognizes, however, that a seller may in good faith believe that the buyer will find substitute goods satisfactory. If the seller does not want to risk contractual liability by shipping substitute goods, it may avoid liability by notifying the buyer that the goods are offered only as an accommodation to the buyer. Com C §2206(1)(b). (An "accommodation" is an act or an instance of making a change or provision as a favor to another. See Black's Law Dictionary (8th ed 2004).) If the buyer wishes, it may accept the nonconforming goods as a suitable alternative to the ordered goods.

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§2.44 3. Notifying Buyer That Goods Are Shipped for Accommodation

A seller furnishing a quantity of goods that differs from those ordered should promptly notify the buyer that the shipment is an accommodation shipment. See Com C §2206(b). By neglecting to so notify the buyer that the goods are an accommodation shipment, the seller may be in breach of a contract that the seller accepted by shipping the goods. In *Corinthian Pharm. Sys., Inc. v Lederle Labs.* (SD Ind 1989) 724 F Supp 605, the buyer ordered 1000 vials of vaccine at $64 each. The seller shipped 50 vials at that price, with a letter offering to fill the balance of the order at $171 per vial. The court held that the seller's shipment was for the buyer's accommodation and did not constitute an acceptance and breach. See §§2.49-2.50 for forms of notice.

The notice to the buyer that nonconforming goods are being shipped only as an accommodation to the buyer must be "seasonable." See Com C §2206(b). Section 2206 does not require that the notification precede or accompany the shipment. However, the seller should ensure that the notification at least accompany, if not precede, the shipment.

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§2.45 4. Buyer's Options on Receipt of Nonconforming Goods

If shipped goods are nonconforming, the buyer may reject them, accept them, or accept any commercial unit or units and reject the rest. Com C §2601.

A merchant buyer has duties toward rightfully rejected goods and may have to sell them if they are perishable or may decline quickly in value. Com C §2603(1).

PRACTICE TIP: The buyer may have no duties toward goods sent solely on the seller's initiative. The voluntary and unsolicited sending of goods not ordered will be deemed a gift. CC §1584.5. Before advising a client that it is safe to ignore a shipment apparently sent without an order, the attorney should ascertain that the goods were not sent as an accommodation to the buyer in place of ordered goods that the seller could not provide.

For further discussion of the buyer's duties with respect to rejected goods, see §§10.44-10.51, 17.60.

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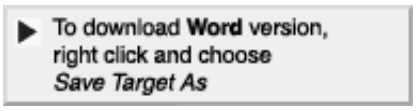
§2.46 5. Precluding Accommodation Shipments

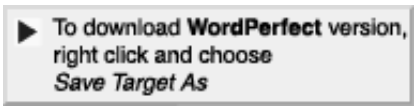
If the buyer wants the goods to conform strictly to the order, the buyer must indicate this unambiguously (see §2.47) or the order will be construed as permitting the seller to ship nonconforming goods. Com C §2206(1)(b). To be sure that the goods will be as expected, the buyer should obtain a promise of performance from the seller. The buyer will then have either the goods or whatever remedies are available for breach of the contract. In any event, the buyer should determine beforehand whether the seller is able to supply the particular goods.

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6. Forms

§2.47 a. Form: Precluding Accommodation Shipments





2.47-1 Precluding accommodation shipments

Goods that do not conform strictly to this order will be rejected. Do not send nonconforming goods for accommodation.

Comment: The purpose of this clause is to indicate unambiguously that the buyer does not want the seller to ship nonconforming goods for accommodation.

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Source: Business Law/California UCC Sales and Leases/2 Formation of Sales Contracts: Express Terms/§2.48 b. Form: Requirement of Seasonable Notification of Acceptance or Accommodation

§2.48 b. Form: Requirement of Seasonable Notification of Acceptance or Accommodation

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2.48-1 Requirement of seasonable notification of acceptance or accommodation

This order is for immediate shipment. If we do not receive your promise to ship or your notice of acceptance by _ _[*date and time*]_ _, this order will lapse. If you intend to ship nonconforming goods in response to this order, we must receive notice of that fact by the same date. That notice should state in detail how the goods will not conform to this order. Otherwise, your shipment of goods will be deemed an acceptance of this order.

Comment: This clause is designed for situations in which the buyer may be willing to accept goods that do not conform but wants to know as soon as possible whether the goods will be suitable. The clause also establishes the "seasonable" time within which the seller must notify the buyer that the goods do not conform. Notices of acceptance are discussed in §§2.28-2.31.

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§2.49 c. Form: Notice of Intentional Accommodation Shipment

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2.49-1 Notice of intentional accommodation shipment

This is to acknowledge your order of _ _[*date*]_ _ for _ _[*describe product ordered*]_ _. Demand has been great for this product, and we regret that we cannot fill your order exactly. As an accommodation to you, we are shipping the same quantity of _ _[*describe product shipped*]_ _, which is substantially similar to what you ordered. The price is the same.

Comment: If the seller ships nonconforming goods in response to an order, the shipment will be considered an acceptance and breach of the contract unless the seller notifies the buyer that the goods are being shipped for accommodation.

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§2.50 d. Form: Notice of Unintentional Accommodation Shipment

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2.50-1 Notice of unintentional accommodation shipment

Thank you for your order of _ _[*date*]_ _. It was shipped via _ _[*manner of shipment*]_ _ on _ _[*date*]_ _. If any of the goods sent do not conform to the order, they are sent for accommodation only and not in acceptance of the offer. Nonconforming goods will be billed at the same price as the goods you ordered.

Comment: A seller may intend to conform but may have doubts about whether the shipment fulfills the order's specifications. If the seller sends nonconforming goods preceded (or, more likely, accompanied) by a notice such as this, the shipment will not be deemed an acceptance. Shipping information is included in this clause as a convenience to the buyer.

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V. ELECTRONIC CONTRACTING

A. ESIGN

§2.50A 1. Introduction

The Electronic Signatures in Global and National Commerce Act (ESIGN) (15 USC §§7001-7031) became effective October 1, 2000. ESIGN confirms the ability of parties to contract electronically, defining an "electronic signature" broadly as "an electronic sound, symbol or process, attached to or logically associated with a contract or other record and executed or adopted by a person with the intent to sign the record." 15 USC §7006(5). ESIGN provides that any signature, contract, or other record cannot be denied legal effect, validity, or enforceability solely because it is in electronic form (15 USC §7001(a)(1)), and any contract cannot be denied legal effect, validity, or enforceability solely because an electronic signature or electronic record was used in its formation (15 USC §7001(a)(2)). ESIGN, however, does not require any person to agree to use or accept electronic records or electronic signatures. 15 USC §7001(b)(2).

NOTE: As indicated in Com C §1108, adopted in 2006, it was the legislature's intention that Com C §§1101-1108 modify, limit, and supersede ESIGN. There are a couple of exceptions to this. The Commercial Code provisions do not affect 15 USC §7001(c), which concerns disclosure of electronic records to consumers. Nor do they authorize electronic delivery of:

- Any of the notices described in 15 USC §7003 (*e.g.,* notices concerning the recall of a product, or the material failure of a product, that risks endangering health or safety); or
- Any document required to accompany any transportation or handling of hazardous materials, pesticides, or other toxic or dangerous materials.

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Source: Business Law/California UCC Sales and Leases/2 Formation of Sales Contracts: Express Terms/§2.50B 2. Electronic Signatures

§2.50B 2. Electronic Signatures

Under common law, any symbol made with the intent to sign a document could qualify as a legally valid signature. The definition of "signed" in the Commercial Code includes "any symbol," as long as it is "executed or adopted with present intention to adopt or accept a writing." Com C §1201(b)(37). ESIGN extends this approach to electronic signatures by requiring that an electronic signature possess three elements (15 USC §7006(5)):

- A sound, symbol, or process;
- Attached to or logically associated with an electronic record; and
- Made with the intent to sign the electronic record.

An electronic signature can take many forms, and can be created by many different technologies. Examples of electronic signatures that probably qualify under ESIGN include:

- Typing the sender's name at the end of an e-mail message sent by him or her (see, *e.g.,* §2.12 and cases cited there);
- Including a digitized image of a handwritten signature attached to an electronic document;
- A mouse click (*e.g.,* on an "I Accept" or "I Agree" button; see §§2.50G-2.50H); and
- A "digital signature" (for example, a signature created through public key cryptography).

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§2.50C 3. Consumer Protection Features

In addition to granting legal effect to electronic documents generally, ESIGN includes several provisions intended to protect the rights of consumers in electronic transactions. ESIGN's consumer protection provisions are triggered only when a statute, regulation, or other rule of law requires that information relating to a transaction be provided or made available to a consumer in writing. 15 USC §7001(c). Providing information electronically in these circumstances is acceptable only if the consumer affirmatively consents to receive the information in electronic form, gives his or her consent electronically, and does so in a manner that reasonably demonstrates that he or she can access the information in the electronic format that will be used to provide it. 15 USC §§7001(c)(1)(A), 7001(c)(1)(C)(ii).

Before giving consent, the consumer must receive a clear and conspicuous statement of his or her rights, the scope of the consent given, and how to withdraw the consent. 15 USC §7001(c). In particular, businesses are required to take the following actions:

- Inform the consumer of (a) any right to have an electronic record made available in nonelectronic (paper) form, (b) the right of a consumer to withdraw his or her consent to have the record provided in an electronic form, and (c) any conditions, consequences (such as termination of the parties' relationship), or fees if the consumer's consent is withdrawn (15 USC §7001(c)(1)(B)(i));
- Inform the consumer whether his or her consent applies (a) only to the specific transaction that gave rise to the obligation to provide the record, or (b) to identified categories of records that may be provided over the course of the parties' relationship (15 USC §7001(c)(1)(B)(ii));
- Describe the procedures the consumer is required to use to withdraw consent and to update information needed to contact the consumer electronically (15 USC §7001(c)(1)(B)(iii));
- Inform the consumer of (a) how, after consenting to the electronic record, the consumer may obtain a paper copy of the electronic record on request, and (b) the fee, if any, to be charged for such copy (15 USC §7001(c)(1)(B)(iv));
- Provide the consumer (before consent) with a description of the hardware and software requirements for access to and retention of the electronic records (15 USC §7001(c)(1)(C)(i)); and
- If the software or hardware requirements necessary to access the electronic record change, advise the consumer of (a) the new hardware and software requirements, and (b) the consumer's right to withdraw consent without the imposition of any fees or any condition or consequence not previously disclosed (15 USC §7001(c)(1)(D)(i)).

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§2.50D 4. Electronic Record Retention

Under ESIGN, if the law requires that a record of a contract be retained, an electronic record is adequate for the purpose, provided that it "accurately reflects the information" in the contract and the record remains accessible for later reference in a form that can be accurately reproduced. 15 USC §7001(d)(1). ESIGN provides that the legal effect, validity, or enforceability of an electronic record "may be denied if such electronic record is not in a form that is capable of being retained and accurately reproduced for later reference by all parties or persons who are entitled to retain the contract or other record." 15 USC §7001(e). Even if a contract is not required by law to be retained, it is always advisable to keep a record of an electronic contract for evidentiary purposes. Thus, a website operator should include online functionalities for printing and saving electronic agreements to better assure their enforceability.

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B. Uniform Electronic Transactions Act (UETA)

§2.50E 1. Overview

Before ESIGN, California adopted a version of the Uniform Electronic Transactions Act (UETA) (see CC §§1633.1-1633.17), which applies to transactions between parties who have each agreed to conduct a transaction electronically. UETA provides for the enforceability of electronic contracts, as well as for records retention and the evidentiary use of electronic records. As of this writing, more than three-fourths of the states have adopted a version of UETA. See http://www.nccusl.org/update/uniformact_factsheets/uniformacts-fs-ueta.asp. Although broader than ESIGN, UETA covers many of the same issues as ESIGN and is therefore subject to federal preemption. ESIGN, however, has an exemption from federal preemption applicable in states where UETA has been enacted in the form recommended by the National Conference of Commissioners on Uniform State Laws (NCCUSL). The California version of UETA is nonconforming; it substantially altered many of UETA's provisions. Under ESIGN, however, only provisions that would create an exception to the scope of UETA (as recommended by NCCUSL) and are otherwise inconsistent with ESIGN are subject to federal preemption by ESIGN. 15 USC §7002. Thus, the scope of ESIGN's potential preemption of California's version of UETA is unclear. It is therefore advisable to assume that ESIGN's restrictions and exclusions will apply in California and any other state that has not enacted UETA in the form recommended by NCCUSL.

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§2.50F 2. Consent Under UETA

Both ESIGN and UETA authorize parties to enter into electronic transactions, but do not require parties to do so. 15 USC §7001(b)(2); CC §1633.5(a). Unlike ESIGN, UETA is premised on consent by the parties; the statute does not apply unless the parties have "agreed to conduct transactions by electronic means." CC §1633.5(b). The consent requirement applies to both business and consumer transactions. Whether the parties have consented to conduct a transaction by electronic means is determined from the context and circumstances surrounding the transaction, and consent may be either express or implied. CC §1633.5(b). Under the California version of UETA, consent must be given by electronic means. CC §1633.5(b). If a company's website is capable of receiving electronic communications from customers, and a customer enters into a transaction with the company using the company's website, it can be inferred that both parties have impliedly agreed to conduct their transaction electronically. See §2.50G for a discussion of browse-wrap agreements.

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C. Shrink-Wrap, Click-Wrap, and Browse-Wrap License Agreements and the Commercial Code

§2.50G 1. Is Transaction Covered by Division 2?

Software developers and owners have sought to license—not sell—their products for a variety of reasons. For example, a licensor may restrict a licensee's use of software under a license. In contrast, under the Copyright Act's first sale doctrine, a seller loses the ability to restrict subsequent use of a product (with exceptions) once the product is sold. 17 USC §109(a).

Some software owners grant rights in the software by a license in the box in which off-the-shelf software is sold (called a "shrink-wrap" license). Other software owners distribute their software and grant rights online by use of one or the other of two methods that have been called "browse-wrap" and "click-wrap" licenses. In a browse-wrap license, the terms and conditions appear somewhere on the Web page. A click-wrap license also appears on a Web page, but the end user is required to acknowledge acceptance of the terms of the license by clicking on an icon or a button that may read, "I Agree" in order to download the software. Even though software owners prefer to treat the grant of rights as a license rather than a sale, the courts have nonetheless tended to view a software transaction as a sale for purpose of the Commercial Code. See, *e.g., Communications Groups v Warner Communications, Inc.* (NY Civ Ct 1988) 527 NYS2d 341.

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§2.50H 2. Enforceability If Transaction Is a Sale

At issue, then, is the degree to which the terms of the license will be enforced when the transaction is treated as a sale of goods under the Commercial Code. The applicability of Division 2 to the software license is significant with respect to such things as the manifestation of acceptance, implied warranties, and a professed disclaimer of those warranties in the license.

There is little disagreement over the enforceability of click-wrap licenses because of the demonstrable affirmative acceptance of the license.

Shrink-wrap licenses have also generally been enforced in California courts since the Seventh Circuit led the way in *ProCD, Inc. v Zeidenberg* (7th Cir 1996) 86 F3d 1447 (court upheld seller's shrink-wrap license when seller specified that buyer's first use of computer software constituted acceptance of license agreement). See *Meridian Project Sys. v Hardin Constr. Co. LLC* (ED Cal 2006) 426 F Supp 2d 1101; *Adobe Sys., Inc. v Stargate Software Inc.* (ND Cal 2002) 216 F Supp 2d 1051; *Adobe Sys., Inc. v One Stop Micro* (ND Cal 2000) 84 F Supp 2d 1086.

Browse-wrap licenses have met with a more mixed degree of acceptance by the courts. See, *e.g., Ticketmaster v Tickets.com* (CD Cal 2000) 2000 US Dist Lexis 12987 (*Ticketmaster I*) and *Sprecht v Netscape* (2d Cir 2002) 306 F3d 17, where browse-wrap licenses were not upheld. Compare with *Register.com v Verio, Inc.* (2d Cir 2004) 356 F3d 393, *Ticketmaster Corp. v Tickets.com, Inc.* (CD Cal 2003) 2003 US Dist Lexis 6483 (*Ticketmaster II)*, *Pollstar v Gigmania Ltd.* (ED Cal 2000) 170 F Supp 2d 974, and *Net2Phone v Superior Court* (2003) 109 CA4th 583, 135 CR2d 149, where browse-wrap licenses were enforced. It appears that there is a trend toward enforcing browse-wrap agreements when the user knew, or had reason to know, of the terms of the agreement, even without an affirmative click on a link or an "I Agree" button to continue, as with click-wrap agreements.

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§2.50I 3. Commercial Code Express and Implied Warranties Applied to Software

As discussed in chap 3, the seller of goods is deemed to have given express warranties by, among other things, furnishing to the buyer "[a]ny description of the goods which is made part of the basis of the bargain." Com C §2313(1)(b). See §3.19. Division 2 also reads into every contract for the sale of goods a warranty by the seller that (Com C §2312(1)(a)-(b)):

- The title conveyed shall be good, and its transfer rightful;
- The goods shall be delivered free from any security interest or other lien; and
- The goods will not infringe any third party's rights.

The seller also warrants that the goods are merchantable (Com C §2314) and are fit for a particular purpose (Com C §2315).

The software developer/seller (as with other sellers of goods) may disclaim both express and implied warranties. The disclaimers should be clear and conspicuous to be enforced. A general limitation of liability is not sufficient. As discussed in chap 3, disclaimer of Commercial Code warranties requires the use of particular language. See generally §§3.46-3.69.

For further discussion of electronic contracting, and the enforceability of shrink-wrap software licenses, click-wrap agreements, and other agreements under ESIGN and UETA, see Internet Law and Practice in California, chap 7 (Cal CEB 2004).

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VI. AUCTIONS

A. Regulation

§2.51 1. State Law

Auction sales have become the subject of considerable regulation. The field of auction licensing is preempted from local regulation by statute. See CC §§1812.600-1812.608.

The Commercial Code does not define the term "auction." For purposes of auction licensing, "auction" is a sale transaction conducted by means of oral or written exchanges between an auctioneer and the members of his or her audience. These exchanges consist of a series of invitations for offers for the purchase of goods made by the auctioneer and offers to purchase made by members of the audience and culminate in the acceptance by the auctioneer of the highest or most favorable offer made by a member of the participating audience. However, "auction" excludes a wholesale motor vehicle auction subject to Department of Motor Vehicles regulation or a sale of real estate under Com C §9604(a)(1)(B). CC §1812.601(b).

In conducting the auction, each auctioneer and auction company, and each of the company's owners, partners, officers, agents, and employees, must do the following (CC §1812.605):

- Follow all lawful requests of the owner or consignor of the goods being sold;
- Perform his or her duties so that the highest or most favorable offer made by a bidder is accepted, except to the extent that any sale is made with reserve or subject to confirmation (see §2.55);
- Truthfully represent the goods to be auctioned; and
- Otherwise perform his or her duties in accordance with California law.

An auctioneer violates CC §§1812.600-1812.608 when he or she fails to comply with any provision of the Commercial Code relating to auctions, which include Com C §§2328 (sales by auction) and 2401 (passage of title and reservation of title for security), as well as any Vehicle Code, Civil Code, Code of Civil Procedure, or Penal Code provisions relating to the auctioneering business. CC §1812.608.

Other statutory enactments relating to auctioneering include Pen C §535, prohibiting fraudulent "mock auctions," and CC §§2362-2363, dealing with the agency relationship among the auctioneer, seller, and bidder.

Commercial Code Division 2 applies to auction sales of goods only; auctions of securities or land are not covered. Com C §2328. Auction sales by warehouses are governed by Com C §7210; auction sales by common carriers are governed by Com C §7308. See generally Anno, *Auction Sales Under UCC §2-328*, 44 ALR4th 110 (1986). Secured parties may dispose of collateral by auction under Com C §9610.

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§2.51A 2. Bankruptcy Auction Sales

Although it is beyond the scope of this book to cover auction sales in bankruptcy court in detail, the subject warrants some comment.

Auctions in bankruptcy court are not governed by Division 2 or by other state law. Instead, bankruptcy court auctions are conducted under 11 USC §363, as expanded or interpreted by common law. The overriding principle is that the court will seek to maximize the liquidation value of the estate for the benefit of creditors, and this principle often colors the decisions of judges and the few written decisions following such sales. Most auction sales are accomplished by the trustee after having given notice to creditors of the debtor and to other parties that the trustee believes may be interested in the property being offered for sale. The sales are usually held in the courtroom. In some courts, the judge will preside and call for bids, and in other courts, the trustee may be the auctioneer. Breaks in the bidding and conferences "in the hallway" may occur, something which is rare if unheard of in auctions under state law.

When all or substantially all of a business and its assets are to be sold in one lot in a bankruptcy auction, the trustee (or Chapter 11 debtor in possession) usually will have entered into an agreement with a potential purchaser. The trustee/debtor in possession will give notice of the sale to creditors and others that might be interested. The potential purchaser is often called a "stalking horse," and it often seeks and obtains advance approval by the court for bidding procedures (*e.g.,* minimum initial overcall bid and minimum subsequent bidding overcalls) and a "breakup fee." This breakup fee is meant to compensate the potential purchaser for incurring expenses associated with its "due diligence" examination of the debtor and its assets, the benefit of which expenditures will flow to a competitive higher bidder.

There are many aspects to the sale of property in a bankruptcy case that are unique to such cases. For example, the property may be sold free of security interests or other interests (11 USC §363(f)) and executory contracts affecting the business or property might be assumed and assigned (11 USC §365(f)). Even the notion that a sale is final on the "fall of the hammer" (see §2.54) cannot be relied on in a bankruptcy court sale. In *Corporate Assets, Inc. v Paloian* (7th Cir 2004) 368 F3d 761, the court upheld the decision of the bankruptcy court to reopen an auction when a losing bidder increased its offer to top the highest bid after the auction had concluded.

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§2.52 B. Separate Sales and Statute of Frauds

The Commercial Code's statute of frauds (Com C §2201) applies to sales of goods for a price of $500 or more, including sales by auction. In an auction sale, however, if goods are put up in lots, each lot is the subject of a separate sale. Com C §2328(1). Thus, if the price paid in each separate sale is under $500, the statute of frauds does not apply.

Civil Code §2363 affects the application of the statute of frauds by stating, in effect, that an auctioneer has authority to bind both the buyer and seller by a memorandum of the contract.

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C. Formation of Auction Contract

§2.53 1. The Bid and Its Acceptance

A bid is an offer to purchase that is accepted or rejected by the auctioneer. The auctioneer accepts a bid with the fall of the hammer or in some other customary manner. Com C §2328(2). The auctioneer rejects a bid by accepting another bid as a continuation of the bidding, just as any offer is rejected by conduct inconsistent with its acceptance. Applying contract principles, the rejection of a bid terminates it. Restatement (Second) of Contracts §38(1) (1981). See also *Iwakiri v Ewing (In re El Camino Press)* (Bankr CD Cal 1983) 31 BR 340 (weight of authority is that when auctioneer presents article for sale at auction and asks for bids, he or she is ordinarily not making operative offer but is asking for offers to be made to him or her; bids made in response are offers. Because a bid is an offer, the bidder may retract his or her bid before the auctioneer completes the sale. Com C §2328(3). See also *Iwakiri v Ewing (In re El Camino Press)*, *supra.* Once a bid is terminated, it cannot be revived except by the bidder. The retraction of a bid does not revive a previous bid. Com C §2328(3).

Although an auction sale is ordinarily complete with the fall of the auctioneer's hammer, the seller may vary this term of the sale and reserve the right to reject any bid even after it has been "accepted" by the auctioneer. For example, in *Eugene Stud & Veneer, Inc. v State Bd. of Forestry* (Or 1970) 469 P2d 635, after the auctioneer had completed the sale, the seller refused to deliver the goods to the highest bidder, who promptly sued for breach of contract. The court found in favor of the seller because in the auction notice the seller had reserved the right to reject all bids. A sale by auction will not be complete "by the fall of the hammer" under Com C §2328 when the parties agree that passage of title will occur on payment of the balance of the purchase price. If payment is not made, title will not pass. *In re Atlantic Orient Corp.* (Bankr D NH 2003) 290 BR 456.

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§2.54 2. Last-Minute Bid

If a bid is made just as a sale is in the process of being completed, the auctioneer has the discretion to reopen the bidding or declare the goods sold under the bid on which the hammer was falling. Com C §2328(2). The auctioneer's recognition of a last-minute bid is not an acceptance of that bid but a reopening of bidding. If the last-minute bid is recognized, the bid on which the hammer was falling is not revived.

In the absence of "special authorization or usage," the auctioneer may sell only to the highest bidder. CC §2362. This section arguably creates a duty for the auctioneer to exercise discretion in favor of reopening the bidding when a last-minute bid is made. To avoid a dispute over a last-minute bid, the auction announcement should state that the auctioneer has the option to receive or ignore such a bid.

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D. Auctions With and Without Reserve

§2.55 1. Distinctions Between "With" and "Without" Reserve

Auction sales may be "with reserve" or "without reserve."

With reserve. If an auction sale is with reserve, the auctioneer reserves the right to reject all bids and withdraw the goods without making a sale. Com C §2328. The term "with reserve" is also commonly used to describe an auction in which the seller has reserved the right to bid on his or her own goods. The purpose of conducting an auction with reserve in either case is to protect the seller from being forced to sell the goods at an excessively low price. An auction sale is with reserve unless it is explicitly stated before the goods are "put up" that the sale is without reserve. Com C §2328(3). See also *Iwakiri v Ewing (In re El Camino Press)* (Bankr CD Cal 1983) 31 BR 340 (when auctioneer announced before bidding that property subject to liens would be sold only if bids exceeded amount of liens and that any other bids would result in sale only if secured parties approved sale, auction was "with reserve" and such condition did not conflict with Com C §2328(2)). If the seller has reserved the right to bid, however, that fact should be communicated to the other bidders before the goods are put up. See Com C §2328(4). See also §2.58.

Without reserve. If an auction is without reserve, the auctioneer has no right to withdraw the goods after bidding has begun. (The auctioneer may withdraw the goods, however, if no bid is made within a reasonable time. Com C §2328(3).) See §2.57. The owner must sell to the highest bidder (see, *e.g., U.S. v Von Cseh* (SD Tex 1972) 354 F Supp 315), and, typically, the owner may not bid.

The notice announcing an auction without reserve must be explicit. A simple statement that sales will be made to the highest bidder is not enough. For instance, in *Sly v First Nat'l Bank* (Ala 1980) 387 So2d 198, a bank announced that a sale would be made "at public outcry to the highest, best and last bidder." The court concluded that, because the announcement did not explicitly indicate that the auction would be without reserve, the bank was not obligated to accept any bid. In fact, the bank did not accept the highest bid. The court held that there was no breach of contract in the bank's refusal to sell to that bidder, because no contract had been created (387 So2d at 200):

> The rule reflects the logic that an auctioneer is not the offeror; instead, it is presumed the bidder is the offeror. A seller is not normally bound by bids unsatisfactory to him—a bidder may not impose a contract on the seller. The seller may reasonably be expected to withdraw the goods or to accept or reject any bid, unless he explicitly undertakes the auction without reserve.

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§2.56 2. Change in Nature of Auction Before Goods Are "Put Up"

Even if the notice of sale advertises that the sale is without reserve, the auctioneer can make the sale with reserve by an appropriate announcement before the goods are "put up." *Milwaukee Stove & Furnace Supply Co. v Apex Heating & Cooling, Inc.* (Wis App 1987) 418 NW2d 4. Commercial Code §2328 does not specify when goods are considered to be "put up," but the statute does provide that the auctioneer's call for bids is the act that cuts off his or her power to withdraw the goods in an auction without reserve. This implies that the goods are put up when bids are called for.

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§2.57 3. Reasonable Time for Bid

In an auction without reserve, once the auctioneer calls for bids, the goods cannot be withdrawn "unless no bid is made within a reasonable time." Com C §2328(3). What constitutes a "reasonable" time depends largely on the nature of the auction, the procedure for submitting bids, and the rapidity with which the auction is conducted. A bidder should bid promptly to prevent the auctioneer from withdrawing the goods. Presumably, a bid made within a reasonable time but then withdrawn would not prevent the auctioneer from subsequently withdrawing the goods.

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§2.58 E. Bids by Seller

The buyer may void a sale if the seller bids at an auction without prior notice to other bidders that it may do so. Com C §2328(4). The purpose of §2328(4) is to protect buyers from unfair and commercially unreasonable tactics by the seller that are designed solely to boost the sales price. *Nevada Nat'l Leasing Co. v Hereford* (1984) 36 C3d 146, 203 CR 118.

Under §2328(4), if the auctioneer knowingly receives a bid on the seller's behalf or the seller makes or procures such a bid, and there was no notice given that the bidding is with reserve, the buyer has the option to void the sale or take the goods at the price of the last good faith bid before completion of the sale. However, §2328(4) specifically excepts bids at forced sales from its provisions.

Determination of what is a forced sale is thus critical to application of the statute. This issue was considered by the California Supreme Court in *Nevada Nat'l Leasing Co. v Hereford, supra.* In that case, a leasing company (the seller) repossessed several items of heavy construction equipment and decided to sell them at auction. Without informing the other bidders, the auctioneer and the seller (through its employee) agreed that the seller's employee would bid on the auctioned items to stimulate the bidding. The seller's employee testified at trial that, had he been the successful bidder, he did not intend to pay the purchase price. Instead he planned to re-auction the equipment later to receive a higher price.

The defendant buyer outbid the seller. In a subsequent lawsuit over payment and transfer of title, the buyer charged that the auction had been illegally conducted, because the seller had failed to notify other bidders that it would also be bidding at the auction. The court agreed and awarded the buyer damages equal to the difference between his winning bid and his last bid before the sham bid entered by the seller's employee. (Note that Com C §2328(4) allows the buyer to avoid the sale or take the goods at the price of the last good faith bid before completion of the sale.) The buyer also received punitive damages for the improper collusive actions of the seller and auctioneer, which were designed to run up the bidding.

The court noted that the term "forced sale" is not defined, but the purpose of the exception is to encourage bidding at execution sales. The court therefore concluded that the forced sale exception of Com C §2328(4) did not apply in this case because the sale was voluntary. The leasing company was the owner of the equipment; it was neither a secured party foreclosing to protect its security interest nor an execution creditor forcing the sale of the equipment to satisfy a judgment. (Under Comment 4 to Com C §2328, an execution sale is an example of a forced sale.)

In addition, the leasing company had other commercially reasonable alternatives to the auction; it could have re-leased the equipment or sold it by other means. Furthermore, the auction itself was conducted with reserve; the leasing company could have withdrawn the equipment from the sale, and it was not obligated to accept the highest bid.

In an auction of goods held following a buyer's breach of the sales agreement, the seller may buy and, impliedly, bid. Com C §2706(4)(d). Note that Com C §9610(c)(1) permits a secured party to bid at a public sale, and Com C §§7210(d) and 7308(c) permit warehouses and common carriers to buy at public sales enforcing their liens.

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§2.59 F. Bidding Abuses

Certain abuses of the bidding process may result in the goods being sold for a fraudulent price. Such abuses include "puffing" by the seller (bidding on the goods without the intention of purchasing) and bid "chilling" by the buyers (agreeing in advance among themselves not to bid in order to lower the price).

Puffing is fraudulent because it induces potential bidders to believe that there is greater demand for the goods than actually exists. Although Com C §2328(4) deals with the problem of puffing, there is no similar provision relating to bid chilling. Rather, the Commercial Code allows the aggrieved seller to pursue its remedies for fraud under common law. See Com C §1103(b). At common law, if bidders at an auction agree to suppress or stifle bidding, the seller has the right to refuse to sell the goods to any party participating in the "chill," even after the sale is completed and even if the auction was held without reserve. See, *e.g., Henderson-Snyder Co. v Polk* (NC 1908) 62 SE 904.

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3

Warranties

Thomas Ross

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I. INTRODUCTION

§3.1 A. Tort Law and Warranty Law

This chapter focuses on the use of warranties in the sale of goods. (For the Commercial Code definition of "goods," see §1.5.) The chapter describes the protections that warranties provide, how the parties may limit those protections, and the buyer's rights and remedies when a warranty is breached.

While suing for breach of warranty, a buyer who is harmed by defective goods often will seek recovery from the seller under tort theories of negligence, fraud, and strict liability. Tort law has several potential advantages over warranty law:

- There are no notice requirements (unless the defendant is a government entity) (see §§3.73-3.82);
- It is more difficult for sellers to insulate themselves from liability through contractual waivers or remedy limitation provisions (see §§3.92-3.98);
- Lack of privity is no defense (see §3.121);
- The statute of limitations runs from the time that the defect was or should have been discovered rather than from the time of tender (see §§3.102-3.104); and
- Punitive damages may be available in tort actions but not in breach of warranty actions (see §18.25).

In fact, since the landmark decision of *Greenman v Yuba Power Prods., Inc.* (1963) 59 C2d 57, 27 CR 697, strict liability in tort has essentially replaced warranty as the theory under which a buyer harmed by defective goods seeks recovery for its personal injuries. *Shepard v Alexian Bros. Hosp*. (1973) 33 CA3d 606, 614, 109 CR 132. If the buyer's loss is purely economic (*i.e.,* costs of repair and replacement of the defective product or consequent loss of profits, without any claim of personal injury or damages to other property), tort law provides no remedy; the buyer must seek recovery under contract (warranty) law. *Sacramento Reg'l Transit Dist. v Grumman Flxible* (1984) 158 CA3d 289, 204 CR 736.

In addition, strict products liability is not available as a theory for recovery when the parties (*Kaiser Steel Corp. v Westinghouse Elec. Corp*. (1976) 55 CA3d 737, 748, 127 CR 838):

- Deal in a commercial setting;
- Operate from positions of relatively equal economic strength;
- Bargain the specifications of the product; and
- Negotiate concerning the risk of loss from defects in the product.

Subsequent to *Kaiser,* decisions have held that *actual* bargaining about risk allocation would not be required; it would be enough if the parties were so situated that they *could* have bargained on the issue. (See, *e.g*., *International Knights of Wine, Inc*. *v Ball Corp.* (1980) 110 CA3d 1001, 1007, 168 CR 301.)

Although tort theories of recovery in commercial litigation practice are often alleged concurrently with breach of warranty claims, tort law is outside the scope of this book. For further information, see California Tort Guide, chap 11 (3d ed Cal CEB 1996). See also Wade, *Tort Liability for Products Causing Physical Injury and Article 2 of the U.C.C*., 48 Mo L Rev 1 (1983); Mann & Roberts, *The Applicability of Tort Law to Commercial Buyers*, 79 Neb L Rev 215 (2000).

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Source: Business Law/California UCC Sales and Leases/3 Warranties/§3.2 B. Kinds of Warranties

§3.2 B. Kinds of Warranties

A warranty relates to the character, quality, identity, condition, or title to goods. *Keith v Buchanan* (1985) 173 CA3d 13, 20, 220 CR 392. The whole purpose of the law of warranty is to determine what the seller has agreed to sell. Official Comment 4 to UCC §2-313 (Official Comment 6 to UCC §2-313 (2003)).

The Commercial Code identifies three types of warranties: express, implied, and statutory.

- *Express*. "Any affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain creates an express warranty that the goods shall conform to the affirmation or promise." Com C §2313(1)(a). An express warranty is created by the seller's words or conduct. See §§3.8-3.11.
- *Implied*. An implied warranty is created by operation of law, on the assumption that the warranty is so essential to the bargain that the parties would have included it in their agreement had they thought of it. See Official Comment 11 to UCC §2-314 (Official Comment 13 to UCC §2-314 (2003)). The Commercial Code creates an implied warranty of merchantability (see §§3.21-3.32) and an implied warranty of fitness for a particular purpose (see §§3.33-3.40). Other implied warranties may result from usage or trade (see §3.41).
- *Statutory*. This is a special term used to describe the Commercial Code's warranties of good title and against infringement, which need not be express but are treated separately from the Commercial Code's implied warranties. See §§3.42-3.45.

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C. Consumer Warranty Legislation

§3.3 1. Overview

State and federal consumer warranty laws afford protection to consumer purchasers in addition to that provided by the Commercial Code. These laws recognize that the consumer often has little or no power to negotiate a warranty or its limitations and must buy products under whatever terms the seller dictates. Typically, the legislation does not apply to transactions between merchants or to transactions involving nonconsumer goods (*i.e.,* goods that are not sold for personal, family, or household use).

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§3.4 2. California Law

California's consumer warranty legislation is found in Title 1.7 of the Civil Code (CC §§1790-1797.96) and consists of six chapters:

(1) *The Song-Beverly Consumer Warranty Act* (CC §§1790-1795.8). The Act is also popularly known as the automobile "lemon law." See *Murillo v Fleetwood Enters., Inc.* (1998) 17 C4th 985, 990, 73 CR2d 682. The principal feature of this Act is the imposition of certain service and repair obligations on manufacturers, distributors, and retailers. See CC §§1793.2-1793.4. Of specific interest to motorists are the "lemon law" provisions, including CC §§1793.2(d) and 1793.22. The Act also provides for possible recovery of attorney fees and treble damages. See CC §1794. The provisions of the Act supplement rather than supersede the Commercial Code. *Park City Servs., Inc. v Ford Motor Co.* (2006) 144 CA4th 295, 50 CR3d 373. When the Act and the Code conflict, the Act prevails. CC §1790.3. Specific provisions of the Act are discussed throughout this chapter. See generally Anno, *Validity, Construction, and Effect of State Motor Vehicle Warranty Legislation (Lemon Laws)*, 88 ALR5th 301 (2001).

(2) *Motor vehicle warranty adjustment programs* (CC §§1795.90-1795.93). This chapter provides that motor vehicle dealers (CC §1795.91) and manufacturers (CC §1795.92) have specified duties to provide notice and disclosures regarding adjustment programs that expand the consumer's warranty period as to certain performance-related repairs.

(3) *Standards for warranty work* (CC §§1796, 1796.5). This chapter provides statutory standards of care for installation (CC §1796) and service or repair (CC §1796.5) of consumer goods. Essentially, these provisions require that the installation, service, or repair be done in a workmanlike manner.

(4) *Mobilehome warranties* (CC §§1797-1797.7).

(5) *Grey market goods* (CC §§1797.8-1797.86). Grey market goods are consumer goods that are imported through channels other than the manufacturer's authorized United States distributor, bearing a trademark but unaccompanied by the manufacturer's usual express written warranties. CC §1797.8. A retail seller of grey market goods is required to disclose in a conspicuous manner the fact that the manufacturer's express warranties are not valid in the United States, plus any other incompatibility or nonconformity with domestic standards. CC §1797.81. A violation of these disclosure requirements constitutes unfair competition (see Bus & P C §17200) and is grounds for a rescission of the sale and a refund to the consumer. CC §§1797.85-1797.86. The seller may avoid the express warranty disclosure requirement if it gives the buyer an equal or better warranty and certain other statutory conditions are met. CC §1797.81(b).

(6) *Home roof warranties* (CC §§1797.90-1797.96). This chapter requires that any home roof repair warranty as to materials or workmanship be in writing (CC §1797.91), and provides certain disclosure requirements (CC §§1797.93-1797.96).

The Consumers Legal Remedies Act (CC §§1750-1784) provides damages and injunctive relief to consumers injured by certain deceptive practices in the sale of consumer goods. See §18.72 for extensive discussion of this Act.

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3. Magnuson-Moss Warranty—Federal Trade Commission Improvement Act

§3.5 a. Scope

The Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312) applies to all "consumer products" covered by a "written warranty" that are distributed in commerce. "Consumer products" include those items normally used for personal, family, or household purposes. Products such as automobiles and typewriters that are used for both personal and commercial purposes are considered to be consumer products for purposes of the Act. 16 CFR §700.1(a).

PRACTICE TIP: If the seller giving a written warranty expects that its product will be used for both consumer and commercial purposes, it may provide alternative written warranty statements—one that complies with the Act and is expressly applicable only when the product is purchased for personal, family, or household use, and another (which need not comply with the Act) that is applicable when the product is purchased for commercial use.

The Act does not require a seller to give any warranty; the Act merely applies when a written warranty has been given. Oral express warranties do not trigger its coverage. The term "written warranty" has a specific meaning for purposes of the Act's application (15 USC §2301(6)):

> (6) The term "written warranty" means—
> (A) any written affirmation of fact or written promise made in connection with the sale of a consumer product by a supplier to a buyer which relates to the nature of the material or workmanship and affirms or promises that such material or workmanship is defect free or will meet a specified level of performance over a specified period of time, or
> (B) any undertaking in writing in connection with the sale by a supplier of a consumer product to refund, repair, replace, or take other remedial action with respect to such product in the event that such product fails to meet the specifications set forth in the undertaking, which written affirmation, promise, or undertaking becomes part of the basis of the bargain between a supplier and a buyer for purposes other than resale of such product.

A statement that qualifies as an express warranty under the Commercial Code may not come within the definition of a written warranty for purposes of the Act. For example, a written statement of fact about a product or a written promise that it will perform in a particular manner must relate to a specific period of time to be considered a "written warranty." 16 CFR §700.3.

The Act also applies to "service contracts," defined as "a contract in writing to perform, over a fixed period of time or for a specified duration, services relating to the maintenance or repair (or both) of a consumer product." 15 USC §2301(8).

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Source: Business Law/California UCC Sales and Leases/3 Warranties/§3.6 b. Contents of Written Warranties

§3.6 b. Contents of Written Warranties

The Federal Trade Commission has promulgated a list of items that a written warranty should contain, including such things as (see 16 CFR §701.3):

- The identity of the party or parties to whom the written warranty is extended;
- A clear identification of the products, parts, characteristics, components, or properties covered by and excluded from the warranty;
- A statement of what the warrantor will do in the event of a defect, malfunction, or failure to conform with the written warranty, including the items or services that the warrantor will pay for or provide and those that it will not;
- The date on which the warranty term commences (if different from the purchase date) and the time period or other measurement of warranty duration;
- A step-by-step explanation of the procedure that the consumer should follow to obtain performance of any warranty obligation;
- Information on the availability of any informal dispute settlement mechanism elected by the warrantor;
- Any limitations on the duration of implied warranties;
- Any exclusion of, or limitations on, relief such as incidental or consequential damages; and
- A statement that the warranty provides specific legal rights, and that the consumer may also have other rights that vary from state to state.

The warrantor must make the warranty available to the consumer before the sale so that the consumer can use it as a basis for comparing products. See 16 CFR §§702.1-702.3. If an advertisement mentions a warranty that is offered with the advertised product, the consumer must be informed of his or her right to review the details of the warranty before the sale. See Federal Trade Commission guidelines for the advertising of warranties and guaranties in 16 CFR pt 239.

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§3.7 c. Full and Limited Warranties

Two types of written warranties are allowed: "full" and "limited." A full warranty must have a statement of duration (*e.g.,* "Full 5-Year Warranty") and otherwise meet federal minimum standards for warranty. If it does not, the warrantor must use the term "limited" to describe the warranty. 15 USC §2303(a). The Magnuson-Moss Warranty Act creates a federal private cause of action for a warrantor's failure to comply with the terms of a written warranty whether it is limited or full. 15 USC §2310(d)(1)(B); *Milicevic v Fletcher Jones Imports, Ltd.* (9th Cir 2005) 402 F3d 912.

The following requirements must be met for a warranty to be characterized as full:

- In the case of a defect, malfunction, or failure of the product to conform with the written warranty, the warrantor must remedy the problem within a reasonable time and without charge. 15 USC §2304(a)(1).
- The warrantor may not impose any limitation on the duration of any implied warranty on the product. 15 USC §2304(a)(2). Thus, a "Full 90-Day Warranty" of a used car may not impose a similar limit on the implied warranty of merchantability. Under the Commercial Code, that implied warranty will last for a "reasonable time," which may or may not be longer than 90 days, depending on the circumstances.
- The warrantor may not exclude or limit consequential damages for breach of any express or implied warranty, unless the exclusion conspicuously appears on the face of the warranty. 15 USC §2304(a)(3).
- If the warrantor is unable to remedy a defect in the product after a reasonable number of attempts, the warrantor must give the consumer a refund or replace the defective item without charge, at the consumer's election. If only a component part of the product is replaced, it must be installed without charge. 15 USC §2304(a)(4).
- The consumer's only duty should be to notify the warrantor of the problem. If other duties are imposed on the consumer to obtain the benefits of the warranty, the warrantor must demonstrate their reasonableness. 15 USC §2304(b).
- The warrantor may not require the consumer to return a warranty registration card as a condition of full warranty coverage. The Federal Trade Commission considers this an "unreasonable" duty. 16 CFR §700.7.
- If the warranted product is useful only when installed, a full warranty must provide for installation without charge, regardless of whether the consumer originally paid for installation. 16 CFR §700.9.
- A full warranty cannot restrict the warranty rights of a transferee from the original buyer, unless the original duration of the warranty was clearly limited to the first purchaser's continued ownership (*e.g.,* an automotive battery may carry a "full warranty for as long as you own your car"). 16 CFR §700.6.

For further information, see Squillante, *Remedies Provided by the Magnuson-Moss Warranty Act*, 92 Com LJ 366 (1987); Note, *Consumer Warranty Law in California Under the Commercial Code and the Song-Beverly and Magnuson-Moss Warranty Acts*, 26 UCLA L Rev 583 (1979).

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II. EXPRESS WARRANTIES

§3.8 A. Made by Affirmation or Promise

Any affirmation of fact or promise made by the seller to the buyer that relates to the goods and becomes part of the basis of the bargain creates an express warranty that the goods shall conform to the affirmation or promise. Com C §2313(1)(a).

Express warranties under Com C §2313(1)(a) have been found in advertisements, brochures, written sales contracts, owner's manuals, repair logbooks, and oral representations. See *Keith v Buchanan* (1985) 173 CA3d 13, 22, 220 CR 392 (statements in sales brochure describing yacht as "a picture of sure-footed seaworthiness" and "a carefully well-equipped and very seaworthy vessel" were affirmations of fact as to quality or condition of vessel and constituted express warranty); *Pau v Yosemite Park & Curry Co*. (9th Cir 1991) 928 F2d 880, 886 (jury could have reasonably concluded that statements in sightseeing brochure that described trail as "a safe and enjoyable cycling area" constituted express warranty of rental bicycle's safety for use on trail). Compare *Maneely v General Motors Corp.* (9th Cir 1997) 108 F3d 1176 (print and television advertisements showing young people standing or sitting in cargo beds of stationary pickup trucks did not constitute representation of fact that riding in back of moving truck was safe; therefore, no express warranty was created).

In CC §1791.2(a)(1), the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) defines an express warranty as a

> *written* statement arising out of a sale to the consumer of a consumer good pursuant to which the manufacturer, distributor, or retailer undertakes to preserve or maintain the utility or performance of the consumer good or provide compensation if there is a failure in utility or performance. [Emphasis added.]

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§3.9 1. Seller's Intent to Warrant

For an express warranty to arise, the seller need not have the specific intention to make a warranty. If the seller makes an affirmation of fact or a promise relating to the goods, and the statement becomes part of the basis of the bargain, a warranty will be found regardless of the seller's intention. Com C §2313(1)(a), (2). See also *Chamberlain Co. v Allis-Chalmers Mfg. Co*. (1942) 51 CA2d 520, 125 P2d 113 (construing former CC §2313, similar to Com C §2313).

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§3.10 2. Words of Warranty

No particular words are required to create an express warranty. Com C §2313(2). The terms "warrant" or "guarantee" or similar words are not necessary. Com C §2313(2). Any statement made by a seller that relates to the goods being sold is presumptively an express warranty. It is the seller's burden to show that a reasonable buyer should have considered the statement to be merely the seller's opinion about the goods and not a statement of fact. *Keith v Buchanan* (1985) 173 CA3d 13, 21, 220 CR 392 (seller's claim that vessel was "seaworthy" was express warranty, not opinion or sales talk).

Often, a limitation of remedies clause is titled as a "warranty" or "guarantee." The use of such titles does not change a limitation of remedies clause into an express warranty. *A & M Produce Co. v FMC Corp*. (1982) 135 CA3d 473, 481 n3, 186 CR 114. On limitation of remedies, see Com C §2719(1), discussed in §§3.92-3.98.

If the court finds that the use of an expression like "these goods are guaranteed" creates an express warranty, it may look to the Commercial Code section dealing with the implied warranty of merchantability (Com C §2314) to give meaning and content to the "guarantee," even if the seller is not a merchant of goods of that kind.

Any manufacturer, distributor, or retailer who makes a warranty relating to consumer goods must state the warranty in simple and readily understandable language. The warranty must conform to the federal standards for disclosure of warranty terms that are found in the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312) and its adopting regulations.

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§3.11 3. Basis of Bargain; Buyer's Reliance

To be characterized as an "express warranty," the seller's statement must become "part of the basis of the bargain." This does not mean that the buyer must show actual reliance on the seller's statements in entering into the sale. Official Comment 3 to UCC §2-313 (Official Comment 5 to UCC §2-313 (2003)) states:

> In actual practice affirmations of fact made by the seller about the goods during a bargain are regarded as part of the description of those goods; hence no particular reliance on such statements need be shown in order to weave them into the fabric of the agreement.

All statements of the seller become part of the basis of the bargain unless good reason is shown to the contrary. See *Keith v Buchanan* (1985) 173 CA3d 13, 23, 220 CR 392, in which the court stated:

> A buyer need not show that he would not have entered into the agreement absent the warranty or even that it was a dominant factor inducing the agreement.... The representation need only be part of the basis of the bargain, or merely a factor or consideration inducing the buyer to enter into the bargain. A warranty statement made by a seller is presumptively part of the basis of the bargain, and the burden is on the seller to prove that the resulting bargain does not rest at all on the representation.

Some courts, however, still consider reliance a factor in determining whether a statement was a basis of the bargain. See, *e.g., Williams v Beechnut Nutrition Corp*. (1986) 185 CA3d 135, 229 CR 605 (requiring plaintiff to plead reliance in action for breach of express warranty). See also *Chandler v Chiron Corp.* (ND Cal, July 28, 1997, No. C-96-1047 SI) 1997 US Dist Lexis 11251, aff'd without published opinion (9th Cir 1999) 176 F3d 481 (surgical patient presented no evidence that she saw or relied on express warranty that surgical instrument was of merchantable quality and fit for its intended purpose). The question of whether a statement is a warranty or mere "sales talk" may also invite the reliance analysis. See §3.13.

Because the seller has the burden of proving that its statements were *not* a basis of the bargain (see Official Comments 3 and 8 to UCC §2-313; Official Comments 5 and 10 to UCC §2-313 (2003)), the courts should resolve any doubts in the buyer's favor.

See generally Anno, *Purchaser's Disbelief in, or Nonreliance Upon, Express Warranties Made by Seller in Contract for Sale of Business as Precluding Action for Breach of Express Warranties*, 7 ALR5th 841 (1992).

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§3.12 4. Inspection of Goods

If the buyer conducts a thorough inspection of the goods before the sale, the seller may be able to argue that the buyer's inspection, rather than the seller's statements, induced the buyer to enter into the bargain. An inspection may nullify *implied* warranties concerning defects that the inspection should have revealed. Com C §2316(3)(b). See §3.32. Whether the buyer's inspection will nullify an express warranty depends on the circumstances. When the inspection is clearly the sole basis for the buyer's purchase decision, a court may find that the seller's statements were not enforceable express warranties. See, *e.g., Sessa v Riegle* (ED Pa 1977) 427 F Supp 760, aff'd without published opinion (3d Cir 1978) 568 F2d 770 (court determined that buyer's decision to purchase horse was influenced almost entirely by his agent's inspection and recommendation to buy; seller's statements that horse was "sound" were not basis of bargain). If the inspection does not reveal defects that conflict with the seller's assurances, those assurances will remain enforceable express warranties. *Werner v Montana* (NH 1977) 378 A2d 1130, 1135.

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§3.13 5. Distinguishing Warranty From Opinion

Under Com C §2313(2), the following do not qualify as express warranties:

- A seller's personal opinions or commendations concerning a product (*e.g.,* "I own one of those myself. It's great. I'm sure you'd be very happy with it"); and
- Mere affirmations of value or worth (*e.g.,* "a $200 value" or "worth up to $500").

It may be difficult, however, to determine where "sales talk" or "puffing" ends and warranty begins. California case law offers many examples of puffing. See, *e.g., Williams v Lowenthal* (1932) 124 CA 179, 12 P2d 75 (jukebox was a "good machine" and "would probably not get out of order"); *Steen v Southern Cal. Supply Co*. (1925) 74 CA 265, 239 P 1098 (caramel coloring agent "just as good or perhaps better than any"); *W.J. Bush & Co. v Van Camp Sea Food Co*. (1921) 55 CA 672, 203 P 1026 (peach kernel oil was equal to the "best grades of imported olive oil"). The basic issue to be decided in each case is which of the seller's statements have "in the circumstances and in objective judgment become part of the basis of the bargain." Official Comment 8 to UCC §2-313 (Official Comment 10 to UCC §2-313 (2003)).

The leading California case on this issue is *Keith v Buchanan* (1985) 173 CA3d 13, 220 CR 392, in which the court held that statements made by a seller during the course of negotiations are presumptively affirmations of fact (*i.e.,* warranties) unless the seller can show that a reasonable buyer could only have considered them statements of opinion. 173 CA3d at 21. The court identified three characteristics that distinguish statements of opinion from those of warranty. According to the court, a seller's statement is probably opinion if it:

- Lacks specificity, *e.g.,* "It is a good machine";
- Is made in an equivocal manner, *e.g.,* "We are not sure, but we think the machine will…"; or
- Reveals that the goods are experimental in nature.

173 CA3d at 21. In *Keith,* the court held that statements in a sales brochure describing a yacht as "a picture of sure-footed seaworthiness" and "a carefully well-equipped and very seaworthy vessel" were affirmations of fact, not statements of opinion. 173 CA3d at 18, 21.

PRACTICE TIP: Be sure the client understands that any statement made by the client's sales staff to a customer may be found to be an express warranty.

In another case, *Hauter v Zogarts* (1975) 14 C3d 104, 112 n5, 120 CR 681, the court identified the following statement from the seller's catalog as an example of puffing:

> [You] may be a duffer and divot digger but just give yourself a few hours with this and you'll be challenging Jack Nicklaus!… Practice with [the Gizmo] and you'll have even your golf pro watching admiringly.

This statement from the same catalog, however, was held to be an express warranty: "Completely safe ball will not hit player." The court noted that promises of safety are consistently held to be affirmations of fact. The court also noted the judicial trend toward narrowing the scope of puffing and expanding the liability of sellers for statements about the quality of their products.

Note that, in an action to enforce a federal water services contract, congratulatory statements and opinions expressed by government officials did not amount to an "affirmation" of a guaranteed availability of water that could reasonably be considered the basis of the bargain, and therefore there was no express warranty under UCC §2-313(2). *O'Neill v U.S.* (9th Cir 1995) 50 F3d 677.

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§3.14 6. Seller Who Is Expert

If the seller is an expert with specialized knowledge, or if the buyer's lack of knowledge about the goods forces it to rely on the seller for guidance, even some statements of opinion may be considered express warranties. For example, in *Carter Hawley Hale Stores, Inc. v Conley* (Fla Dist Ct App 1979) 372 So2d 965, the court held a gem expert's statement that a diamond was "flawless" to be a warranty of quality. See also *Goldman v Barnett* (D Mass 1992) 793 F Supp 28, in which the court held that a seller who gave his expert opinion as an appraiser of the fair market value of paintings he was selling went beyond merely affirming value; therefore, a triable issue existed concerning whether the seller's opinion of value amounted to an express warranty.

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7. Time of Warranting

§3.15 a. Warranties Made Before Sale

Assume that on the first of January a seller makes statements to a buyer about goods that it has for sale. Without further conversation, on the first of March the buyer instructs the seller to ship the goods. Later, the goods are found not to be as the seller represented them on the first of January. Do statements made such a long time before the sale qualify as express warranties?

The answer to that question depends on the type of statement made. If a seller makes a statement about the *nature* of the goods (*e.g.,* "These sardines are packed in olive oil") that turns out to be false (*e.g.,* they are actually packed in fish oil), warranty liability should attach. But if the seller makes a statement about the *condition* of the goods (*e.g.,* "The automobile has been recently tuned-up"), the court will not deem the statement to be a warranty unless it determines that the passage of time has caused a change in condition for which the seller should be held responsible.

The controlling test of an express warranty is whether the seller's statements were "part of the basis of the bargain." Com C §2313(1)(a). The burden is on the seller to convince the trier of fact that a reasonable buyer would not have entered into the bargain on the basis of a statement that could have been accurate only for a short time.

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§3.16 b. Warranties Made After Sale

A seller may seek to reassure a reluctant buyer with promises after the sale is completed. Do such statements qualify as express warranties? According to Official Comment 7 to UCC §2-313:

> The precise time when words of description or affirmation are made… is not material. The sole question is whether the language [is] fairly to be regarded as a part of the contract. If language is used after the closing of the deal (as when the buyer when taking delivery asks and receives an additional assurance), the warranty becomes a modification, and need not be supported by consideration if it is otherwise reasonable and in order.

See also Official Comment 9 to UCC §2-313 (2003).

In *Downie v Abex Corp*. (10th Cir 1984) 741 F2d 1235, 1240 (applying either California law or Utah law, both UCC provisions being identical), the court held that an express warranty was made when the seller, on a maintenance call after the sale, assured the buyer that a ball-screw assembly was fail-safe. See also *Bigelow v Agway, Inc*. (2d Cir 1974) 506 F2d 551, in which, 2 months after the sale of a chemical, the manufacturer's agent, on a joint visit with the seller's agent, guaranteed the buyer that hay treated with the chemical was safe to bale. The hay was subsequently destroyed when the chemical failed to work as represented. The court held that there was sufficient evidence for the jury to determine whether the postsale statement was an enforceable express warranty.

Whether a postsale statement must be in writing to be considered a warranty is somewhat complicated:

- If the transaction itself was oral, the statement can be oral. See Com C §2209(2).
- If the transaction was memorialized in a writing, and the writing contains a clause that any modification must also be in writing, the warranty statement must be in writing. For a nonmerchant buyer to be held to such a clause in a form supplied by a merchant, however, the clause must be separately signed. Com C §2209(2).
- If the transaction was memorialized in a writing that does *not* include a clause requiring modifications to be in writing, then whether the postsale statement must be in writing is arguably controlled by the Commercial Code's statute of frauds. Com C §§2201, 2209(3).

See chap 7 on the statute of frauds.

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§3.17 8. Duration of Warranty

Warranties often are made limited in duration (*e.g.,* "90-Day Warranty"). If the warranted goods are consumer goods (*i.e.,* purchased for personal, family, or household purposes), the implied warranties of merchantability (see §§3.21-3.32) and fitness (see §§3.33-3.40) must be coextensive in duration with any express warranty that accompanies the goods, provided the duration of the express warranty is reasonable. In no event will the duration of the implied warranties be less than 60 days or more than one year. If the express warranty has no stated duration, the duration of the implied warranties is one year. CC §1791.1(c). Used consumer goods covered by an express warranty are considered to have implied warranties of merchantability and fitness of the same duration as the express warranty, but not less than 30 days nor more than three months. CC §1795.5.

If the goods are subject to the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312), the duration of implied warranties may not be shorter than the duration of the express written warranty. Any limitation of the duration of implied warranties must be set forth in clear and unmistakable language and be prominently displayed on the face of the warranty. 15 USC §2308(b).

For consumer goods, the duration of the warranty may be extended by the amount of time it takes to repair or service them. The Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) requires that the following statement appear on every work order or repair invoice for warranty repairs or service:

> A buyer of this product in California has the right to have this product serviced or repaired during the warranty period. The warranty period will be extended for the number of whole days that the product has been out of the buyer's hands for warranty repairs. If a defect exists within the warranty period, the warranty will not expire until the defect has been fixed. The warranty period will also be extended if the warranty repairs have not been performed due to delays caused by circumstances beyond the control of the buyer, or if the warranty repairs did not remedy the defect and the buyer notifies the manufacturer or seller of the failure of the repairs within 60 days after they were completed.

This statement must be in ten-point boldface type. If it does not appear on the front of the work order or repair invoice, another boldface statement on the front of the order must say: "Notice to Consumer: Please read important information on back." CC §1793.1(a)(2).

The warranty period is tolled from the time that the buyer delivers the goods to the seller or manufacturer for repairs (or notifies the seller that repairs are required) until the time that the seller redelivers the repaired goods to the buyer (or notifies the buyer that the repaired goods can be picked up). CC §1795.6(a).

Subject to the foregoing, an express warranty generally does not cover repairs made after the applicable time or mileage periods have elapsed. *Daugherty v American Honda Motor Co.* (2006) 144 CA4th 824, 830, 51 CR3d 118.

In *Canal Elec. Co. v Westinghouse Elec. Co.* (1st Cir 1992) 973 F2d 988, the court strictly interpreted the meaning of the word "appear" within the context of a one-year limited service warranty. The warranty provided in part that, should any failure to conform to the warranty *appear* within the warranty period, the service provider would correct the nonconformity. The court held that a defect "appears" within the warranty period if it is either perceived in fact, or would have been perceived during the course of an ordinary inspection; a defect does not "appear" simply because it exists. 973 F2d at 991.

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§3.18 9. Warranty by Remote Seller

Although the language of the Commercial Code requires that the affirmation of fact or promise be made "by the seller *to the buyer*" (Com C §2313(1)(a); emphasis added), California courts have consistently held that privity is not a requirement for recovery for breach of an express warranty. The warrantor can be a remote seller (*e.g.,* a manufacturer) who makes representations about the product on labels, in advertising, or through representatives. See, *e.g., Hauter v Zogarts* (1975) 14 C3d 104, 114 n8, 120 CR 681; *Seely v White Motor Co*. (1965) 63 C2d 9, 14, 45 CR 17; *Williams v Beechnut Nutrition Corp*. (1986) 185 CA3d 135, 142, 229 CR 605; *Fundin v Chicago Pneumatic Tool Co*. (1984) 152 CA3d 951, 957, 199 CR 789; *Rodrigues v Campbell Indus*. (1978) 87 CA3d 494, 500, 151 CR 90.

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§3.19 B. Description of Goods as Creating Express Warranty

Any description of the goods that is made part of the basis of the bargain creates an express warranty that the goods will conform to the description. Com C §2313(1)(b).

Like affirmations of fact or promises, express warranties by description may appear in advertisements, brochures, invoices, owner's manuals, and written sales agreements. See Goetz, Moore, Perry & Ross, *Special Report: Article Two Warranties in Commercial Transactions: An Update*, 72 Cornell L Rev 1159, 1171 (Sept. 1987). Warranties by description also may be found in technical specifications, blueprints, and the like. Official Comment 5 to UCC §2-313 (Official Comment 7 to UCC §2-313 (2003)).

California has a substantial body of pre-Code law on the words required to create a warranty by description. See, *e.g., Square Deal Mach. Co. v Garrett Corp*. (1954) 128 CA2d 286, 275 P2d 46 (descriptive name constitutes warranty that article delivered will conform to general characteristics of description; "36-tooth gear" promises gear with 36 teeth); *Porter v Gestri* (1926) 77 CA 578, 247 P 247 ("black grapes" warrants black-colored grapes).

A trade term may be a warranty that the goods will conform to the understanding of the trade of the description associated with the term. See Official Comment 5 to UCC §2-313 (Official Comment 7 to UCC §2-313 (2003)): "[A]ll descriptions by merchants must be read against the applicable trade usages." See also *Bracker v American Nat'l Food, Inc*. (1955) 133 CA2d 338, 284 P2d 163 ("Blue Goose" tomatoes); *Brandenstein v Jackling* (1929) 99 CA 438, 278 P 880 ("No. 1 Saigon Long Grain Rice"); *Barrios v Pacific States Trading Co*. (1919) 41 CA 637, 183 P 236 ("export-cured boneless codfish").

Through a course of dealing, past deliveries may give rise to an express warranty by description. Official Comment 5 to UCC §2-313 (Official Comment 7 to UCC §2-313 (2003)).

EXAMPLE: If a buyer has ordered "No. 10 grass seed" from a seller several times in the past and has consistently received a product with certain characteristics, the buyer may expect that a present shipment of No. 10 grass seed will have the same characteristics.

Unlike an express warranty by affirmation of fact or promise, an express warranty by description can be made by the buyer as well as the seller. The buyer does this by providing the seller with specifications for a particular product. The resulting warranty is that the product sold will conform to those specifications.

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§3.20 C. Sample or Model as Creating Express Warranty

Any sample or model that is made part of the basis of the bargain creates an express warranty that the whole of the goods will conform to the sample or model. Com C §2313(1)(c).

A "sample" is actually drawn from the bulk of goods that are the subject of the sale; a "model" is offered for inspection when the subject matter is not at hand and is not drawn from the bulk of goods. Official Comment 8 to UCC §2-313. In either case, the primary issue is whether the sample or model was part of the basis of the bargain. That issue is a question of fact. As with a seller's affirmation of fact or promise, there is a presumption that the sample or model *was* a part of the basis of the bargain. See *Eagle Ottawa Leather Co. v Yorkshire Arms, Inc.* (WD Mich, Mar. 30, 1999, No. 1:97-CV-905) 1999 US Dist Lexis 4653 (genuine issue of material fact existed as to whether dye samples created warranty by sample).

If the seller can prove that the sample or model was understood merely to suggest or illustrate characteristics of the goods, and not to represent them, no warranty will arise. See, *e.g., Kopper Glo Fuel*, *Inc. v Island Lake Coal Co.* (ED Tenn 1977) 436 F Supp 91 (seller provided buyer with coal sample, but both parties realized that quality of coal from single mine could vary greatly; no warranty created).

Official Comment 8 to UCC §2-313 indicates that the "basis of the bargain" presumption is more difficult for the seller to overcome when a sample rather than a model is used, because the sample is taken from the bulk of goods sold, and the buyer may more reasonably believe that it actually represents them. Still, even if the sample or model constitutes an express warranty, an issue of fact remains about the precise nature of the warranty; *i.e.,* does the sample or model represent the average or only the minimum characteristics of the goods sold?

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III. IMPLIED WARRANTIES

A. Warranty of Merchantability

§3.21 1. Described

Unless the parties explicitly exclude it, every contract for the sale of goods contains a warranty, implied by law, that the goods are of merchantable quality. Com C §2314(1); *Hauter v Zogarts* (1975) 14 C3d 104, 117, 120 CR 681; *Isip v Mercedes-Benz, USA LLC* (2007) 155 CA4th 19, 26, 65 CR3d 695. The warranty applies whether the goods are for use or resale. Official Comments 2, 10 to UCC §2-314 (Official Comments 3, 12 to UCC 2-314 (2003)). The warranty does not depend on any specific conduct or promise by the seller. *Hauter v Zogarts, supra*.

The fundamental concept of the implied warranty of merchantability is that the goods are fit for their ordinary purposes. Official Comment 8 to UCC §2-314 (Official Comment 10 to UCC §2-314 (2003)).

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§3.22 2. Only Merchants Warrant Merchantability

Only "a merchant with respect to goods of [the] kind" involved in the sale can impliedly warrant merchantability. Com C §2314(1). Thus, the implied warranty analysis starts with two questions:

(1) Is the seller a merchant?

(2) If the seller is a merchant, does the seller deal in the goods that are the subject of the transaction?

"Merchant," a term of art broadly defined in Com C §2104(1), may include within its scope manufacturers, processors, and dealers. Merchant status may be based on specialized knowledge of the goods involved or knowledge of the business practices in the trade. Official Comment 2 to UCC §2-104(1). See *K&M Joint Venture v Smith Int'l, Inc.* (6th Cir 1982) 669 F2d 1106, 1115, in which the court, construing California law, ruled that even though the plaintiff lacked knowledge about a particular tunnel-boring machine, it was an experienced sewer contractor and therefore a merchant for purposes of the Commercial Code. See also *D & K Broad. Props. v Still (In re Jackson Television, Ltd.)* (Bankr ED Tenn 1990) 121 BR 790 (bankruptcy trustee was not "merchant" with respect to property sold as part of liquidation plan, so warranty of merchantability could not be implied).

Merchant status can also be attributed to a person or entity through the employment of an agent who has knowledge or skill peculiar to the goods or practices involved in the transaction. Com C §2104(1). For example, a bank selling a repossessed automobile through a dealer may be considered a merchant.

Whether a farmer is a merchant is a question of fact, depending on the circumstances and the purpose for which merchant status is being ascribed. See Anno, *Farmers as "Merchants" Within Provisions of UCC Article 2, Dealing With Sales*, 95 ALR3d 484 (1979). No California court has yet considered this question.

The qualification that the warranty of merchantability is implied only "if the seller is a merchant with respect to goods of [the] kind" involved in the sale (Com C §2314(1)) restricts the warranty to a smaller group. Thus, in *Rock Creek Ginger Ale Co. v Thermice Corp*. (D DC 1971) 352 F Supp 522, 528, the court held that a beer manufacturer did not impliedly warrant a shipment of surplus carbon dioxide gas, because the shipment was an isolated sale outside the scope of the manufacturer's ordinary business.

For the implied warranty to exist, the merchant with respect to the goods must also be the immediate seller; *i.e.,* privity of contract must exist. *All W. Electronics, Inc. v M-B-W, Inc.* (1998) 64 CA4th 717, 725, 75 CR2d 509; *Osborne v Subaru of Am., Inc*. (1988) 198 CA3d 646, 656, 243 CR 815. A member of the immediate buyer's family is considered to be in privity with the seller. *Hauter v Zogarts* (1975) 14 C3d 104, 114 n8, 120 CR 681.

Even in transactions in which the implied warranty does not apply, the seller must disclose any latent material defects of which the seller is aware. Failure to do so is a violation of the Commercial Code's general obligation of good faith and may be fraudulent as well. Official Comment 3 to UCC §2-314 (Official Comment 4 to UCC §2-314 (2003)). For the definition of good faith, see Com C §§1201(b)(20).

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3. Meaning of "Merchantable"

§3.23 a. Summary of Standard

Commercial Code §2314(2) establishes a six-part standard of merchantability. The goods must:

(1) Pass without objection in the trade under the contract description;

(2) In the case of fungible goods, be of fair average quality within the description;

(3) Be fit for the ordinary purposes for which such goods are used;

(4) Be, within the variations permitted by the agreement, of even kind, quality, and quantity within each unit and among all units involved;

(5) Be adequately contained, packaged, and labeled as the agreement may require; and

(6) Conform to promises or affirmations of fact made on any container or label.

See *Hauter v Zogarts* (1975) 14 C3d 104, 114 n8, 120 CR 681 (holding that training device for golfers failed standard of merchantability relating to (3) and (6), above).

The Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) establishes a similar standard of merchantability for consumer goods, but omits items (2) and (4), above. See CC §1791.1(a).

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§3.24 b. Pass Without Objection in the Trade and Be of Fair Average Quality

To be considered merchantable, goods must "pass without objection in the trade under the contract description." Com C §2314(2)(a). In the case of fungible goods, they must also be "of fair average quality within the description." Com C §2314(2)(b). These two requirements must be read together. Official Comment 7 to UCC §2-314 (Official Comment 9 to UCC §2-314 (2003)). Both refer to the standards of the industry involved; *i.e.,* what do those in the industry consider to be an acceptable product? See Official Comment 2 to UCC §2-314 (Official Comment 3 to UCC §2-314 (2003)).

The requirement that fungible goods must be of "fair average" quality within the description means that the goods must center around the middle belt of quality. Official Comment 7 to UCC §2-314 (Official Comment 9 to UCC §2-314 (2003)). (Fungible goods are goods of which any unit is the equivalent of any other unit. Com C §1201(b)(18).) This test has its roots in agriculture. Official Comment 7 to UCC §2-314 (Official Comment 9 to UCC §2-314 (2003)). Although one would expect some California cases on the application of this test, there are none.

The price at which goods are sold is a guide to their quality and an indicator of whether the warranty has been breached. If no reasonable buyer in the trade would have paid the price demanded for the quality of goods delivered, the warranty of merchantability has been breached. See *Sylvia Coal Co. v Mercury Coal & Coke Co*. (W Va 1967) 156 SE2d 1, 5.

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§3.25 c. Fit for Ordinary Purposes

To be considered merchantable, goods must be "fit for the ordinary purposes for which such goods are used." Com C §2314(2)(c). Anything that does not work the way it should in ordinary use is unmerchantable. This is a "fundamental concept" of the section defining merchantability. Official Comment 8 to UCC §2-314 (Official Comment 10 to UCC §2-314 (2003)). (It is also a fundamental protection for a buyer to relinquish if the buyer allows the warranty of merchantability to be disclaimed.)

In *Hauter v Zogarts* (1975) 14 C3d 104, 117, 120 CR 681, the court held that a training device for unskilled golfers was not fit for ordinary purposes. The court relied on expert testimony that, because of the device's construction, an accident was likely if a ball was not hit properly. The court held that because beginning golfers are not apt to hit a ball properly, a training device requiring such skill simply to avoid injury is not fit for its ordinary purpose.

In *American Suzuki Motor Corp. v Superior Court* (1995) 37 CA4th 1291, 44 CR2d 526, the court refused to certify as a class certain owners of the Suzuki Samurai sport utility vehicle. The plaintiffs alleged that the Samurai was defective because it had a tendency to roll over during normal use; consequently, a claim could be stated for breach of the implied warranty of merchantability. The court adopted the reasoning that because cars are designed to provide transportation, the implied warranty of merchantability is simply a guarantee that they will operate in a "safe condition" and "substantially free of defects." Thus, if a car can provide safe, reliable transportation, it is generally considered merchantable. 37 CA4th at 1297. The test of merchantability is *not* "whether [the product] is free of all speculative risks, safety-related or otherwise." 37 CA4th at 1297. Because the vast majority of the vehicles sold to the putative class had not rolled over, they remained fit for their ordinary purpose, and their owners were therefore not entitled to assert a breach of implied warranty claim as a class.

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§3.26 d. Be of Even Kind, Quantity, and Quality

To be merchantable, goods must be, "within the variations permitted by the agreement, of even kind, quality and quantity within each unit and among all units involved." Com C §2314(2)(d). This subsection adopts the view of the court in *Nye & Nisson v Weed Lumber Co*. (1928) 92 CA 598, 268 P 659, that merchants must adhere to established grade tolerances in deliveries of multiple units of merchandise. Grade variations are governed not only by the express terms of the agreement but also by usages of trade. Official Comment 8 to UCC 2-314 (Official Comment 11 to UCC §2-314 (2003)).

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§3.27 e. Adequately Contained, Packaged, and Labeled

To be merchantable, goods must be "adequately contained, packaged, and labeled as the agreement may require." Com C §2314(2)(e). Thus, the package itself must be merchantable; it may neither break apart in shipment so that the goods are damaged nor constitute a danger to those handling the goods.

A creative application of this principle is found in *Shaffer v Victoria Station, Inc*. (Wash 1978) 588 P2d 233. In that case, a restaurant customer was injured when a wine glass shattered in his hand. One theory of recovery he alleged was a breach of the warranty of merchantability. The restaurant argued that the wine, not the glass, was the subject of the sale and that the wine was merchantable. The court agreed with the injured customer, however, that the warranty was breached because the wine was not "adequately contained."

This element of merchantability may require a seller to warn of dangers related to the use of the product. See, *e.g., Hanson v Murray* (1961) 190 CA2d 617, 623, 12 CR 304 (seller failed to warn of possible damage to other crops from use of spray on carrot field). The issue of duty to warn comes up most often in product liability cases. For discussion of this issue, see California Tort Guide §§11.14-11.18, 11.43 (3d ed Cal CEB 1996).

All contracts contain an implied understanding that the seller will not deliver mislabeled goods. Official Comment 10 to UCC §2-314 (Official Comment 12 to UCC §2-314 (2003)).

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§3.28 f. Conform to Representations on Container or Label

Goods must conform to the promises or affirmations of fact made on any container or label. Com C §2314(2)(f). This provision overlaps with the Commercial Code's express warranty provision in Com C §2313. If statements on the container or label are part of the "basis of the bargain," they qualify as express warranties. See §3.11. If the buyer purchases the goods without reading the container or label but later learns that they are not as represented, the buyer still may claim that the goods are unmerchantable under Com C §2314(2)(f).

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§3.29 4. Sales of Food or Drink

The serving for value of food or drink to be consumed on the premises or elsewhere also carries with it a warranty of merchantability. Com C §2314(1).

The court in *Mexicali Rose v Superior Court* (1992) 1 C4th 617, 633, 4 CR2d 145, summarized the test in California for determining whether the warranty has been breached when a restaurant patron is injured by something served in his or her food (emphasis added):

> If the injury-producing substance is *natural to the preparation of the food served,* it can be said that it was reasonably expected by its very nature and the food cannot be determined unfit or defective. A plaintiff in such a case has no cause of action in strict liability or implied warranty. If, however, the presence of the natural substance is due to a restaurateur's failure to exercise due care in food preparation, the injured patron may sue under a negligence theory.
>
> If the injury-causing substance is *foreign* to the food served, then the injured patron may also state a cause of action in implied warranty and strict liability, and the trier of fact will determine whether the substance (i) could be reasonably expected by the average consumer and (ii) rendered the food unfit or defective.

California is among a handful of jurisdictions that base warranty liability on whether the injury-causing substance is foreign or natural to the food served. In the overwhelming majority of jurisdictions, liability depends on the reasonable expectations of the consumer, *i.e.,* whether the consumer should have anticipated the object that caused the injury. See *Mexicali Rose v Superior Court* (1992) 1 C4th 617, 640, 4 CR2d 145 (dissenting opinion of Mosk, J. (and cases cited therein)).

When the subject of the sale is food, the warranty runs to the consumer, even though it may not be in contractual privity with the seller. *Klein v Duchess Sandwich Co*. (1939) 14 C2d 272, 283, 93 P2d 799. See also *Shade Foods, Inc. v Innovative Prods. Sales & Marketing, Inc.* (2000) 78 CA4th 847, 871, 93 CR2d 364 ("In the peculiar context of foodstuffs, the theory of breach of an implied warranty of merchantability has closer affinities to tort law than to contract law because it allows recovery of damages, without regard to privity of contract, for personal injuries as well as economic loss.") Privity therefore is not a defense in an action for breach of the implied warranty of merchantability when the goods sold were items of food or drugs. See generally 4 Witkin, Summary of California Law, *Sales* §§112-113 (10th ed 2005).

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§3.30 5. Sales of Livestock

In the absence of an express warranty, the mere sale of livestock does not imply a warranty for any particular purpose. Food & A C §18501. Furthermore, in the absence of any express warranty, the sale of livestock for slaughter does not imply a warranty of fitness for any particular purpose or warranty of merchantable quality. Food & A C §18502.

Consequently, a buyer of livestock has a right of action only for warranties that are *expressly* made by the seller; no warranty of merchantability or fitness for a particular purpose will be implied as a term of the sale. On warranty of fitness for particular purpose, see §§3.33-3.40.

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§3.31 6. Sales of Secondhand Goods

Merchant sellers of used goods impliedly warrant the goods' merchantability. (The definition of "goods" in Com C §2105(1) covers used as well as new merchandise.) Although the warranty applies, the seller is only under an obligation that "is appropriate to such goods." See Official Comment 3 to UCC §2-314 (Official Comment 4 to UCC §2-314 (2003)). For example, if a new car requires a new transmission two weeks after purchase, a breach of the implied warranty of merchantability has probably occurred. If a used car that has been driven 100,000 miles needs a new transmission two weeks after purchase, the seller's warranty liability is much less certain.

The basic question is: What risks did the buyer reasonably assume as part of the sale? If the buyer realized that the used goods would require repair to function properly, the costs of repair fall on the buyer and the implied warranty of merchantability has not been breached. If, however, the buyer reasonably expected the goods to function immediately without repairs, the seller of the broken goods is in breach and must respond in damages. The court must determine the intentions of the parties, with the reasonable reliance interest of the buyer being the primary factor to protect. See Com C §1305(a). Past dealings of the parties or usages of the trade may aid in this determination.

As a practical matter, of course, secondhand goods are often sold "as is" or with some other disclaimer of the merchantability warranty. See §3.56.

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§3.32 7. Effect of Buyer's Inspection of Goods

If a buyer examines the goods (or a sample or model of the goods) to the buyer's full satisfaction, or if the buyer refuses to examine the goods when given the opportunity to do so, no implied warranty of merchantability arises with respect to defects that the examination should have revealed. Com C §2316(3)(b). For there to be a refusal to examine within the meaning of this provision, there must be a demand by the seller that the buyer fully examine the goods. Official Comment 8 to UCC §2-316 (Official Comment 6 to UCC §2-316 (2003)); *Agricultural Servs. Ass'n v Ferry-Morse Seed Co*. (6th Cir 1977) 551 F2d 1057, 1065 (construing California law).

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B. Warranty of Fitness for Particular Purpose

§3.33 1. Described

One element of merchantability (see §§3.21-3.32) is that the goods sold are "fit for the ordinary purposes for which such goods are used." Com C §2314(2)(c). If the goods are intended for a special purpose, another warranty may apply: that the goods will be fit for that particular purpose. Com C §2315.

A sale can (and often does) imply both warranties. Official Comment 2 to UCC §2-315.

PRACTICE TIP: Because a sale can give rise to both the implied warranty of merchantability and the implied warranty of fitness for a particular purpose, counsel should allege both in an action for breach of warranty if the facts allow it. If one cause of action cannot be adequately proved, the other might still provide a basis for recovery.

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§3.34 2. Who Warrants Fitness for Particular Purpose?

Although the statute holds any "seller" responsible for the warranty of fitness, as a practical matter the warranty normally will arise only when the seller is a *merchant* with the appropriate skill or judgment. Official Comment 4 to UCC §2-315.

The seller must be in privity of contract with the buyer for the implied warranty of fitness to arise. *Fieldstone Co. v Briggs Plumbing Prods., Inc.* (1997) 54 CA4th 357, 371, 62 CR2d 701; *Rodrigues v Campbell Indus*. (1978) 87 CA3d 494, 500, 151 CR 90. This requirement should come as no surprise. When the buyer has a special purpose for the goods, one would expect direct dealings between the parties to be necessary before the seller could be held liable for failure to accomplish that special purpose.

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Source: Business Law/California UCC Sales and Leases/3 Warranties/§3.35 3. Elements of Warranty

§3.35 3. Elements of Warranty

An implied warranty of fitness for a particular purpose arises only when:

- The buyer at the time of contracting intends to use the goods for a particular purpose;
- The seller at the time of contracting has reason to know of this particular purpose;
- The buyer relies on the seller's skill or judgment to select or furnish goods suitable for the particular purpose; and
- The seller at the time of contracting has reason to know that the buyer is relying on that skill and judgment.

See Com C §2315; *Keith v Buchanan* (1985) 173 CA3d 13, 25, 220 CR 392; *Metowski v Traid Corp*. (1972) 28 CA3d 332, 341, 104 CR 599.

The Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) defines the warranty of fitness in a similar way for sales of consumer goods. See CC §§1791.1(b), 1792.1-1792.2.

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§3.36 a. Seller's Knowledge of Buyer's Purpose

A buyer need not state a particular purpose for which the goods are required in so many words. If, "from all the facts and circumstances known to him or her" at the time the contract is entered into, the seller *should know* what the buyer's special requirements are, this element of the warranty is satisfied. See Com C §1202(a)(3); Official Comment 1 to UCC §2-315.

For example, in *Agricultural Servs. Ass'n v Ferry-Morse Seed Co*. (6th Cir 1977) 551 F2d 1057, 1065 (construing California law), the court determined that a seller of commercial seed had reason to know that the buyer's purpose was to resell an order of seed, because the buyer was also in the business of selling seed, its order was for 25,000 pounds, and it had purchased large lots of seed in the past for resale.

In *Computerized Radiological Servs. v Syntex Corp*. (ED NY 1984) 595 F Supp 1495, 1508, aff'd in part and rev'd in part on other grounds (2d Cir 1986) 786 F2d 72 (construing California law), the seller acquired knowledge of the buyer's need for a CAT scanner (medical device) with particular capabilities from several conversations with the buyer. When the device failed to perform as the buyer required, the seller was held to have breached the implied warranty of fitness for a particular purpose.

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§3.37 b. Buyer's Reliance on Seller's Skill or Judgment

The buyer must actually rely on the seller's skill or judgment before the warranty of fitness for a particular purpose will apply. Official Comment 1 to UCC §2-315. A buyer who furnishes the seller with technical plans or specifications or that otherwise minimizes the seller's role in selecting the goods cannot claim to have "relied" on the seller. Official Comment 9 to UCC §2-316 (Official Comment 7 to UCC §2-316 (2003)). See, *e.g., Blockhead, Inc. v Plastic Forming Co*. (D Conn 1975) 402 F Supp 1017, in which the buyer had many years of experience with the product (a wiglet case), was familiar with its production methods, chose the process by which the product was to be manufactured, and rejected the seller's suggestions that would have increased the product's durability. The court held that the buyer's reliance on the seller was insufficient to create a warranty.

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§3.38 c. Seller's Knowledge of Buyer's Reliance

The seller also must have "reason to know" of the buyer's reliance on the seller's skill or judgment. *Keith v Buchanan* (1985) 173 CA3d 13, 25, 220 CR 392; *Metowski v Traid Corp*. (1972) 28 CA3d 332, 341, 104 CR 599.

In *Keith,* the court held that the buyer had not relied on the seller's skill or judgment in selecting or furnishing a sailboat. The court's conclusion was based on the following facts:

- The buyer had extensive experience with sailboats;
- He developed detailed specifications about the type of boat that he wanted to purchase;
- He looked at a number of boats and reviewed advertising literature before the purchase; and
- He asked friends who were knowledgeable about boats to examine the boat before the purchase.

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§3.39 d. Seller's Selecting or Furnishing of Goods

Before the implied warranty of fitness for a particular purpose can arise, the seller must have selected or furnished the goods. Com C §2315. The word "or" is significant. In the pre-Code case of *Willig v Brethauer* (1954) 127 CA2d 650, 274 P2d 202, a warranty of fitness of a bull for breeding purposes was implied although the buyer selected the animal from several made available by the seller. The Commercial Code endorses the principle underlying this decision in situations in which the buyer does the "selecting" but the seller does the "furnishing."

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§3.40 4. No "Trade Name" Limitation

One roadblock to recovery under the former Uniform Sales Act (former CC §§1721-1800) was the rule that a warranty of fitness for a particular purpose was *canceled* if the buyer specified what he or she wanted by its trade name. The Commercial Code eliminated this rule. It is now simply a question of fact as to whether a buyer requesting an item by its patent or trade name is relying on the seller's skill or judgment. Official Comment 5 to UCC §2-315; Official Comment 1 to UCC §2-317.

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Source: Business Law/California UCC Sales and Leases/3 Warranties/§3.41 C. Other Implied Warranties From Course of Dealing or Usage of Trade

§3.41 C. Other Implied Warranties From Course of Dealing or Usage of Trade

Warranties other than merchantability and fitness for a particular purpose can be implied in sales of goods: Unless excluded or modified as provided under Com C §2316, other implied warranties may arise from course of dealing or usage of trade. Com C §2314(3). See Official Comment 12 to UCC §2-314 (Official Comment 14 to UCC §2-314 (2003)).

Under Com C §1303(b), a course of dealing is:

> a sequence of conduct concerning previous transactions between the parties to a particular transaction that is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct.

Commercial Code §1303(c) defines a usage of trade as

> any practice or method of dealing having such regularity of observance in a place, vocation or trade as to justify an expectation that it will be observed with respect to the transaction in question.

Stated another way, a usage of trade is an industry-wide practice that the parties impliedly recognize as a term of their agreement, and a course of dealing is a practice that the seller and buyer follow in their commercial dealings with each other that also may become an implied term of their agreement.

Both usage of trade and course of dealing are construed consistently when possible; if that is not possible, however, course of dealing controls. See Com C §1303(e)(3). See further discussion in §§4.94-4.104.

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IV. WARRANTY OF TITLE

§3.42 A. Accompanies Any Sale of Goods

A warranty of title generally accompanies any sale of goods. Com C §2312(1)(a); as to exclusions or modifications of warranty, see Com C §2312(2). This warranty is not designated as "implied" in Com C §2312(1)(a) but rather is "statutory" in nature. The Commercial Code uses this unique category to protect the title warranty from disclaimers that refer broadly to all implied warranties. Official Comment 6 to UCC §2-312. On title warranty disclaimers, see §§3.65-3.67.

The warranty of title includes two types of protection under Com C §2312(1)(a)-(b):

(1) The title conveyed must be good and its transfer rightful; and

(2) The goods must be delivered free from any security interest or other lien or encumbrance of which the buyer at the time of contracting has no knowledge.

There is no requirement in Com C §2312(1) that the seller be a merchant or that the seller know of the defective title.

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§3.43 B. Breach of Warranty of Title

The seller is obligated to deliver a good title by a rightful transfer. Com C §2312(1)(a). A good title is one that will not expose the buyer to a lawsuit. Official Comment 1 to UCC §2-312. The buyer has the right to expect that it will not be required to enter into a contest over the validity of its ownership. "The mere casting of a substantial shadow over [the buyer's] title, regardless of the ultimate outcome, is sufficient to violate a warranty of good title." *Wright v Vickaryous* (Alaska 1980) 611 P2d 20, 22. See *Maroone Chevrolet, Inc. v Nordstrom* (Fla App 1991) 587 So2d 514 (adopting majority view that buyer of used motor vehicle who demonstrates existence of substantial cloud on title, based on some objective factor, can recover for breach of warranty of title, regardless of whether it can be shown that third party's title is superior).

Stated another way, the warranty provides protection against all colorable claims of ownership by another. The warranty is breached if a third party asserts anything more than a spurious title claim. *Jefferson v Jones* (Md App 1979) 408 A2d 1036. Spurious claims—those with no reasonable basis—are the buyer's risk.

Because many aspects of this warranty have not been litigated, courts may use real property rules by analogy in deciding warranty of title issues. See, *e.g., Jefferson v Jones, supra*.

Commercial Code §2312(1)(a) implies that the seller need not have good title at the time of contracting or sale but only at the time of delivery. Even so, a buyer who innocently enters into a contract and learns before delivery that the seller does not have good title probably has grounds for suspending performance and demanding adequate assurances from the seller of the seller's ability to deliver the goods free of the claims of others. See Com C §2609(1). The seller's failure to provide those assurances may then be considered a repudiation of the contract. See chap 16.

In addition to the requirements of good title and rightful transfer, the warranty of title requires that the goods must be delivered free from any security interest or other lien or encumbrance of which the buyer at the time of contracting has no knowledge. Com C §2312(1)(b). A security interest is excepted from the warranty only if the buyer actually knows of it. A person "knows" or has "knowledge" of a fact if he or she has actual knowledge of it. Com C §1202(b).

PRACTICE TIP: Counsel with a client who becomes aware of a third party's interest in the goods should advise the client to ask (1) the seller for an express warranty that the goods will be delivered free of the interest; and (2) the third party for a release of any lien or ownership interest in the goods. If the seller knows of a third party's interest in the goods, the seller should disclose that interest to the buyer to prevent a breach of warranty claim and thereby avoid the costs of a suit defending the buyer's title.

In some circumstances, a buyer in the ordinary course of business can take goods free of a security interest even if the buyer actually knows about the interest. Com C §9320(a). See §§12.20-12.26. Similarly, in some limited situations buyers can take good title to goods even though the seller's title was deficient or nonexistent. Com C §2403(2)-(3). See §§12.3-12.6.

Notice of breach of the warranty of title must be given to the seller within a reasonable time after the buyer's discovery of the breach. Com C §2607(3)(A). For purposes of the statute of limitations, the breach occurs when tender of delivery is made. See Com C §2607(5); Official Comment 2 to UCC §2-312 (Official Comment 7 to UCC §2-312 (2003)). See also §§3.102-3.104 for further discussion of the statute of limitations.

A buyer who becomes involved in litigation with a third party over title to the goods can utilize the vouching in procedure described in Com C §2607(5). Official Comment 7 to UCC §2-607 (Official Comment 8 to UCC §2-607 (2003)). On vouching in, see §§3.83-3.88. Regardless of the merits of the claim, the seller may find that furnishing a defense for the buyer is in the seller's interest. If the buyer is successful in defending the third party's suit, the seller is likely to have to bear the costs of defense in any event.

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V. WARRANTY AGAINST INFRINGEMENT

§3.44 A. Patent or Trademark Infringement

A "merchant" seller (see Com C §2104(1)) regularly dealing in goods of the kind being sold is considered to warrant that the goods are not subject to any valid third party claim for infringement of a patent or trademark. Com C §2312(3).

A buyer who furnishes specifications to the seller does not receive this warranty, however, and is required to hold the seller harmless from any infringement claims arising from manufacture of the goods under the buyer's specifications. Com C §2312(3).

The warranty against infringement applies only to "rightful" claims. Com C §2312(3). A rightful claim is not synonymous with a claim that ultimately will prove successful in litigation. Rather, a rightful claim is a nonfrivolous claim of infringement that has any significant and adverse effect on the buyer's ability to make use of the purchased goods. *Pacific Sunwear, Inc. v Olaes Enters.* (2008) 167 CA4th 466, 84 CR3d 182. The court noted (167 CA4th at 478):

> As between a buyer and "a seller who is a merchant regularly dealing in goods of the kind"… the burden of infringement claims is most sensibly placed on the seller who will generally have superior knowledge as to the existence of such claims, and a stronger incentive to seek out and resolve potential infringement claims prior to sale.… The seller's incentive to reduce or eliminate prospective claims of infringement is undermined, however, if the [Com C §2312(3)] warranty applies only to meritorious claims, leaving the risk of closely contested, but ultimately unsuccessful, infringement claims to be borne by unsuspecting purchasers.

The seller may demand control of the litigation, but if the seller does so, the seller must agree to bear all expenses and to satisfy any adverse judgment. Com C §2607(5)(B), (6).

In practice, the seller most often will bear the cost of defending claims of infringement, rightful or not, either because the seller fears that the buyer will inadequately defend the action or because the seller has agreed to pay expenses to take control of the defense. Sellers often cannot avoid conflict with the third party in any event.

If the seller has manufactured the goods to the buyer's specifications, however, the buyer may bear the cost of defense because of the buyer's indemnity obligation under Com C §2312(3).

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§3.45 B. Copyright Infringement

Official Comment 3 to UCC §2-312 (Official Comment 4 to UCC §2-312 (2003)) explicitly refers only to claims of infringement of a patent or trademark. However, because Com C §2312(3) uses the phrase "or the like," the question arises whether the seller's warranty also applies to copyright infringement claims.

Although this issue is of particular interest to California attorneys (owing to the vast amount of commerce in literary and musical properties in California), no California cases have addressed it. A federal court in New York concluded that the duty of indemnification *does* extend to claims of copyright infringement. See *Dolori Fabrics, Inc. v The Limited, Inc*. (SD NY 1987) 662 F Supp 1347, 1358.

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VI. EXCLUSION OF WARRANTIES

A. General Principles

§3.46 1. Distinguished From Limiting Remedies

When a seller excludes or disclaims a warranty, it is no longer a term of the agreement with the buyer. (In this chapter, the terms "exclude" and "disclaim" are used interchangeably.) In contrast, a limitation of remedies provision recognizes the existence of the warranty but limits the buyer's remedial options when the warranty is breached. See §§3.92-3.98.

Sellers often use both techniques together to limit their total exposure to liability. It is not unusual to find a limited express warranty, a disclaimer of all other warranties, and a limitation of remedies provision together in one paragraph, often misleadingly labeled "Warranty." In this chapter, the exclusion of warranties and the limitation of remedies are treated as the separate subjects that they are.

Note that the successful exclusion of warranties will not insulate the seller from attack under theories of fraud, negligence, or strict product liability.

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§3.47 2. Strict Construction

Disclaimers of warranties are generally construed strictly against the seller. *Hauter v Zogarts* (1975) 14 C3d 104, 119, 120 CR 681; *Philippine Airlines, Inc. v McDonnell Douglas Corp*. (1987) 189 CA3d 234, 237, 234 CR 423. This bias in favor of the buyer may not be so compelling in a commercial setting between two equally sophisticated parties. See *Appalachian Ins. Co. v McDonnell Douglas Corp*. (1989) 214 CA3d 1, 26, 262 CR 716 (buyer agreed to obtain insurance for telecommunications satellite rather than have seller warrant its performance; parties negotiated warranty issue; court rejected buyer's claim that warranty disclaimer was commercially unreasonable).

The Commercial Code protects the buyer from unexpected disclaimers by (a) denying effect to disclaimers when they either are inconsistent with express warranties or cause them to fail in their essential purpose and (b) permitting disclaimers of implied warranties only when certain formalities are observed. *Hauter v Zogarts, supra*.

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§3.48 3. Unconscionability

A warranty disclaimer that otherwise meets the Commercial Code's formal requirements (see §§3.50-3.69) may be ineffective if it is unconscionable. *A & M Produce Co. v FMC Corp*. (1982) 135 CA3d 473, 483, 186 CR 114. *A & M* involved the sale of a specialized machine by a large diversified company to a small farming company, using a standardized preprinted form contract with a disclaimer on the reverse side, which the buyer never read. The court found both common law grounds (see *Graham v Scissor-Tail, Inc*. (1981) 28 C3d 807, 171 CR 604) and statutory grounds (see CC §1670.5) to apply the doctrine of unconscionability to disclaimers.

NOTE: The language of CC §1670.5 is practically identical to that of UCC §2-302, which was not enacted in California at the time of the adoption of the California Commercial Code. However, CC §1670.5 is not limited to commercial transactions.

PRACTICE TIP: In *Martin v Joseph Harris Co*. (6th Cir 1985) 767 F2d 296, 304 (concurring opinion of Merritt, J), the court found a disclaimer clause to be unconscionable in part because the plaintiff farmers did not understand the meaning of "implied warranty of merchantability" and, even if the seller had explained it to them, the disclaimer of the warranty was a nonnegotiable term in a preprinted form. To avoid this problem, a client who sells goods to consumers or others who may be unsophisticated in legal matters should explain to buyers the impact of the disclaimer provision in the sales agreement and have them initial it. If the agreement excludes the implied warranty of merchantability, a supplemental explanation of that warranty may also be desirable. See Form 3.62-1.

For further discussion of unconscionability, see §§18.69-18.71.

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§3.49 4. Postsale Disclaimers

Theoretically, the disclaimer of a warranty after a sale is concluded should be allowed. Because postsale warranties are permitted (Official Comment 7 to UCC §2-313 (Official Comment 9 to UCC §2-313 (2003)); see §3.16), both parties *by agreement* should be able to insert a postsale warranty disclaimer into a contract as a modification. Com C §2209(1).

Case law on this issue is mixed. In *Dorman v International Harvester Co*. (1975) 46 CA3d 11, 19, 120 CR 516, the court held that the disclaimer of a warranty after the buyer signs the contract is *not* binding. The decision in *Dorman* implied that a postsale disclaimer could be effective if the parties specifically bargained for it. Whether such a modification would require additional consideration (unlike other modifications under Com C §2209(1)) is not clear from the opinion.

In *Temple v Velcro USA, Inc*. (1983) 148 CA3d 1090, 196 CR 531, the court upheld a unilateral postsale disclaimer. In this case, a remote seller manufactured polyester Velcro fasteners. A maker of hot air balloons used the fasteners without the remote seller's knowledge. When the remote seller became aware of the usage, it warned all purchasers of the hot air balloons of the dangers of using its fasteners on the balloons. The warning was considered to be a postsale disclaimer. Consequently, the plaintiff, whose husband was killed in a balloon crash when the fastener failed, could not recover for breach of warranty.

In *Gideon Serv. Div. v Dunham-Bush, Inc*. (Ill App 1980) 400 NE2d 89, 92, the court held that a warranty disclaimer on the back of a sales order was ineffective, when received by the buyer with the delivery of a furnace. The court noted that there was no indication that the buyer assented to the disclaimer terms or that it even knew of the conditions contained therein. Citing *Trane Co. v Gilbert* (1968) 267 CA2d 720, 73 CR 279, the court recognized that the seller's attempts to disclaim an implied warranty by means of a document submitted contemporaneously with delivery of the goods, such as an invoice or similar notice, as here, is insufficient.

A pre-Code case that reached the same conclusion was *India Paint & Lacquer Co. v United Steel Prod. Corp*. (1954) 123 CA2d 597, 608, 267 P2d 408. In that case, the court distinguished between postsale disclaimers to which the buyer assents (enforceable) and disclaimers to which the buyer does not assent (not enforceable).

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B. Disclaiming Express Warranties

§3.50 1. Reconciling Warranty and Disclaimer

Whenever it is reasonable to do so, express warranties and the seller's attempted disclaimers of those warranties will be reconciled so that both will be given effect. To the extent that a disclaimer cannot reasonably be construed to be consistent with the express warranty, it will be inoperative. Com C §2316(1). For example, in *Computerized Radiological Servs. v Syntex Corp*. (ED NY 1984) 595 F Supp 1495, 1506, aff'd in part and rev'd in part on other grounds (2d Cir 1986) 786 F2d 72 (construing California law), the seller in presale discussions with the buyer had made oral and written warranties concerning the capabilities of an item of medical equipment. The contract of sale provided a one-year warranty against defects in material and workmanship and purported to exclude all other warranties: "No other warranty except Title to Materials furnished shall be implied with respect to this order…." The court construed this statement as a disclaimer of *implied* warranties only. Thus, the express warranties were not affected and could be enforced by the buyer.

In *Fundin v Chicago Pneumatic Tool Co*. (1984) 152 CA3d 951, 957, 199 CR 789, the seller gave several detailed specifications in a sales brochure about the capabilities of a drill rig. In the same brochure, the seller tried to disclaim those express warranties, stating that "the only warranty applicable is our standard written warranty" and "we make no other warranty… expressed or implied…." The court concluded that it would be "unfair and unreasonable" to give the disclaimer effect, particularly when a buyer might mistakenly believe that the "standard written warranty" was the performance specifications. See also *Guntert & Zimmerman, Inc. v Thermoid Co*. (1963) 216 CA2d 771, 31 CR 99 (general disclaimer ineffective against subsequent express warranty).

In *Temple v Velcro USA, Inc*. (1983) 148 CA3d 1090, 1094, 196 CR 531, however, a manufacturer's warning that its Velcro fastener should not be used any longer on hot air balloons disclaimed all express or implied warranties. One factor that seemed to impress the court was the manufacturer's extensive effort to contact and warn buyers of the product about its unsafe applications. This decision suggests that the "reasonableness" of an express warranty disclaimer may depend in part on whether the buyer's attention was drawn to it.

In *Appalachian Ins. Co. v McDonnell Douglas Corp*. (1989) 214 CA3d 1, 26, 262 CR 716, the court found that the seller's disclaimer of all warranties, express or implied, was valid. The buyer had agreed to hold the seller harmless for any loss and to obtain insurance to cover any potential loss. The transaction involved a highly specialized, risky technology: the launch of a telecommunications satellite from a space shuttle. This context, and the fact that the parties had negotiated at length over the allocation of risks, weighed heavily in the court's determination that the disclaimer clauses were reasonable.

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§3.51 2. Significance of Parol Evidence Rule

Assume that a buyer purchases a used car from a dealer, based on certain statements made by the dealer's salesperson. The statements, being part of the basis of the bargain, are express warranties. Com C §2313. If the buyer signs a purchase contract providing that there are *no* express warranties covering the used car, a parol evidence problem is created because the buyer will need to establish a precontractual term that is inconsistent with the "no express warranties" term of the written contract.

Under the Commercial Code's parol evidence rule (Com C §2202), the issue is whether the parties intended the written contract as the final expression of their agreement regarding express warranties. The intention of the parties in this regard is a question of fact. If the parties had this intention, evidence about the salesperson's statements would not be admissible to prove the contract's terms (although the evidence still may be admissible to prove a claim of fraud in the inducement; see *Price v Wells Fargo Bank* (1989) 213 CA3d 465, 261 CR 735). If the parties did not intend the written contract to be their integrated, final understanding on the matter of express warranties, the evidence would be admissible and, under Com C §2316(1), the disclaimer in the contract probably would not be effective against the express warranties. See further discussion of the parol evidence rule in chap 7.

In *Aplications, Inc. v Hewlett-Packard Co*. (SD NY 1980) 501 F Supp 129, 133, aff'd (2d Cir 1982) 672 F2d 1076 (construing California law), an integrated contract warranted the products against defects in materials and workmanship and disclaimed all other express warranties. The court held that this disclaimer clause excluded a pretransaction express warranty that was not included within the integrated agreement.

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§3.52 3. Effect of Merger Clause

A "merger clause" typically provides that the written contract constitutes the complete agreement of the parties, superseding all prior written or oral agreements. Although a merger clause is strong evidence of the parties' intent, it is not conclusive. *Sierra Diesel Injection Serv., Inc. v Burroughs Corp*. (9th Cir 1989) 890 F2d 108.

In *Sierra Diesel,* the court held that, despite the existence of a merger clause, the parol evidence rule did not exclude from evidence a letter that the buyer had received from the seller before signing a sales agreement for the purchase of a computer. The letter contained several representations about the computer's capabilities. The court considered the following factors in ruling that the warranty exclusion issue could not be decided on summary judgment: The buyer was unsophisticated, knew little about computers, and expected the seller's representations to be part of the ultimate contract. There were several contract documents, none of which could be fully understood without reference to the others. All the documents were drafted by the seller and presented to the buyer without negotiation. Finally, when the computer developed problems, the seller attempted to repair it, thus implicitly acknowledging its duty to make good on the warranties that it had given before the agreement was signed.

DRAFTING CONSIDERATIONS: Because a merger clause is not conclusive evidence of which warranties or other terms are part of the parties' agreement, the attorney should include *both* a merger clause and another clause providing that there are no other warranties except those specifically set forth in the agreement.

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C. Disclaiming Implied Warranties

§3.53 1. Disclaiming Warranty of Merchantability

To exclude the implied warranty of merchantability or any part of it, the disclaimer must mention "merchantability" and, if written, the disclaimer must be conspicuous. Com C §2316(2). See §3.54. Unlike an implied warranty of fitness for a particular purpose, which can be disclaimed only in writing, an implied warranty of merchantability can be disclaimed orally.

If the subject of the sale is consumer goods, the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) prohibits waiver of the warranty of merchantability, except when the goods are sold on an "as is" or "with all faults" basis. CC §1792.3.

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Source: Business Law/California UCC Sales and Leases/3 Warranties/§3.54 2. Conspicuousness Requirement

§3.54 2. Conspicuousness Requirement

The concept of "conspicuousness" is defined in Com C §1201(b)(10):

> (10) "Conspicuous," with reference to a term, means so written, displayed, or presented that a reasonable person against whom it is to operate ought to have noticed it. Whether a term is "conspicuous" or not is a decision for the court. Conspicuous terms include the following:
> (A) a heading in capitals equal to or greater in size than the surrounding text, or in contrasting type, font, or color to the surrounding text of the same or lesser size; and
> (B) language in the body of a record or display in larger type than the surrounding text, or in contrasting type, font, or color to the surrounding text of the same size, or set off from surrounding text of the same size by symbols or other marks that call attention to the language.

The test of "conspicuousness" is whether "a reasonable person against whom it is to operate ought to have noticed it." This is a question of law. Com C §1201(b)(10). The Commercial Code's definition of "conspicuous" indicates some of the methods of making a term attention-calling.

In *Dorman v International Harvester Co*. (1975) 46 CA3d 11, 18, 120 CR 516, the court found a disclaimer to be inconspicuous and inadequate for three reasons. First, the clause was not in larger print or boldface type. Second, although a portion of it was italicized, the italicized words ("merchantability and fitness for a particular purpose shall apply") made the clause misleading, because a buyer glancing at it could conclude that those warranties applied to the goods. Third, the attempted disclaimer lacked a heading, such as "DISCLAIMER OF WARRANTIES," to call the buyer's attention to the clause.

In *Office Supply Co. v Basic/Four Corp*. (ED Wis 1982) 538 F Supp 776, 783 (construing California law), the seller set forth its disclaimers twice, each time in italicized print. The court held that the disclaimers were not conspicuous, because they lacked headings drawing attention to their existence and the print contrasted insufficiently with the balance of the document. The disclaimers were enforced, however, because the buyer was aware of them and had analyzed them before entering into the contract.

Similarly, in *Smith v Sharpensteen* (Okla 1974) 521 P2d 394, the court held that an inconspicuous disclaimer that the buyer had actually read was effective.

Whether a term is conspicuous depends on the circumstances. Words are not automatically conspicuous simply because they are capitalized and in boldface print. The question is whether, all things considered, a reasonable person would have noticed the term. *Sierra Diesel Injection Serv., Inc. v Burroughs Corp*. (9th Cir 1989) 890 F2d 108, 114.

DRAFTING CONSIDERATIONS: To ensure that the implied warranty of merchantability will be excluded, a seller should:

- Set the actual disclaimer language in boldface, large, and capitalized print. The surrounding text should not have the same appearance as the disclaimer.
- Use a conspicuous heading that is not misleading. "DISCLAIMER" or "WARRANTIES EXCLUDED" would be preferable to "WARRANTY."
- Position the disclaimer on the front side of the document or near the signature lines, to avoid a claim that its location made the disclaimer inconspicuous. (Better yet, have the buyer initial the disclaimer provision.)
- Use the term "merchantability" in the disclaimer, as the Commercial Code requires. See Com C §2316(2).

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§3.55 3. Disclaiming Warranty of Fitness

To exclude the implied warranty of fitness for a particular purpose, the disclaimer must be in writing and conspicuous. Language of exclusion is sufficient if it states that "[t]here are no warranties which extend beyond the description on the face hereof." Com C §2316(2).

Unlike a disclaimer of an implied warranty of merchantability, which the seller can make orally, a disclaimer of an implied warranty of fitness for a particular purpose must always be in writing. Com C §2316(2).

If the subject of the sale is consumer goods, the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) prohibits waiver of the warranty of fitness, except when the goods are sold on an "as is" or "with all faults" basis. CC §1792.3.

As with disclaimers of warranties of merchantability, case law has focused on the issue of whether the disclaimer of the warranty of fitness is sufficiently conspicuous. The cases discussed in §3.54 apply equally to implied warranties of fitness for a particular purpose. See also *Computerized Radiological Servs. v Syntex Corp*. (ED NY 1984) 595 F Supp 1495, 1508, aff'd in part and rev'd in part on other grounds (2d Cir 1986) 786 F2d 72 (construing California law), in which the court held that a disclaimer of the implied warranty of fitness, written in small letters and buried within the body of a paragraph, was inconspicuous and therefore ineffective.

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§3.56 4. Disclaiming Implied Warranties by "As Is" and Similar Phrases

Unless the circumstances indicate otherwise, all implied warranties are excluded by expressions like "as is," "with all faults," "as they stand," or other language that in common understanding calls the buyer's attention to the exclusion of warranties and makes plain that there is no implied warranty. Com C §2316(3)(a); Official Comment 7 to UCC §2-316 (Official Comment 5 to UCC §2-316 (2003)).

"As is" and similar disclaimers apply only to implied warranties. If express warranties are given, "as is"-type disclaimers are ineffective against them. See *Session v Chartrand Equip. Co*. (Ill App 1985) 479 NE2d 376 ("as is" disclaimer had no effect on express oral warranty that tractor engine would operate satisfactorily for 1000 hours); *Shelton v Farkas* (Wash App 1981) 635 P2d 1109 (express warranties about quality of violin were not excluded by "as is" term of sale).

Must an "as is" disclaimer be conspicuous? The Commercial Code does not specify that it be conspicuous. The Code does require that the seller use language "which in common understanding calls the buyer's attention to the exclusion of warranties and makes plain that there is no implied warranty." Com C §2316(3)(a). If the seller buried an "as is" disclaimer in the fine print so that a buyer might not notice it, the disclaimer arguably would not meet the standards of Com C §2316(3)(a). See *Fairchild Indus. v Maritime Air Serv*. (Md 1975) 333 A2d 313; *Gindy Mfg. Corp. v Cardinale Trucking Corp*. (NJ Super 1970) 268 A2d 345, overruled on other grounds in *Ramirez v Autosport* (NJ 1982) 440 A2d 1345, 1350. Alternatively, the buyer could claim that the seller was not acting in good faith. Com C §1304.

If the subject of the sale is consumer goods, the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) requires any "as is" or "with all faults" disclaimer to be in writing and conspicuous. The writing must be attached to the goods and must inform the buyer, before the sale, in simple and concise language, each of the following (CC §1792.4(a)):

- The goods are being sold on an "as is" or "with all faults" basis;
- The buyer carries the entire risk regarding the quality and performance of the goods; and
- Should the goods prove defective following their purchase, the buyer rather than the manufacturer, distributor, or retailer assumes the entire cost of all necessary servicing or repair.

If a sale of consumer goods is governed by the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312), an "as is" disclaimer may not be effective. The Act provides that if a supplier and consumer enter into a service contract at or within 90 days after the time of sale, the supplier cannot disclaim or modify any implied warranty with respect to that product. 15 USC §2308(a). See *Ismael v Goodman Toyota* (NC App 1992) 417 SE2d 290 (sale of used car; "as is" ineffective as disclaimer of implied warranty of merchantability).

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§3.57 5. Excluding Warranties by Examination Before Sale

If the buyer has examined the goods (or a sample or model of the goods) to its satisfaction before entering into the contract or, given the opportunity to examine the goods, has refused, there is no implied warranty with regard to defects that an examination in the circumstances should have revealed. Unless the buyer examines the goods before the contract is made, the examination will not serve to exclude implied warranties. Com C §2316(3)(b).

This examination should not be confused with the postcontractual right of inspection given by Com C §2513. *Keith v Buchanan* (1985) 173 CA3d 13, 24 n3, 220 CR 392; Official Comment 8 to UCC §2-316 (Official Comment 6 to UCC §2-316 (2003)). That inspection determines whether the goods conform to what was ordered. The precontractual examination provides a way for a seller to reduce its warranty obligations.

For the buyer's refusal to operate as an exclusion of warranties, the seller must demand that the buyer examine the goods fully. By making a demand, the seller shifts the risk of defects that the examination should have revealed to the buyer. Official Comment 8 to UCC §2-316 (Official Comment 6 to UCC §2-316 (2003)).

By the statute's terms, the examination excludes only implied warranties. Com C §2316(3)(b). Statements made by the seller during the examination, if they become part of the basis of the bargain, can still give rise to express warranties. See §§3.8-3.15.

A contract clause reciting that the buyer has examined the goods or has refused to examine them will not effectively exclude warranties if no examination ever occurred or if the seller never actually told the buyer that it should inspect the goods. *Performance Motors, Inc. v Allen* (NC 1972) 186 SE2d 161.

The buyer's knowledge and skill and the normal method of examining goods under the circumstances determine defects to which the implied warranties do not apply. Official Comment 8 to UCC §2-316 (Official Comment 6 to UCC §2-316 (2003)). Note that if the defect would not ordinarily be uncovered by the examination, the warranty will not be excluded. See *Garlock Sealing Technols., LLC v Nak Sealing Technols. Corp.* (2007) 148 CA4th 937, 56 CR3d 177 (implied warranty of merchantability was not excluded because latent abrasive characteristic of oil seals was not a defect that was, or ought to have been, revealed under circumstances or prevailing testing methodologies).

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§3.58 6. Excluding Warranties by Past Experience

An implied warranty can be excluded or modified by course of dealing, course of performance, or usage of trade. Com C §2316(3)(c). See chap 4.

Thus, if it is customary in the trade for a warranty not to be implied regarding certain matters (*e.g.,* the health of young animals), or if the parties have not recognized certain warranties in the performance of the present contract or in their past dealings with each other (*e.g.,* the buyer has accepted goods that would not pass without objection in the trade), these facts may show what warranties, if any, were intended in the transaction.

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§3.59 7. Excluding Warranties by Providing Specifications

Implied warranties are often excluded when the buyer gives precise and complete specifications to the seller. Official Comment 9 to UCC §2-316 (Official Comment 7 to UCC §2-316 (2003)). Those specifications, however, give rise to an express warranty that the goods will comply with the specifications. Com C §2313(1)(b).

The warranty of fitness for a particular purpose would normally not be implied because in such a circumstance the buyer usually does not rely on the seller's skill or judgment. Official Comment 9 to UCC §2-316 (Official Comment 7 to UCC §2-316 (2003)). The warranty of merchantability ordinarily would not impose any obligations on the seller beyond those already imposed by the express warranty (*i.e.,* to meet all the specifications). Official Comment 9 to UCC §2-316 (Official Comment 7 to UCC §2-316 (2003)). See in this regard, however, *Garlock Sealing Technols., LLC v Nak Sealing Technols. Corp.* (2007) 148 CA4th 937, 56 CR3d 177 (where buyer specifies a standard component with no knowledge of its ingredients and no reason to know of any potential flaws in such ingredients, its specification of the standard component is not inconsistent with an implied warranty of merchantability by the seller of that component).

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§3.60 8. Excluding Implied Warranties in Sales of Consumer Goods

If the subject of the sale is consumer goods, the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) prohibits limiting, modifying, or disclaiming the implied warranties of merchantability or fitness, except when the goods are sold on an "as is" or "with all faults" basis. CC §§1792.3, 1793. For the disclaimer to be effective, a notice must be attached to the goods, indicating that they are being sold "as is." CC §1792.4.

If the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312; see §§3.5-3.7) applies to the sale, special restrictions apply. The Act does not require anyone to give a warranty, but if a seller decides to give a written warranty, or if it enters into a service contract with the buyer within 90 days after the sale, the seller cannot disclaim the implied warranties that arise automatically under state law. 15 USC §2308(a).

If the seller gives a "limited" warranty (see 15 USC §2303(a)), the implied warranties of merchantability or fitness may be limited to the duration of the limited written warranty as long as that period is reasonable. The limitation must be prominently displayed on the face of the warranty, in clear and unmistakable language, and must not be unconscionable. 15 USC §2308(b). See §3.126 for additional required language.

If the seller gives a "full" warranty (see 15 USC §2303(a)), the implied warranties may not be limited in duration.

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§3.61 9. Excluding Implied Warranties in Sales of Pesticides

Pesticides, elaborately defined in Food & A C §12753, include insect sprays, weed killer, and the like. Food and Agricultural Code §12853 deals specifically with warranty disclaimers in the sale of these goods.

The seller is permitted to print on the label of the package containing the pesticide whatever limitations of warranty it may consider proper. No matter how broad the disclaimer language is, the seller cannot exclude either the implied warranty that the pesticide (a) corresponds to all claims and descriptions that the seller has made regarding it in print, or (b) is reasonably fit for any purpose for which it is intended according to any printed statement of the seller. Food & A C §12854.

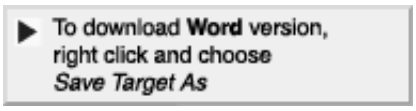
The warranty created by the advertising of pesticide is implied, a characterization of considerable importance for purposes of disclaimer. Food & A C §12854(a). See §§3.53-3.60 on disclaiming implied warranties. The Commercial Code typically views warranties created by advertising as express warranties. See §3.8.

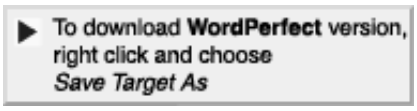
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Source: Business Law/California UCC Sales and Leases/3 Warranties/ D. Disclaimer Forms/§3.62 1. Form: Merchantability and Particular Purpose Warranties Disclaimed

D. Disclaimer Forms

§3.62 1. Form: Merchantability and Particular Purpose Warranties Disclaimed





3.62-1 Merchantability and particular purpose warranties disclaimed

EXCLUSION OF WARRANTIES

THERE ARE NO WARRANTIES THAT EXTEND BEYOND THE DESCRIPTION OF THE GOODS PROVIDED ON THE FACE OF THIS CONTRACT. SELLER DISCLAIMS ANY WARRANTY OF ANY OTHER KIND, INCLUDING ANY WARRANTY THAT THE GOODS ARE MERCHANTABLE OR FIT FOR A PARTICULAR PURPOSE.

Comment: This language and the style of type are based on Com C §2316(2), which requires disclaimers of the implied warranties of merchantability and fitness to be "conspicuous," as that term is defined in Com C §1201(b)(10). Capital letters and boldface type should be used. A color of ink different from that used in the contract should be considered for the disclaimer. See §3.54. For an expanded form of warranty with disclaimer provisions, see §3.126.

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Source: Business Law/California UCC Sales and Leases/3 Warranties/§3.63 2. Form: Sale of Goods 'As Is' and 'With All Faults'

§3.63 2. Form: Sale of Goods "As Is" and "With All Faults"

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3.63-1 Alternative: Sale of goods "as is" and "with all faults"

THE GOODS ARE SOLD AS IS AND WITH ALL FAULTS.

3.63-2 Alternative: Sale of consumer goods "as is" and "with all faults"

THESE GOODS ARE BEING SOLD AS IS AND WITH ALL FAULTS. THE ENTIRE RISK AS TO THE QUALITY AND PERFORMANCE OF THE GOODS IS WITH THE BUYER. SHOULD THE GOODS PROVE DEFECTIVE FOLLOWING THEIR PURCHASE, THE BUYER AND NOT THE MANUFACTURER, DISTRIBUTOR, OR RETAILER ASSUMES THE ENTIRE COST OF ALL NECESSARY SERVICING OR REPAIR.

Comment: The language in Form 3.63-1 is taken from Com C §2316(3)(a). Although the Commercial Code does not expressly require it to be conspicuous, a hidden clause may violate the obligation of good faith or may be held unconscionable. See §§1.21, 18.70.

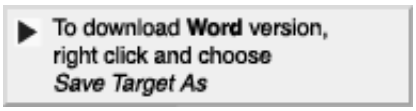
Note that an "as is" disclaimer does not exclude any express warranty or the warranty of title; it only excludes implied warranties. See Com C §2316(3)(a).

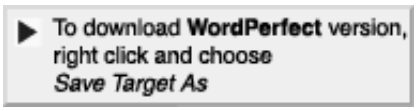
If the subject of the sale is consumer goods, the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) requires that the language in Form 3.63-2 be used. The disclaimer must be in writing and conspicuous, and the writing must be attached to the goods. CC §1792.4(a).

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Source: Business Law/California UCC Sales and Leases/3 Warranties/§3.64 3. Form: Examination Made or Refused

§3.64 3. Form: Examination Made or Refused





3.64-1 Examination made or refused

The buyer acknowledges that before the closing of the transaction the seller offered the buyer an opportunity to examine _ _[*the goods/a* _ _[*sample/model*]_ _ *of the goods*]_ _ **as fully as the buyer wished and demanded that the buyer** _ _[*inspect or refuse to inspect* _ _[*them/it*]_ _]_ _**. The buyer acknowledges that the** _ _[*goods/sample/model*]_ _ _ _[*were/was*]_ _ **freely accessible and that the buyer** _ _[*inspected/refused to inspect*]_ _ _ _[*them/it*]_ _**.**

Comment: This language is taken from Com C §2316(3)(b).

For there to be a refusal to examine within the meaning of Com C §2316(3)(b), it is not sufficient that that goods are available for the buyer's inspection; there must be a demand by the seller that the buyer fully examine the goods. Official Comment 8 to UCC §2-316 (Official Comment 6 to UCC §2-316 (2003)).

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E. Disclaiming Warranty of Title

§3.65 1. By Specific Language

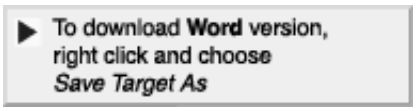
A warranty of title (see §§3.42-3.43) can be excluded or modified only by specific language or by circumstances that give the buyer reason to know that the seller does not claim title or is purporting to sell only a limited right or title held by the seller or a third person. Com C §2312(2).

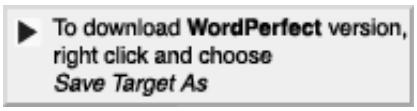
Although the warranty of title may be an implied term in a contract for the sale of goods, it is not treated as an implied warranty. A clause that disclaims "all warranties, express or implied," or an "as is" disclaimer does not effectively disclaim the warranty of title. To be effective, a disclaimer of the warranty of title must be made by language that mentions it specifically. Official Comment 6 to UCC §2-312.

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Source: Business Law/California UCC Sales and Leases/3 Warranties/§3.66 2. Form: Warranty of Title Disclaimed

§3.66 2. Form: Warranty of Title Disclaimed





3.66-1 Warranty of title disclaimed

The seller disclaims:

(1) All warranties of title or warranties of the seller's right to transfer the goods;

(2) All warranties that the goods will be free from security interests, liens, or other encumbrances; and

(3) Any warranty that the buyer's possession of the goods will not be disturbed.

These disclaimers apply whether those warranties arise from California Commercial Code §2312(1), from expressions of the seller by implication, or from the common law. The seller assumes no responsibility for defending whatever interest is conveyed.

Comment: If the seller is willing to warrant the title for all but a particular encumbrance, or warrant only for a particular encumbrance, the warranty may be modified to do that. Com C §2312(2). The Commercial Code does not require that a disclaimer of the title warranty be conspicuous, but a careful practitioner will make it so.

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§3.67 3. By Circumstances

The warranty of title can also be excluded by circumstances of the sale that suggest to the buyer that the seller does not claim title or purports to sell only a limited right or title. In Official Comment 5 to UCC §2-312 (Official Comment 6 to UCC §2-312 (2003)), the drafters of the Uniform Commercial Code state that such circumstances may occur in sales by sheriffs, executors, foreclosing lienors, and similar persons who

> may be so out of the ordinary commercial course that their peculiar character is immediately apparent to the buyer and therefore no personal obligation is imposed upon the seller who is purporting to sell only an unknown or limited right.

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§3.68 F. Disclaiming Warranty Against Infringement

Unless otherwise agreed, a seller who is a merchant regularly dealing in goods of the kind being offered for sale automatically warrants that the goods will be delivered free of any third person's rightful claim of infringement or the like. Com C §2312(3). See §§3.44-3.45.

The Commercial Code does not prescribe a method for excluding the warranty against infringement. Because the Code recognizes that the parties can agree about the existence of the warranty, specific language disclaiming the warranty should be upheld. See form 3.69-1.

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Source: Business Law/California UCC Sales and Leases/3 Warranties/§3.69 G. Form: Warranty Against Infringement Disclaimed

§3.69 G. Form: Warranty Against Infringement Disclaimed

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3.69-1 Warranty against infringement disclaimed

The seller makes no warranty that the goods are or will be delivered free of any person's claim of patent, trademark, or similar infringement. The buyer assumes all risks (including the risk of suit) that the goods or any use of the goods will infringe existing or subsequently issued patents, trademarks, or copyrights.

Comment: On warranty against infringement, see §§3.44-3.45. If the buyer is furnishing specifications for the seller to follow, the parties may agree that the seller must obtain licenses or other rights. The Commercial Code does not require that a disclaimer of the warranty against infringement be conspicuous, but a careful practitioner will make it so.

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VII. CUMULATION AND CONFLICT OF WARRANTIES

§3.70 A. Cumulation Favored

Warranties whether express or implied will be construed as consistent with each other and as cumulative, but, if such construction is unreasonable, the parties' intention determines which warranty is dominant. Com C §2317.

Warranties are consistent when the seller can comply with each one. To the extent that the seller has led the buyer to believe that all the warranties can be performed, the seller is estopped from using inconsistency as a defense. Official Comment 2 to UCC §2-317.

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§3.71 B. Resolving Inconsistent Warranties

Commercial Code §2317 provides principles to resolve conflict when the bargain contains more than one warranty and the intention of the parties about which dominates is not clear. Courts usually construe the warranties as consistent, unless this is unreasonable, and then reconstruct the parties' intention by certain rules of construction. Typically, the rules give preference to the specific over the general.

When warranties cannot be construed as consistent with each other, the following rules apply:

- Exact or technical specifications displace an inconsistent sample or model or general language of description. Com C §2317(a).
- A sample from the goods being sold displaces inconsistent general language of description. This rule recognizes that a buyer who inspects a sample probably relies on visual impressions rather than descriptive phrases. Com C §2317(b).

DRAFTING CONSIDERATIONS: If the seller wishes the description to supersede the sample in the event of conflict, the contract should indicate this intent. See form 3.72-1.

- Express warranties displace inconsistent implied warranties. If the implied warranty of fitness for a particular purpose would otherwise apply, however, an express warranty will not displace it. Com C §2317(c). The reasoning behind this provision is that, if a buyer can prove an intent to rely on the seller's skill or judgment to furnish the proper goods, then the buyer could not have made an independent decision based on the express warranty. Because this rule assumes that the parties have not excluded the implied warranty of fitness for a particular purpose, it does not conflict with the principle (see Official Comment 9 to UCC §2-316; Official Comment 7 to UCC §2-316 (2003)) that an express warranty arising from a buyer's precise and complete specifications normally excludes the implied warranty of fitness for a particular purpose. That principle assumes that the buyer does not rely on the seller's skill or judgment to select or furnish goods.

Because the above rules are not absolute, the parties' intention and the circumstances at the time of contracting may support a different resolution. Official Comment 3 to UCC §2-317.

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§3.72 C. Form: Description Displaces Sample

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3.72-1 Description displaces sample

The buyer and seller intend that, if the description contained in this agreement conflicts with any sample or model shown to the buyer, the description will displace any warranty arising from the buyer's inspection of the sample or model.

Comment: A seller may want to resolve other warranty conflicts in the agreement of sale. For example, the seller may want to provide that express warranties displace any warranty that the goods are fit for a particular purpose. See Com C §2317(c) (stating contrary general rule).

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VIII. NOTICES

A. Notice of Breach of Warranty

§3.73 1. Introduction

After the buyer has accepted tender of the goods, within a reasonable time after he or she discovers or should have discovered any breach, the buyer must notify the seller of breach or be barred from any remedy. Com C §2607(3)(A).

This notice requirement gives the seller the opportunity to repair the defective item, to avoid the sale of further defective products, and to negotiate a settlement with the buyer. In addition, the requirement permits the seller to promptly gather and preserve evidence for possible litigation. *Pollard v Saxe & Yolles Dev. Co*. (1974) 12 C3d 374, 380, 115 CR 648.

For general discussion of notice of breach of warranty, see Anno, *Sufficiency and Timeliness of Buyer's Notice Under UCC §2-607(3)(a) of Seller's Breach of Warranty*, 89 ALR5th 319 (2001).

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§3.74 2. Importance of Tender of Delivery

Tender of delivery triggers the notice requirement and normally determines when a cause of action for a breach of warranty accrues. A breach of warranty occurs at tender of delivery, unless the warranty explicitly extends to future performance. Com C §2725(2).

"Tender of delivery requires that the seller put and hold conforming goods at the buyer's disposition." Com C §2503(1). On tender, see §§9.44-9.50.

Once the buyer accepts the seller's tender, with or without knowledge of a nonconformity, the buyer must timely notify the seller of the breach or be barred from any remedy. Com C §2607(3)(A).

If acceptance occurs as a result of the buyer's failure to inspect the goods at an agreed location, the time for giving notice of defects that could have been discovered begins to run at the time the inspection was to have taken place. Official Comment 6 to UCC §2-513.

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§3.75 3. Whom to Notify

The Commercial Code requires that the seller be notified of any claimed breach of warranty. Com C §2607(3)(A). When the goods are also warranted by a remote seller (*e.g.,* the manufacturer), must the buyer notify that party as well? In the pre-Code case of *Greenman v Yuba Power Prods., Inc*. (1963) 59 C2d 57, 27 CR 697, the court held that notice is not required when the action is for breach of a warranty that arises independently of a contract of sale, such as the manufacturer's express warranty. This appears to be the majority rule in jurisdictions in which the question has been raised in reported decisions. See the cases cited in Anno, *Necessity That Buyer of Goods Give Notice of Breach of Warranty to Manufacturer Under UCC §2-607, Requiring Notice to Seller of Breach*, 24 ALR4th 277 (1983). The reasoning behind this rule is that the buyer should not have the burden of contacting a party with whom it has never dealt. Thus, the immediate seller must contact the manufacturer and other parties up the stream of distribution. Compare *Fieldstone Co. v Briggs Plumbing Prods., Inc.* (1997) 54 CA4th 357, 62 CR2d 701 (sophisticated developer whose subcontractors installed defective bathroom sinks in new houses was required to give notice of breach of express warranty to manufacturer; court distinguished *Greenman v Yuba Power Prods., Inc., supra*); *Hobbs v General Motors Corp*. (MD Ala 2001) 134 F Supp 2d 1277 (for remote manufacturers to be held liable for unintentionally created express warranty, they should be afforded same protections as sellers, either by notice provided directly to them or through notice provided to them by direct seller who received such notice from buyer).

An injured third party (not the buyer) who sues the seller for breach of warranty also must give the seller notice of the breach. Official Comment 5 to UCC §2-607. See *Branden v Gerbie* (Ill App 1978) 379 NE2d 7 (woman sued manufacturer for breach of warranty for injuries from IUD supplied by physician; complaint dismissed because of 15-month delay in giving notice).

If the theory of recovery is strict liability in tort, rather than breach of warranty, notice to the seller is not required. See generally 3 Witkin, California Procedure, *Actions* §222 (5th ed 2009).

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§3.76 4. When to Give Notice

The buyer must notify the seller within a reasonable time after the buyer has or should have discovered the alleged breach "or be barred from any remedy." Com C §2607(3)(A). The parties may fix any time for notice by agreement as long as the time is not manifestly unreasonable. Com C §1302(b).

DRAFTING CONSIDERATIONS: The attorney should consider including a provision in the sales agreement that specifies the time limit for giving notice of a claimed breach of warranty.

What is a reasonable time is normally a question of fact but may become a question of law. *Los Angeles Nut House v Holiday Hardware Corp*. (9th Cir 1987) 825 F2d 1351, 1354 (construing California law). The drafters of the Uniform Commercial Code urged the courts to give a liberal interpretation to "reasonable." Official Comment 2 to UCC §2-607 (Official Comment 4 to UCC §2-607 (2003)). In two post-Code cases, the courts addressed timeliness and determined that periods of 4 years and 10 years for notification of breach were unreasonable as a matter of law. See *Pollard v Saxe & Yolles Dev. Co*. (1974) 12 C3d 374, 380, 115 CR 648 (4 years unreasonable); *McCune v F. Alioto Fish Co*. (9th Cir 1979) 597 F2d 1244, 1253 (10 years unreasonable).

A consumer is allowed a greater time for giving notice than a merchant buyer. Official Comment 4 to UCC §2-607; *Eastern Air Lines, Inc. v McDonnell Douglas Corp*. (5th Cir 1976) 532 F2d 957, 977 (construing California law). The Official Comment explains that the rule requiring notification is designed to defeat commercial bad faith, not to deprive a good faith consumer of his or her remedy.

Case authorities differ about whether filing suit may serve as notice. See *Armco Steel Corp. v Isaacson Structural Steel Co*. (Alaska 1980) 611 P2d 507 (lawsuit is not adequate notice); *Pace v Sagebrush Sales Co*. (Ariz 1977) 560 P2d 789 (lawsuit is adequate notice). Because a merchant is held to a higher notice standard than a retail consumer, it can be argued that, at least for merchants, the filing of suit would not be adequate notice. See *Quaker Alloy Casting Co. v Gulfco Indus.* (ND Ill 1988) 686 F Supp 1319, 1340 (holding that litigation filings alone are unacceptable vehicle for giving notice of breach, but only as to claims of which party has knowledge before start of litigation or well before it is required to file response in lawsuit).

PRACTICE TIP: Even if the buyer is certain that the seller knows about the alleged breach of warranty from other sources, notice of breach should be given. See *Eastern Air Lines, Inc. v McDonnell Douglas Corp*. (5th Cir 1976) 532 F2d 957, 970 (construing and applying California law).

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§3.77 5. Content of Notice

Although Official Comment 4 to UCC §2-607 states that "the content of the notification need merely be sufficient to let the seller know that the transaction is still troublesome and must be watched," the prudent buyer's notice should specify that a breach has occurred. See *K&M Joint Venture v Smith Int'l, Inc.* (6th Cir 1982) 669 F2d 1106, 1111 (construing California law); *Eastern Air Lines, Inc. v McDonnell Douglas Corp*. (5th Cir 1976) 532 F2d 957, 970 (construing California law).

The Commercial Code does not require that the notice be written (see Com C §1202(d)), but a written notice is preferable. Because the giving of notice must be pleaded and proved (*Redfield v Mead, Johnson & Co*. (Or 1973) 512 P2d 776, 781), having a written notice to attach to the complaint simplifies the process. The contract may also require that the notice be written. See, *e.g., Prompt Elec. Supply Co. v Allen-Bradley Co*. (ED NY 1980) 492 F Supp 344.

PRACTICE TIP: When drafting the notice, the buyer's attorney should remember that it may ultimately be filed as an exhibit to the client's complaint. As such, the notice can be the attorney's first opportunity to plead the client's case. Although the notice need not state all the objections on which the client will rely (Official Comment 4 to UCC §2-607), the attorney should err on the side of inclusion by describing everything about the suit that the judge and anyone who reads the complaint should know. The notice can also emphasize the equities in the client's favor, offer a compromise, or suggest a reasonable course of action for the seller to follow to avoid a lawsuit. The client should sign and deliver the notice of breach so that the attorney will not be required to testify as a witness at a subsequent trial. If desired, a separate attorney notice can be sent contemporaneously.

Care should be taken that the buyer's conduct after notification does not negate the intent of the notice. See *Eastern Air Lines, Inc. v McDonnell Douglas Corp*. (5th Cir 1976) 532 F2d 957, 978, in which the court held that evidence of extended dealings between the parties over a 3-year period presented the jury with the question of whether the plaintiff had ever informed the defendant that the plaintiff considered a late delivery to be a breach. See also *K&M Joint Venture v Smith Int'l, Inc., supra,* in which the buyer of a malfunctioning machine continued to order and pay for spare parts without protest over a 6-month period. The court ruled that, as a whole, the buyer's conduct did not constitute notice that it claimed a breach.

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§3.78 6. Additional Notice in Infringement Actions

Unless otherwise agreed by the parties, a merchant seller automatically warrants that sale of the goods does not infringe on the rights of third parties. Com C §2312(3). If the buyer furnishes the merchant seller with specifications, however, the buyer must hold the seller harmless from any infringement claims that arise out of compliance with those specifications. Com C §2312(3).

In either situation, a buyer that is sued for infringement must give notice of the litigation to the seller within a reasonable time after the buyer learns of the litigation or be barred from any remedy against the seller for liability established in the litigation. Com C §2607(3)(B), (6). Likewise, a seller sued for infringement by a third party should notify the buyer of the litigation to preserve the seller's remedy against the buyer when the goods were furnished according to the buyer's specifications. See Com C §2312(3).

If the buyer first learns of the breach only when the lawsuit is served, the notice of the lawsuit should also serve as the notice of breach. If the buyer learns of the infringement claim before any suit is filed (*e.g.,* through a letter from the third party), the buyer should notify the seller of the claim as it would with any other breach. Then, if the buyer is subsequently sued, it should give the seller additional notice of the litigation.

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§3.79 7. Proof of Purchase Requirement

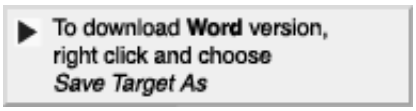
In any retail sale of goods, if the manufacturer or seller issues a written warranty that requires the buyer to complete and return any form to the manufacturer or seller as proof of the purchase of the goods, the buyer's failure to complete or return the form will not by itself make the warranty unenforceable. If the buyer brings an action for breach of the warranty, the buyer will have to prove that it purchased the goods and the date of purchase if those facts become issues in the case. Com C §2801.

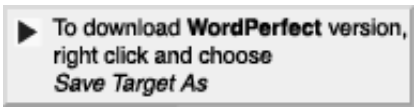
Although the buyer may waive the protections of §2801, if the waiver is not in writing, it is contrary to public policy, void, and unenforceable. Com C §2801.

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Source: Business Law/California UCC Sales and Leases/3 Warranties/§3.80 8. Form: Written Notice Required

§3.80 8. Form: Written Notice Required



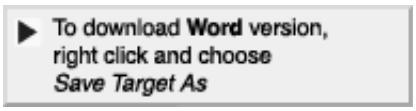


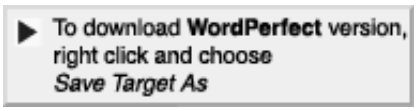
3.80-1 Written notice required

The buyer's cause of action for breach of any warranty concerning the goods will be barred unless the seller receives written notice of the alleged breach from the buyer within _ _[*e.g., 10*]**_ _ days after _ _**[*e.g., delivery of the goods*]**_ _.**

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§3.81 9. Form: Notice of Breach of Warranty





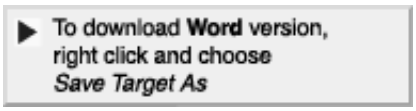
3.81-1 Notice of breach of warranty

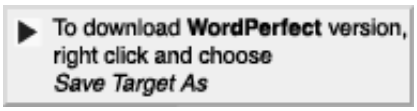
Under California Commercial Code §2607(3)(A), we notify you that the goods you delivered to us under the contract of sale dated _ _[*date*]**_ _ are defective in that _ _**[*specify defects*]**_ _. The described defects are breaches of _ _**[*e.g., the warranties of quality implied in our contract/the express warranty that the goods would be as described/the warranty that the goods would conform to the sample shown to us*]**_ _. We intend to hold you responsible for all damages resulting from your breach of the described warranty(ies).**

Comment: The notice of breach should be sent as soon as possible to avoid the defense that it was unreasonably late. See §3.76.

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§3.82 10. Form: Notice of Infringement Suit





3.82-1 Notice of infringement suit

Under California Commercial Code §2607(3)(B), we notify you that _ _[*name*]_ _ has commenced an action against us for infringement of its _ _[*e.g., trademark*]_ _. The alleged infringement concerns goods _ _[*sold to us by you/manufactured for you in accordance with plans and specifications furnished to us by you*]_ _ under our contract dated _ _[*date*]_ _. The action was begun on _ _[*date*]_ _, in the _ _[*specify type of court*]_ _ for _ _[*name of county or judicial district*]_ _. We were served on _ _[*date*]_ _. We had no notice of the litigation before that date. We intend to hold you responsible for all damages that we are entitled to recover from you under California law.

Comment: Additional language that requires the answerable party to come in and defend the action may be necessary. See §§3.83-3.88. For language requiring the alleged infringer to permit the answerable party to come in and defend, see form 3.88-1.

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B. Vouching In

§3.83 1. Background and Rule

Assume that a retailer is sued for breach of warranty by an aggrieved consumer. If the consumer recovers from the retailer, the retailer generally will be entitled to recover in turn from its seller. See CC §1792. This can result in a multiplicity of actions unless all litigation arising from the sale of the goods can be joined in one suit. If the retailer's seller (*e.g.,* the manufacturer) is "doing business" within the retailer's jurisdiction and is therefore amenable to normal third party process (*e.g.,* suit by cross-complaint) or a direct suit by the consumer, no joinder problem arises. If the manufacturer is not doing business in the retailer's jurisdiction, the retailer may be unable to compel the manufacturer to join the litigation. The Commercial Code provides no method of compulsory joinder, which is left to local jurisdictional rules. It does, however, provide a way of binding the out-of-state manufacturer if the manufacturer refuses to come in and defend the warranty suit against the retailer. Commercial Code §2607(5)(A) provides:

> Where the buyer is sued for breach of a warranty or other obligation for which his or her seller is answerable over[,]… [h]e or she may give the seller written notice of the litigation. If the notice states that the seller may defend and that if the seller does not do so he or she will be bound in any action against the seller by the buyer by any determination of fact common to the two litigation actions, then unless the seller after seasonable receipt of the notice does defend he or she is so bound.

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§3.84 2. Vouching In and Notice of Breach of Warranty

The notice to come in and defend, referred to in Com C §2607(5)(A), and the notice of breach of warranty required by Com C §2607(3)(A) are separate and distinct requirements. Both notices must be given.

When the retailer first learns from a customer that the goods are defective, the retailer should give its own seller (*e.g.,* the manufacturer) notice of the claimed breach of warranty. The retailer must dispatch the notice within a reasonable time after the breach is discovered or be barred from vouching in the manufacturer or pursuing any other remedy against it.

The vouching-in notice must meet additional statutory requirements. Because the notice must identify the litigation, the retailer cannot give notice until after the suit against the retailer has begun. In most cases, the vouching-in notice cannot double as a notice of breach of warranty unless the consumer starts the action against the retailer soon after the retailer is notified of the breach, because the reasonable time for the retailer to give notice of breach will have expired. For vouching-in notice, see form 3.87-1.

Besides identifying the litigation, the vouching-in notice must invite the manufacturer to come in and defend the retailer and warn the manufacturer that, if it does not come in and defend, the manufacturer will be bound by adjudications of fact in the pending action that also arise in a later suit by the retailer against the manufacturer. *Bendix-Westinghouse Automotive Air Brake Co. v Swan Rubber Co*. (1976) 55 CA3d 256, 260, 127 CR 571. In this case, a supplier's notice to the manufacturer demanded that the manufacturer assume the defense of a breach of warranty action and indemnify the supplier. The notice failed to explain that the manufacturer would be bound if it did not come in and defend. The court held that, because the vouching-in notice was insufficient, the manufacturer was not bound by the finding in the supplier's lawsuit that the air hose was defectively manufactured.

The retailer must prove "seasonable receipt" of the vouching-in notice by the manufacturer. In contrast, a notice of breach of warranty may be effective even if it is never received. See Com C §1202(d).

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§3.85 3. Effect of Judgment If Manufacturer Refuses to Defend

If the manufacturer refuses to come in and defend, several issues still must be settled in the retailer's indemnification action against the manufacturer, despite the prior judgment in the consumer's action against the retailer. The retailer must prove that the manufacturer was the retailer's seller, that the manufacturer made a warranty or incurred some other obligation to the retailer, and that the defendant breached the warranty or other obligation.

The retailer must also demonstrate that it has suffered damages as a consequence of the breach and the amount of those damages. This can be shown by proving that the retailer has satisfied the adverse judgment or made a reasonable settlement of the consumer's claim. The retailer's costs and attorney fees for defending the suit against the consumer may also be a recoverable item of damages. See CCP §1021.6.

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§3.86 4. Infringement Actions and Vouching In

Merchant sellers are held to an implied warranty that the buyer will receive the goods free of any rightful trademark, patent, or similar infringement claims by third parties. Com C §2312(3); Official Comment 3 to UCC §2-312 (Official Comment 4 to UCC §2-312 (2003)). See §§3.44-3.45. If the buyer is sued by a third party for infringement or the like, the buyer must notify the seller of the litigation. Com C §2607(3)(B).

At this juncture, the seller may demand in writing that the buyer turn over control of the litigation, including settlement, or else be barred from any remedy against the seller. If the seller also agrees to bear all expense and to satisfy any adverse judgment, then the buyer will be barred from proceeding against the seller unless the buyer turns over control. Com C §2607(5)(B).

If the seller refuses to become involved in the litigation with the third party, and the third party is successful, the seller has breached the warranty against infringement and the buyer is entitled to its damages, including its attorney fees. See *De La Hoya v Slim's Gun Shop* (1978) 80 CA3d Supp 6, 146 CR 68. If the third party is not successful, the buyer might still recover its costs of suit and attorney fees for defending the infringement action under a theory of implied indemnity, as long as the action was not frivolous. See CCP §1021.6.

When the seller is being sued for infringement but specifications for the goods were originally furnished by the buyer, the buyer must hold the seller harmless from liability. Com C §2312(3). The defending seller is required to notify the buyer of the pending lawsuit, and the buyer may then demand control of the litigation. Com C §2607(3)(B), (6).

PRACTICE TIP: In either of the situations described, if the party that is ultimately responsible refuses to become a party to the infringement litigation, the opposing party may wish to add to the party's notice of litigation a request to come in and defend and a statement that failure to do so will result in the responsible party's being bound by any determination of fact common to the infringement litigation and a subsequent lawsuit by the opposing party against the responsible party. See Com C §2607(5)(A), (6). This addition will simplify the notifying party's case if that party is forced to sue the responsible party for damages or indemnification.

Nothing in Com C §2607 prevents a party from reserving in the contract the right to defend the infringement action or at least to be represented at trial.

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§3.87 5. Form: Notice of Litigation; Requesting Defense

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

3.87-1 Notice of litigation; requesting defense

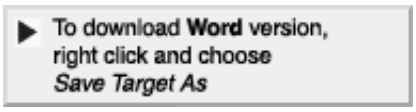
Under California Commercial Code §2607(5)(A), we notify you that an action for breach of warranty, entitled _ _[*name of plaintiff*]_ _ **v** _ _[*name of defendant*]_ _**, No.** _ _[*specify docket number*]_ _**, was filed against us on** _ _[*date*]_ _**, in the** _ _[*specify type of court*]_ _ **for** _ _[*specify county or judicial district*]_ _**. The action alleges that goods purchased by us from you under a contract dated** _ _[*date*]_ _**,** _ _[*e.g., and subsequently sold to the plaintiff are defective/infringe on a trademark owned by the plaintiff*]_ _**. You may and are requested to come in and defend the action. If you do not, you will be bound by any determination of fact common to this litigation and an action by us against you.**

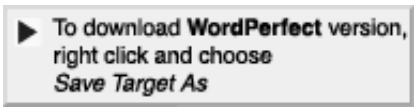
Please consult your attorney for further information about your rights in this matter.

Comment: Because the risk of failure to notify is on the sender, the notifying party should use certified mail with return receipt requested. See Com C §2607(5)(A).

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§3.88 6. Form: Demand for Control of Infringement Action





3.88-1 Demand for control of infringement action

We have received your notice of suit dated _ _[*date*]_ _. We demand that you turn over to us control of the litigation, including settlement. Failure to do so may preclude you from pursuing any remedy you may have against us. We agree to bear all expenses of the litigation and to satisfy any adverse judgment.

Please consult your attorney for further information about your rights in this matter.

Comment: This clause can be used by either the buyer or the seller. Because the risk of failure to notify is on the sender, the notifying party should use certified mail with return receipt requested. See Com C §2607(5)(A).

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IX. REMEDIES FOR BREACH OF WARRANTY

§3.89 A. Overview

If goods do not conform to a warranty, the buyer may do one of the following before acceptance (Com C §2601):

- Reject the whole;
- Accept the whole; or
- Accept any commercial unit or units and reject the rest.

If the seller gives no instructions within a reasonable time after the buyer's notification of rejection, the buyer may store, reship, or resell the goods. Com C §2604. See §§17.53-17.60.

Special rules govern installment shipments (see Com C §2612), and merchant buyers have certain duties with respect to rejected goods (see Com C §2603). See §§10.35-10.51, 17.60 for further discussion of the remedy of rejection.

In addition to the above, the buyer may take the following actions, if applicable (Com C §2711(1), (3)):

- Cancel the contract (see §§17.84-17.86);
- Recover what it has already paid (see §18.48);
- "Cover" (see §§17.67-17.69);
- Enforce its security interest (see §§17.71-17.74); or
- Recover damages (see §§18.25-18.45).

The same remedies are available if the buyer, after acceptance, is able to revoke acceptance. See Com C §2608. See also §§17.62-17.66.

Once the buyer has accepted the goods and the time period for revocation of acceptance has passed, the remedial options are narrowed. The buyer cannot reject the goods or revoke acceptance, is liable for the price, and must give the seller notice of the breach. Com C §2607(1)-(3). If the breach of warranty can be proved, the buyer can recover direct damages (Com C §2714; see §§18.25-18.31) and, in a proper case, incidental and consequential damages (Com C §§2714(3), 2715; see §§18.35-18.39).

After notifying the seller of an intention to do so, the buyer may deduct all or any part of the damages resulting from breach from any part of the price still due under the contract. Com C §2717. See §18.45. A seller may not claim interest on the amount offset. *Hughes Tool Co. v Max Hinrichs Seed Co*. (1980) 112 CA3d 194, 202, 169 CR 160. In this case, when a helicopter was destroyed in an accident, the buyer offset damages against the balance of the purchase price and refused to make further payments on the balance until the court had determined liability. The court held that the seller could not recover interest on the amount of the balance that was subject to legitimate offset.

By agreement, the parties may limit the remedies available for breach of warranty as long as the limitation is not unconscionable (CC §1670.5; see §§18.54-18.57) and the buyer is not deprived of a minimum adequate remedy (Official Comment 1 to UCC §2-719). For further discussion of remedy limitation provisions, see §§3.92-3.98, 18.51-18.53.

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B. Consumer Warranty Legislation

§3.90 1. Song-Beverly Consumer Warranty Act

Other statutory enactments may provide additional remedies for breach of warranty. For example, a buyer suing for breach of the implied warranties of merchantability or fitness with respect to consumer goods has all the Commercial Code remedies available to it plus a right to damages as provided in the Song-Beverly Consumer Warranty Act (see CC §§1791.1(d), 1794; see also *Park City Servs., Inc. v Ford Motor Co.* (2006) 144 CA4th 295, 50 CR3d 373). Depending on the circumstances, damages may include costs of replacement or reimbursement of necessary repair costs. A buyer need not allow a seller an opportunity to repair before rescinding a purchase based on breach of the implied warranty of merchantability. *Mocek v Alfa Leisure, Inc.* (2003) 114 CA4th 402, 408, 7 CR3d 546.

If the action is for breach of an express warranty or a service contract, the buyer may recover a civil penalty (not to exceed twice the amount of actual damages) if the breach was willful. CC §1794(c). The buyer may not recover, however, both the civil penalty under CC §1794(c) and punitive damages under CC §3294 for the same willful, oppressive, and malicious acts. *Clauson v Superior Court* (1998) 67 CA4th 1253, 79 CR2d 747; *Troensegaard v Silvercrest Indus*. (1985) 175 CA3d 218, 227, 220 CR 712; *Ortega v ToyotaMotor Sales, USA, Inc.* (SD Cal 2008) 572 F Supp 2d 1218, 1221. See also *Gomez v Volkswagen of Am*. (1985) 169 CA3d 921, 926, 215 CR 507, in which the court held that a plaintiff with a cause of action under the Act is limited to the remedies under CC §1794 and may not seek a tort measure of damages, including punitive damages, for breach of the covenant of good faith and fair dealing in a written warranty.

In all the above instances, the prevailing buyer may also recover its reasonable attorney fees. CC §1794(d).

The remedies provided by the Song-Beverly Act are "cumulative and shall not be construed as restricting any remedy that is otherwise available." CC §1790.4; *Ortega v Toyota Motor Sales, USA, Inc.* (SD Cal 2008) 572 F Supp 2d 1218, 1221.

The Act specifies procedures for repair or replacement of nonconforming goods (CC §§1793.2-1793.3), and it requires every manufacturer of consumer goods sold under express warranty in California to maintain service and repair facilities in the state, reasonably close to all areas where its goods are sold, to carry out the terms of those warranties. CC §1793.2(a)(1). See in this regard *California State Electronics Ass'n v Zeos Int'l Ltd.* (1996) 41 CA4th 1270, 49 CR2d 127. In that case, the defendant was a computer manufacturer located in Minnesota who solicited orders for its computers through advertising, took those orders over a toll-free line, and shipped the computers by overnight carrier. The plaintiff was a trade association of businesses that serviced warranties on consumer electronic products. The purpose of its lawsuit was to compel the defendant and other computer manufacturers located outside California to comply with the Act's requirement that manufacturers provide local repair facilities to service those warranties. The court found that defendant's arrangement with its customers constituted a contract calling for shipment by the seller. Under Com C §2401(2), title thereby passed in Minnesota on shipment by the defendant. Because title passed in Minnesota, the sale was in Minnesota, and the Act did not apply.

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§3.91 2. Magnuson-Moss Warranty—Federal Trade Commission Improvement Act

If the nonconforming consumer goods were covered by a written warranty and the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312) applies, the seller (warrantor) is allowed to choose among repair, replacement, or refund of the purchase price. The warrantor may not elect refund, however, unless the buyer agrees to accept it, or unless the warrantor cannot provide a replacement and repair is commercially impracticable or cannot be made in a timely manner. 15 USC §2301(10). Note that the Act defines "refund" as the actual purchase price less reasonable depreciation based on actual use. 15 USC §2301(12). Any incidental expenses incurred by the buyer because the remedy is not accomplished within a reasonable time are recoverable. 15 USC §2304(d). The Act allows recovery of damages and other legal and equitable relief and, if allowed by the court, reasonable attorney fees. 15 USC §2310(d)(1)-(2).

If the amount in controversy is $50,000 or more, suit may be filed in either state or federal district court. Otherwise, state court is the appropriate forum. 15 USC §2310(d)(1), (3).

The Act is intended to supplement remedies available under state law and other federal warranty laws. It specifically does not (a) affect the liability of, or impose liability on, any person for personal injury or (b) supersede any state law regarding consequential damages for personal injury or other injury. 15 USC §2311(b).

The Act also provides for injunction proceedings by the United States Attorney General or Federal Trade Commission and for class action relief. 15 USC §2310(c), (e).

Both the Magnuson-Moss Act and the Song-Beverly Consumer Warranty Act (see §3.90) provide for informal dispute settlement procedures. If such procedures are applicable by the terms of the written warranty or otherwise, the buyer must utilize them before pursuing other remedies at law. See CC §1793.22(c); 16 CFR pt 703.

PRACTICE TIP: When drafting a complaint for breach of warranty, the attorney should consider the applicability of consumer warranty laws to the transaction. The broad remedial scope of 15 USC §2310(d), for instance, permits a federal claim for breach of the implied warranties that arise under state law. Because §2310(d) allows suit for "damages and other legal and equitable relief," there is no reason why a revocation of acceptance suit (see §§17.62-17.66) cannot also be a Magnuson-Moss action. In either instance, the buyer may recover attorney fees. The complaint should contain separate counts for these claims, and each count should be captioned to show the basis for recovery (*e.g.,* "Breach of Implied Warranty Under Magnuson-Moss Warranty Act" or "Revocation of Acceptance Under Magnuson-Moss Warranty Act").

See §18.72 for additional remedies available under the Consumers Legal Remedies Act (CC §§1750-1784).

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C. Limitation of Remedies

§3.92 1. Remedy Limitation Provisions Distinguished From Disclaimers and Warranties

Although they are sometimes treated as similar, a warranty disclaimer is not a type of remedy limitation provision. The disclaimer shields the seller from liability for breach of a specified warranty. It is the parties' agreement that the warranty will not apply to a particular sale of goods. A remedy limitation provision, in contrast, acknowledges that the warranty applies but narrows the buyer's options in the event it is breached. *A & M Produce Co. v FMC Corp*. (1982) 135 CA3d 473, 481 n3, 186 CR 114. See Official Comment 1 to UCC §2-719: "[The] parties are left free to shape their remedies to their particular requirements[,] and reasonable agreements limiting or modifying remedies are to be given effect."

Remedy limitation provisions often appear in contracts under the heading "Warranty" or "Guarantee" but are not a form of warranty recognized by the Commercial Code. *A & M Produce Co. v FMC Corp., supra*.

When the seller attempts to have a remedy limitation provision enforced, the buyer typically will attack it with one or more of the following arguments:

- The provision does not establish the buyer's exclusive remedy (see §3.93);
- The limited remedy provided has failed of its essential purpose (see §3.94); or
- Enforcement of the limited remedy provision would be unconscionable (see §§18.69-18.70).

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§3.93 2. Cumulative or Exclusive Remedies

Contractual remedies may be "in addition to" the remedies provided by the Commercial Code (*i.e.,* cumulative or optional) or "in substitution for" them (*i.e.,* exclusive). Com C §2719(1)(a).

Unless a remedy is expressly agreed to be exclusive, it is cumulated with all other remedies available. The Code creates a presumption that clauses prescribing remedies are cumulative rather than exclusive. Com C §2719(1)(b). This presumption can be rebutted by the contract terms. Official Comment 2 to UCC §2-719.

Sellers normally desire that a remedy limitation clause provide the buyer's sole remedy. To achieve this, the buyer and seller must expressly agree that the provided remedy will be the only remedy. Com C §2719(1)(b). Courts apply a dual standard in determining whether the parties agreed to this. In consumer cases, courts are more apt to construe the limited remedy as a cumulative one. In commercial cases, they are more willing to find a limited remedy to be the sole remedy. Even in commercial cases, however, the language must clearly show an intent to make the remedy exclusive. *Kaiser Cement & Gypsum Corp. v Allis-Chalmers Mfg. Co*. (1973) 35 CA3d 948, 960, 111 CR 210.

DRAFTING CONSIDERATIONS: To overcome the presumption that a limited remedy is cumulative or optional, counsel for the seller should describe the remedy with phrases such as "exclusive remedy," "sole remedy," or "only remedy."

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§3.94 3. Repair or Replacement Provisions and Failure of Essential Purpose

In the warranty law area, the most common remedy limitation provisions are those that provide for "repair or replacement" of the defective product. The issue that arises most often with a repair or replacement remedy is whether it has "failed of its essential purpose" and is thus invalid. See Official Comment 1 to UCC §2-719.

If the seller is unwilling or unable to repair the defective goods within a reasonable period of time, the limited repair or replacement remedy fails of its essential purpose. *S.M. Wilson & Co. v Smith Int'l* (9th Cir 1978) 587 F2d 1363, 1375 (construing California law). What is a reasonable period of time to make repairs is a question of fact, which depends on the circumstances of each case. Com C §1205(a); *Murray v Holiday Rambler, Inc*. (Wis 1978) 265 NW2d 513. Repairs to consumer goods are required to be made within 30 days unless the buyer agrees otherwise in writing. CC §1793.2(b).

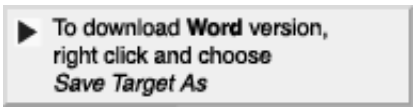
Is the seller's good faith or due care relevant in determining whether a limited remedy has failed of its essential purpose? Nothing in the language of Com C §2719(2) suggests that it is. The emphasis is not on the seller's behavior but on the adequacy of the remedy. See *Fargo Mach. & Tool Co. v Kearney & Trecker Corp*. (ED Mich 1977) 428 F Supp 364 (court recognized seller's conscientious efforts to cure defects but still found failure of essential purpose when goods could not be adequately repaired).

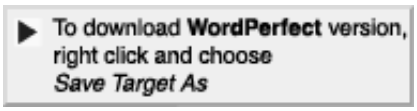
When an exclusive or limited remedy fails of its essential purpose, the aggrieved party may resort to any remedy provided by the Commercial Code, as if the remedy limitation provision had never appeared in the contract. Com C §2719(2).

DRAFTING CONSIDERATIONS: The seller should offer a backup remedy in case the limited remedy fails of its essential purpose. For example, the contract may provide for repair or replacement of the defective product, but, if the seller is unable to do either, the buyer is entitled to a refund of the purchase price or a stipulated sum as liquidated damages. The failure of the buyer's remedy thus becomes a logical impossibility. This point is illustrated by *Computerized Radiological Servs. v Syntex Corp*. (ED NY 1984) 595 F Supp 1495, aff'd in part and rev'd in part on other grounds (2d Cir 1986) 786 F2d 72 (construing California law), which involved the sale of sophisticated medical equipment to a group of doctors. The sales agreement's warranty provision had repair and replacement of defective parts as the primary remedy and return of the full purchase price as a backup remedy. The court held that this safety net precluded failure of essential purpose and insulated the seller from liability for consequential economic loss. 595 F Supp at 1510. See also *American Elec. Power Co. v Westinghouse Elec. Corp*. (SD NY 1976) 418 F Supp 435, 458 (backup remedy of return of purchase price aided court in upholding exclusion of consequential damages despite failure of essential purpose).

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§3.95 4. Form: Remedy Limitation





3.95-1 Remedy limitation

In the event of breach of this warranty or any warranties, the seller must repair or replace any defective part. This will be the buyer's exclusive remedy for breach of warranty. The seller will not be liable for incidental or consequential damages even if the seller's attempt to repair the defects fails, but in such a case the buyer will be entitled to a refund of monies paid to the seller under this contract.

Comment: For discussion of clauses excluding consequential damages, see §§18.40-18.41.

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§3.96 5. Strict Construction of Limitation Provisions

Courts strictly construe remedy limitation provisions and resolve any ambiguities in these provisions against the seller seeking to limit the buyer's rights. *Nunes Turfgrass, Inc. v Vaughan-Jacklin Seed Co*. (1988) 200 CA3d 1518, 1538, 246 CR 823; *Philippine Airlines, Inc. v McDonnell Douglas Corp*. (1987) 189 CA3d 234, 237, 234 CR 423.

In *Hawaiian Tel. Co. v Microform Data Sys., Inc.* (9th Cir 1987) 829 F2d 919, 925 (construing California law), the seller contended that a clause excluding consequential damages for breach of warranty should bar recovery of those damages when the seller failed to deliver the ordered system. Construing the clause narrowly, the court held that it applied only when there was an actual breach of warranty, not when there was a failure to perform. Therefore, the buyer could recover its consequential damages.

DRAFTING CONSIDERATIONS: Prudent counsel for sellers draft provisions limiting remedies with care. Consider this example: "This machine is warranted to operate for one year without any failure. The liability of the seller under this warranty is limited to the repair or replacement of any failed parts." This limitation may not apply to remedies for breach of other express warranties or for breach of any implied warranties. For instance, the machine could operate for a year but be unable to meet some of its performance characteristics. What are the parties' rights and duties in that situation?

Careless drafting may lead to unexpected liability. If the seller's attorney had split the two concepts, placing the warranty in a warranty section and the repair or replace clause in a limitation of remedies section, the gaps in protection may have been more readily apparent. Separating the warranty and remedy provisions also helps to eliminate needless disputes about the seller's warranty obligations, because there is less chance of confusion about which warranties are affected by the limitation of remedies. Finally, courts are less likely to find a limitation of remedies provision unconscionable if it is separately stated and labeled rather than mixed in with the language of warranty.

For further discussion of remedy limitation provisions, see §§18.53-18.57.

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§3.97 6. Conspicuousness

Remedy limitation provisions need not be conspicuous. *Computerized Radiological Servs. v Syntex Corp*. (ED NY 1984) 595 F Supp 1495, 1509, aff'd in part and rev'd in part on other grounds (2d Cir 1986) 786 F2d 72 (construing California law); *AMF, Inc. v Computer Automation, Inc*. (SD Ohio 1983) 573 F Supp 924, 929; *Office Supply Co. v Basic/Four Corp*. (ED Wis 1982) 538 F Supp 776, 787 (all construing California law). Neither Com C §2719 nor the drafters' comments to that section require conspicuousness; however, conspicuousness is a factor when a clause is tested for unconscionability (*Computerized Radiological Servs. v Syntex Corp., supra*; *AMF, Inc. v Computer Automation, Inc., supra*). A seller is therefore advised to make any limitation of remedy clause conspicuous.

For further discussion of remedy limitation provisions, see §§18.53-18.57.

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§3.98 7. Remedy Limitations and Consumer Warranty Legislation

Both the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) and the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312) contain restrictions concerning the limitation of a consumer buyer's remedies.

A buyer may not waive the remedies and other protections of the Song-Beverly Consumer Warranty Act. Any such waiver is deemed to be contrary to public policy, unenforceable, and void. CC §1790.1.

The Magnuson-Moss Warranty Act establishes minimum federal standards for written warranties designated as "full" warranties. Those standards require that the warrantor (15 USC §2304(a)):

- Must, at a minimum, remedy a defective consumer product within a reasonable time and without charge;
- May not impose any limitation on the duration of any implied warranty for the product; and
- May not exclude or limit consequential damages for breach of any written or implied warranty on the product, unless the exclusion or limitation conspicuously appears on the face of the warranty.

On additional warranty language required by Federal Trade Commission Rules, see §3.126.

In addition, the warrantor under a "full" warranty may not impose on a consumer buyer any duty other than notification as a condition of securing any remedy. 15 USC §2304(b)(1).

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X. STATUTE OF LIMITATIONS

A. Applicable Limitations Period

§3.99 1. Overview

An action for breach of any contract for the sale of goods must be commenced within 4 years after the cause of action has accrued. By the original agreement, the parties may reduce the period of limitations to not less than 1 year, but they may not extend it. Com C §2725(1).

If the contract for sale is oral, the 4-year period of limitations of Com C §2725(1) still applies—not the 2-year period of limitations of CCP §339 for oral contracts. *Filmservice Labs., Inc. v Harvey Bernhard Enters., Inc.* (1989) 208 CA3d 1297, 1304, 256 CR 735.

In an action brought under both the Commercial Code and the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8), the code's 4-year statute of limitations applies, rather than the 3-year limitations period prescribed by CCP §338(a) for actions based on statute. *Krieger v Nick Alexander Imports, Inc.* (1991) 234 CA3d 205, 212, 285 CR 717.

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§3.100 2. Exceptions to Applicability of Commercial Code Limitations Period

The Commercial Code's 4-year limitations period does not apply to a cause of action against a remote seller for breach of an express warranty, because there is no contract between the buyer and the remote seller. The applicable period of limitations in that situation would be the 2-year period of CCP §339. *Fundin v Chicago Pneumatic Tool Co*. (1984) 152 CA3d 951, 958, 199 CR 789.

The 4-year limitations period also does not apply to an action that, although couched in terms of a breach of warranty, actually is an action for strict liability in tort for personal injury. The applicable period of limitations in that situation is the 2-year period of CCP §340. *Becker v Volkswagen of Am.* (1975) 52 CA3d 794, 796, 125 CR 326 (note that when *Becker* was decided, limitations period under CCP §340 was 1 year). For actions in which a party is seeking indemnification for damages paid under a breach of warranty claim, the traditional limitations period will apply, rather than the period provided by Com C §2725. *Carrier Corp. v Detrex Corp.* (1992) 4 CA4th 1522, 6 CR2d 565. Although the limitations period in *Carrier Corp.* also was 4 years (CCP §337(1)), the period did not commence with the delivery of the defective product, as it would have if Com C §2725 had applied.

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§3.101 3. Conflict of Law; Variations in Limitation Periods

When there is a conflict of law issue (*e.g.,* a federal diversity action involving a contract governed by the law of California but brought in a state other than California), normally the forum's statute of limitations will govern, even though the law of California will be applied to the substantive provisions of the contract. *Office Supply Co. v Basic/Four Corp*. (ED Wis 1982) 538 F Supp 776, 780. In most states, the limitations period will be the same. The attorney should keep in mind, however, that differences may exist from jurisdiction to jurisdiction. For example, Wisconsin has a 6-year period of limitations in its version of the Uniform Commercial Code (see Wis Stat §402.725(1)), and Oklahoma has a 5-year period of limitations (see Okla Stat tit 12A, §2-725(1)).

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B. Accrual and Tolling

§3.102 1. General Rule

A cause of action accrues when the breach occurs, regardless of the aggrieved party's knowledge of the breach. A breach of warranty occurs when tender of delivery is made, except for a warranty explicitly extending to the future. Com C §2725(2). On warranties of future performance, see §3.103

The Commercial Code uses "tender" in two different senses:

(1) The term "due tender" "contemplates an offer coupled with a present ability to fulfill all the conditions [which] must be followed by actual performance if the other party [is] ready to proceed." Official Comment 1 to UCC §2-503(1).

(2) The term "tender" may also mean "an offer of goods … under a contract as if in fulfillment of its conditions even though there is a defect when measured against the contract obligation." Official Comment 1 to UCC §2-503(1).

Commercial Code §2725(2), which concerns accrual of the cause of action, uses "tender" in the latter sense. A contrary construction would extend the commencement of the limitations period indefinitely into the future, because a defect would prevent "due tender" from ever occurring.

The Commercial Code does not alter California law on the tolling of the statute of limitations. Com C §2725(4). For example, the statute may be tolled while the seller is attempting to repair the goods or assuring the buyer that the defects will be corrected. See *Southern Cal. Enters. v D.N. & E. Walter & Co*. (1947) 78 CA2d 750, 178 P2d 785; Anno, *Promises or Attempts by Seller To Repair Goods as Tolling Statute of Limitations for Breach of Warranty*, 68 ALR3d 1277 (1976). The statute may also be tolled for up to 4 years by the parties' agreement in writing. CCP §360.5.

For actions under the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) if the parties resort to a third party dispute resolution process (see CC §1793.22(c)-(d)), the limitations period is extended for a period equal to the number of days between the filing of a complaint and the rendering of a decision in that process. If the buyer accepts the decision rendered, the limitations period will be further extended by the period of time allowed the manufacturer to fulfill the terms of the decision. CC §1793.22(c).

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§3.103 2. Future Performance

When a warranty explicitly extends to the future performance of the goods and discovery of the breach must await the time of this performance, the cause of action accrues when the breach is or should have been discovered. Com C §2725(2). Because the warranty must "explicitly" extend to some time in the future, this accrual rule applies only to express warranties; an implied warranty by its nature cannot "explicitly" extend into the future. *Cardinal Health 301, Inc. v Tyco Electronics Corp.* (2008) 169 CA4th 116, 134, 87 CR3d 5.

The "future performance" exception to the four-year limitations period of Com C §2725 applies only when the seller explicitly has agreed to warrant its product for a defined period of time. See *Cardinal Health*, 169 CA4th at 130 (warranty that spring probe connector would have "mechanical life" of 50,000 cycles was not warranty extending to future performance because it did not refer to specific future time period, and thus did not extend statute of limitations period); *Carrau v Marvin Lumber & Cedar Co*. (2001) 93 CA4th 281, 112 CR2d 869 (general assertions as to performance or durability of product, such as those made by window manufacturer that products were durable and long-lasting, did not explicitly extend to future performance). See generally Anno, *What Constitutes Warranty Explicitly Extending to "Future Performance" for Purposes of UCC §2-725(2)*, 81 ALR5th 483 (2000). A seller's warranty that adhesive used on aluminum would work satisfactorily on fiberglass is not an explicit warranty of future performance. *Western Recreational Vehicles, Inc. v Swift Adhesives, Inc.* (9th Cir 1994) 23 F3d 1547, 1550. But if a seller expressly warrants a product for a specified number of years, it is clear that, by this action alone, the seller is explicitly warranting the future performance of the product or goods for that period of time. *Standard Alliance Indus. v Black Clawson Co*. (6th Cir 1978) 587 F2d 813, 820.

In *Rosen v Spanierman* (2d Cir 1990) 894 F2d 28, the buyer purchased a painting from a gallery, which guaranteed it to be an original work by artist John Singer Sargent. Approximately 20 years later, the buyer discovered that the painting was a fake. In the lawsuit for breach of warranty, the court held that a warranty of authenticity does not "explicitly" extend to future performance, nor is it correct to state that discovery of its breach "must await" future performance. The court dismissed the case as time-barred.

According to the general rule, a breach of warranty occurs when the goods are tendered for delivery, and the cause of action accrues then. If a defect is latent and the buyer discovers it within the 4-year limitations period, the buyer can sue for the breach. With a future warranty, if a defect is discovered (or should have been discovered) *within the period of extended warranty,* the cause of action accrues at the time of discovery (or when discovery should have occurred), and the buyer has 4 years from that date to sue.

What if a latent defect is not discovered (or could not be discovered) until after the period of extended warranty but less than 4 years after that period? Because the Commercial Code permits the buyer with a normal warranty to sue on a discoverable latent defect at any time within 4 years after tender of delivery, it should permit a similar result with a future warranty.

Certain defects may be considered to be discoverable at the time of delivery. See, *e.g., Voth v Chrysler Motor Corp*. (Kan 1976) 545 P2d 371 (defect in automobile). In that situation, a warranty of future performance would not give the buyer any additional time for bringing a lawsuit.

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§3.104 3. Breach of Warranty Against Infringement

A breach of the warranty against infringement claims by third parties (Com C §2312(3); see §§3.44-3.45) occurs when the buyer receives notice of the infringement claim. See Official Comment 4 to UCC §2-312 (Official Comment 5 to UCC §2-312 (2003)).

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XI. PLEADINGS AND JURY INSTRUCTIONS

A. Allegations in Complaints

§3.105 1. Summary

The forms in the following sections are representative of required allegations concerning express, implied, and title warranties.

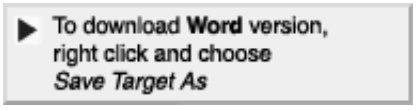
Any complaint for breach of warranty should allege:

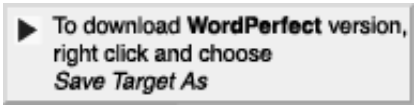
- The identities of the plaintiff and defendant and, if merchant status is important, a description of their businesses;
- The sale or other transfer of the goods, with all relevant data, including a description of the goods, dates of sale and tender of delivery, and the price paid;
- The warranty, whether express or implied or a warranty of title;
- Breach of the warranty;
- Notice of breach;
- The plaintiff's fulfillment of all conditions for remedial relief (see, *e.g., Melcher v Boesch Motor Co*. (Neb 1972) 198 NW2d 57 (buyer of new truck lost breach of warranty suit because he could not demonstrate compliance with maintenance schedule mandated by warranty as a condition to its effectiveness)); and
- Damages proximately resulting from the breach (see §§18.25-18.34 for discussion of damages available).

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Source: Business Law/California UCC Sales and Leases/3 Warranties/§3.106 2. Form: Allegation of Express Warranty by Affirmation

§3.106 2. Form: Allegation of Express Warranty by Affirmation





3.106-1 Allegation of express warranty by affirmation

Defendant expressly _ _[*affirmed/promised*]_ _ **to plaintiff that** _ _[*describe warranty in detail, e.g., the software program would enable plaintiff to prepare comparative revenue and expense reports using data from five different data bases*]_ _**. This** _ _[*affirmation/promise*]_ _ **was made a part of the basis of the bargain and created an express warranty that the goods would conform to the** _ _[*affirmation/promise*]_ _**.**

Comment: This language is based on Com C §2313(1)(a). For discussion of express warranties by affirmation or promise, see §§3.8-3.18.

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§3.107 3. Form: Allegation of Express Warranty by Description

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3.107-1 Allegation of express warranty by description

Defendant described the _ _[*e.g., goods*]_ _ **as** _ _[*e.g., 16-ounce denim/conforming to*]_ _ _ _[*describe or refer to attached blueprint, specification, or document*]_ _**.**

[*Add if description has a special trade meaning*]

In the trade in which plaintiff and defendant are engaged, the description means that _ _[*e.g., the cloth would be cotton twill weighing 16 ounces per square yard*]_ _**.**

[*Continue*]

This description was made a part of the basis of the bargain and created an express warranty that the goods would conform to the description.

Comment: This language is based on Com C §2313(1)(b). For discussion of express warranties by description, see §3.19.

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§3.108 4. Form: Allegation of Express Warranty by Sample or Model

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3.108-1 Allegation of express warranty by sample or model

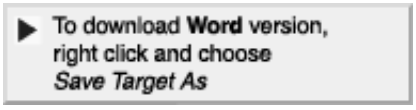
During the course of negotiations for the sale of the _ _[*e.g., goods*]**_ _ and before agreement was reached, defendant represented to plaintiff that _ _**[*describe object, e.g., a certain bolt of cloth*]**_ _ was a _ _**[*sample/model*]**_ _ of the _ _**[*e.g., goods*]**_ _, and plaintiff examined the purported _ _**[*sample/model*]**_ _. This purported _ _**[*sample/model*]**_ _ was made a part of the basis of the bargain and created an express warranty that the whole of the _ _**[*e.g., goods*]**_ _ would conform to the _ _**[*sample/model*]**_ _.**

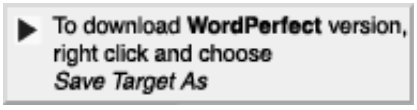
Comment: This language is based on Com C §2313(1)(c). For discussion of express warranties by sample or model, see §3.20.

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Source: Business Law/California UCC Sales and Leases/3 Warranties/§3.109 5. Form: Allegation of Implied Warranty of Merchantability

§3.109 5. Form: Allegation of Implied Warranty of Merchantability





3.109-1 Allegation of implied warranty of merchantability

Defendant impliedly warranted that the _ _[*e.g., goods*]**_ _ would be of good and merchantable quality and would _ _**[*describe element of warranty breached, e.g., pass without objection in the trade under the contract description/be of fair average quality/be fit for the ordinary purposes for which these goods are used/vary not more than 10 percent in quantity in each shipment/be accurately and legibly labeled/conform to the affirmations of fact on the container*]**_ _. Defendant was at all times mentioned a merchant with respect to the _ _**[*e.g., goods*]**_ _.**

Comment: This language is based on Com C §2314. For discussion of the implied warranty of merchantability, see §§3.21-3.32.

Because a sale can give rise to both the implied warranty of merchantability and the implied warranty of fitness for a particular purpose, counsel should allege both in an action for breach of warranty if the facts allow it. If one cause of action cannot be adequately proved, the other might still provide a basis for recovery.

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Source: Business Law/California UCC Sales and Leases/3 Warranties/§3.110 6. Form: Allegation of Implied Warranty of Fitness for Particular Purpose

§3.110 6. Form: Allegation of Implied Warranty of Fitness for Particular Purpose

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3.110-1 Allegation of implied warranty of fitness for particular purpose

At the time of contracting, defendant had reason to know that plaintiff required the _ _[*e.g., goods*]**_ _ for the purpose of _ _**[*describe*]**_ _ and that plaintiff was relying on defendant's skill and judgment to _ _**[*select/select and furnish*]**_ _ suitable _ _**[*e.g., goods*]**_ _. Defendant thereby impliedly warranted that the _ _**[*e.g., goods*]**_ _ would be fit for that purpose.**

Comment: This language is based on Com C §2315. For discussion of the implied warranty that the goods will be fit for a particular purpose, see §§3.33-3.40.

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§3.111 7. Form: Allegation of Noncompliance With Warranty

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3.111-1 Allegation of noncompliance with warranty

The goods did not conform with the warranty alleged in paragraph _ _[*number*]**_ _ in that _ _**[*describe how goods differed, e.g., the cloth was only 14-ounce denim*]**_ _.**

Comment: To avoid unnecessary litigation over the adequacy of its pleading, the buyer should specifically allege the manner in which the warranty was breached. For example, if the breach lies in the fact that the goods do not conform to the sample or model, the buyer should describe the manner in which they vary.

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Source: Business Law/California UCC Sales and Leases/3 Warranties/§3.112 8. Form: Allegation of Notice of Breach

§3.112 8. Form: Allegation of Notice of Breach

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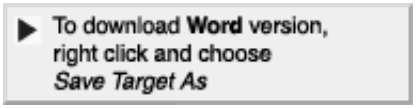
3.112-1 Allegation of notice of breach

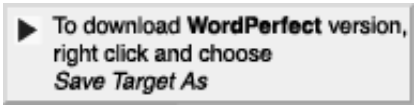
On or about _ _[*date*]_ _, and within a reasonable time after plaintiff learned that the goods were not as warranted by defendant, plaintiff gave notice of the breach of warranty to defendant. A copy of the notice is attached to this complaint, labeled Exhibit _ _[*number*]_ _ and incorporated by this reference as though fully set forth here.

Comment: This allegation is based on Com C §2607(3)(A), which requires that notice be given within a reasonable time. For discussion of notice and the effect of lack of notice, see §§3.73-3.82.

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§3.113 9. Form: Allegation That Notice of Litigation Was Given





3.113-1 Allegation that notice of litigation was given

On or about _ _[*date*]_ _, within a reasonable time after plaintiff received notice of the litigation, plaintiff gave notice to defendant that plaintiff had been sued. Defendant received the notice seasonably but did not come in and defend the action.

Comment: If the claim of breach relates to infringement of third party rights, the buyer must notify the seller of the litigation or be barred from pursuing any remedy against the seller. Com C §2607(3)(B). For further discussion, see §3.78. For form of notice, see form 3.82-1.

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§3.114 10. Form: Allegation of Warranty of Title

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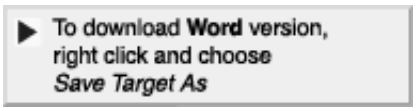
3.114-1 Allegation of warranty of title

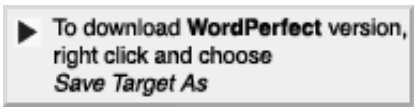
Defendant warranted that defendant had good title in the goods, that defendant had the right to transfer title to plaintiff, and that the goods would be delivered free of any security interest or other lien or encumbrance _ _[*unknown to plaintiff at the time of contracting*]_ _. Plaintiff had no knowledge of _ _[*any security interest or other lien/the security interest described in paragraph _ _[number*]_ _]_ _ affecting the goods until after the contract was made.

Comment: This language is based on Com C §2312(1). The buyer's knowledge at the time of contracting is crucial in determining which encumbrances are being warranted against. Com C §2312(1)(b).

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§3.115 11. Form: Allegation of Lack of Title





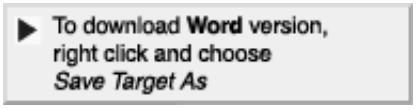
3.115-1 Allegation of lack of title

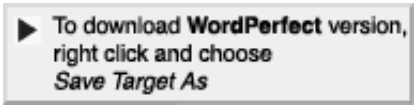
Defendant had no title to the goods and had no right to sell or otherwise transfer title to plaintiff.

Comment: This allegation takes into account Com C §2403(2), which provides that even if a merchant dealing in goods of that kind lacks authority to make the sale, the merchant can convey good title in goods "entrusted" to the merchant by selling them to a buyer in the ordinary course of business. See §§12.11-12.14.

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§3.116 12. Form: Allegation of Disturbance of Quiet Possession





3.116-1 Allegation of disturbance of quiet possession

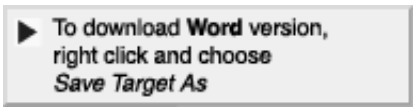
On or about _ _[*date*]_ _, _ _[*name*]_ _ notified plaintiff that _ _[*name*]_ _ was the owner of the goods and had never entrusted them to defendant or authorized defendant to transfer title to any person. _ _[*Name*]_ _ demanded that plaintiff return the goods and on _ _[*date*]_ _, as a result of defendant's lack of title to the goods and by virtue of _ _[*e.g., process of the Superior Court of California, County of* _ _ _ _ _ _]_ _, plaintiff was deprived of the goods.

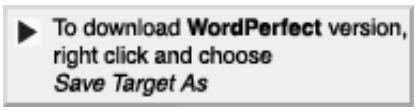
Comment: The warranty of title may be breached in many ways, one of which is disturbance of quiet possession. Official Comment 1 to UCC §2-312. For further discussion of the warranty of title, see §§3.42-3.43.

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Source: Business Law/California UCC Sales and Leases/3 Warranties/§3.117 13. Form: Allegation of Damages

§3.117 13. Form: Allegation of Damages





3.117-1 Allegation of damages

The actual value of the goods at the time and place of their acceptance by plaintiff was _ _[*dollar amount*]_ _. If they had been as warranted by defendant, they would have been worth _ _[*dollar amount*]_ _.

Comment: The measure of damages for breach of warranty is the difference at the time and place of acceptance between the value of the goods accepted and the value they would have had if they had been as warranted, unless special circumstances show proximate damages of a different amount. Com C §2714. On litigation remedies generally, see chap 18.

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§3.118 14. Form: Allegation of Incidental and Consequential Damages

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3.118-1 Allegation of incidental and consequential damages

As a proximate result of the failure of the goods to conform to defendant's warranty, plaintiff has _ _[*e.g., incurred necessary expense for repairs/lost profits through delayed production*]**_ _, all to plaintiff's damage in the amount of _ _**[*dollar amount*]**_ _.**

Comment: Under Com C §2715(1), incidental damages include:

- Expenses reasonably incurred in inspection, receipt, transportation, care, and custody of goods rightfully rejected;
- Any commercially reasonable charges, expenses, or commissions in connection with effecting cover (see §§17.67-17.69); and
- Any other reasonable expense incident to the breach.

Under Com C §2715(2), consequential damages include:

- Any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know (and which could not reasonably be prevented by cover or otherwise); and
- Injury to person or property proximately resulting from the breach of warranty.

When injury follows use of the goods without awareness of the defect causing the damage, the question of "proximate" cause turns on whether it was reasonable for the buyer to use the goods without an inspection that would have revealed the defect. If the buyer should have inspected the goods before use, or if the buyer did discover the defect before use of the goods, the injury would not proximately result from the breach of warranty. Official Comment 5 to UCC §2-715.

For additional discussion of the buyer's right to damages, see chap 18.

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B. Allegations in Answers; Defenses

§3.119 1. Introduction

The seller in a warranty action may need to plead no more than a general denial. The Commercial Code, however, contains several specific defenses that a seller may find appropriate. Because transactions and complaints vary so greatly, the allegations in §§3.120-3.124 merely suggest possibilities available to a seller.

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§3.120 2. Form: Allegation of Exclusion or Disclaimer

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3.120-1 Allegation of exclusion or disclaimer

In answer to the allegations of paragraph _ _[*number*]_ _ of the complaint, defendant alleges that the warranty of _ _[*describe*]_ _ alleged to have been made was expressly excluded by the contract for sale of the goods, _ _[*attached as Exhibit _ _[number]_ _/which provides: _ _[Specify language of exclusion*]_ _]_ _.

Comment: Both express and implied warranties may be excluded. See Com C §§2314-2316, 2719; Official Comment 4 to UCC §2-313 (Official Comment 6 to UCC §2-313 (2003)). The defendant may wish to attach a copy of the contract of sale to the answer if the contract is not part of the complaint. In any event, the defendant should plead in some way the language claimed to be the exclusion or disclaimer.

For additional discussion of exclusion of warranties, see §§3.46-3.69.

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§3.121 3. Lack of Privity

Privity is not required for an action based on breach of an express warranty. *Rodrigues v Campbell Indus*. (1978) 87 CA3d 494, 500, 151 CR 90. Nor is privity a condition for bringing an action based on strict liability in tort (see 6 Witkin, Summary of California Law, *Torts* §1509 (10th ed 2005)) or for personal injury or injury to property (*Greenman v Yuba Power Prods., Inc.* (1963) 59 C2d 57, 27 CR 697).

Vertical privity between the plaintiff and defendant is still a requirement for actions based on breach of the implied warranties of merchantability and fitness, in which the damages are for purely commercial or economic losses arising from the defective quality of the goods. *All W. Electronics, Inc. v M-B-W, Inc.* (1998) 64 CA4th 717, 75 CR2d 509; *Clemens v DaimlerChrysler Corp.* (9th Cir 2008) 534 F3d 1017. See 4 Witkin, Summary of California Law, *Sales* §§97-101 (10th ed 2005).

California did not enact UCC §2-318, the Uniform Commercial Code's privity requirement.

An exception to the privity requirement may be allowed when the parties have extensive "direct dealings" with each other, even though they do not have a formal contractual relationship. See, *e.g., Cardinal Health 301, Inc. v Tyco Electronics Corp.* (2008) 169 CA4th 116, 87 CR3d 5. In *Cardinal Health*, the allegedly defective product was a "spring probe connector" used in a hospital pill-dispensing system. Although defendant Tyco did not itself engage in negotiations with plaintiff Cardinal pertaining to the initial purchase agreement for the spring probe connectors, Tyco accepted and benefited from those negotiations in taking T&B's place as the product supplier (after Tyco purchased T&B's electrical connector division). Tyco was fully aware that Cardinal was the exclusive purchaser of the spring probe connectors, and that the product was manufactured to meet precise specifications. It was also aware that Cardinal had expected and intended that Tyco would abide by the purchase agreement that had been negotiated between T&B and Cardinal. Tyco evidenced its acceptance of these sales terms by manufacturing and supplying the custom spring probe connectors for Cardinal according to the same terms, specifications, design requirements, and manufacturing techniques agreed to by T&B and Cardinal. In the court's view, these facts gave rise to an exception to the privity requirement. 169 CA4th at 143.

See also *U.S. Roofing, Inc. v Credit Alliance Corp.* (1991) 228 CA3d 1431, 279 CR 533. In *U.S. Roofing*, a roofing contractor needed a crane for a roofing job and began negotiating with a crane supplier for the purchase of a crane. After the contractor and supplier reached an agreement on the type and price of the crane, the contractor asked the supplier to assist with financing the purchase. In response, the supplier suggested the contractor enter into a lease agreement with a third party as a financing method to obtain tax and other financial savings. Relying on this recommendation, the contractor entered into a lease agreement with a third party lessor. Under the lease agreement, the lessor was required to obtain the particular equipment from the supplier that the parties had already agreed on, and then lease this equipment to the contractor. The lessor then purchased the equipment from the supplier and leased the equipment to the contractor. Shortly after receiving the crane, the contractor experienced problems and canceled the lease. The contractor brought a lawsuit against the supplier, alleging breach of warranty and other claims. The supplier at trial and on appeal argued that it could not be held liable on the warranty claim because it did not have a direct privity relationship with the contractor; the contractor and supplier had never entered into a contract. Rejecting this argument, the court reasoned that the supplier "focuses solely on the paper contract" and (228 CA3d at 1444):

> ignores the considerable testimony regarding the direct dealings between [the supplier and the contractor] for the sale and purchase of the crane. These parties had an oral agreement for the sale of the crane, supported by a deposit of $1,000, followed by a second deposit. [The supplier] admits it made at least one express warranty as to the crane. When [the contractor] experienced problems with the crane, it contacted [the supplier] for relief. Repairs on the crane were arranged and paid for by [the supplier]. From this evidence the jury could find the necessary privity to support liability for breach of an implied warranty.

The Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) effectively eliminates the requirement of privity between the buyer, manufacturer, retailer, or distributor for actions based on breach of the implied warranties of merchantability or fitness when the subject of the sale is consumer goods. See CC §1791.1(b)-(c).

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§3.122 4. Form: Allegation of Lack of Privity

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3.122-1 Allegation of lack of privity

Plaintiff lacks standing to assert a claim for breach of warranty because at no time was there privity of contract between plaintiff and defendant.

Comment: See discussion in §3.121.

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§3.123 5. Form: Allegation of Examination or Refusal to Examine

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3.123-1 Allegation of examination or refusal to examine

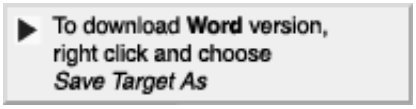
Before entering into the contract, plaintiff _ _[*examined the* _ _[*goods/sample/model*]_ _ *as fully as plaintiff desired/refused to examine the* _ _[*goods/sample/model*]_ _]_ _**. The alleged defects** _ _[*should under the circumstances/would*]_ _ **have been revealed by such an examination.**

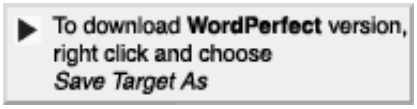
Comment: This language is based on Com C §2316(3)(b).

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Source: Business Law/California UCC Sales and Leases/3 Warranties/§3.124 6. Form: Allegation of Exclusion or Modification by Past Experience

§3.124 6. Form: Allegation of Exclusion or Modification by Past Experience





3.124-1 Allegation of exclusion or modification by past experience

By reason of _ _[*the course of dealing between the parties/the course of performance of the contract/a usage of trade*]_ _**, any warranty that the** _ _[*e.g., goods*]_ _ **would** _ _[*describe implied warranty negated, e.g., be of fair average quality within the description*]_ _ **was** _ _[*describe how warranty was modified, e.g., excluded*]_ _**.**

Comment: This language is based on Com C §2316(3)(c).

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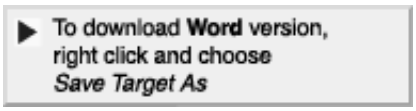
Source: Business Law/California UCC Sales and Leases/3 Warranties/§3.125 C. Jury Instructions

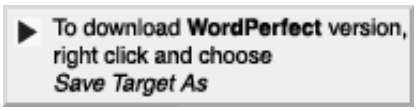
§3.125 C. Jury Instructions

The Judicial Council of California Civil Jury Instructions (CACI) contains a series of instructions relating to warranties and issues arising in breach of warranty actions. See CACI 1230-1233, 1240-1245.

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§3.126 XII. SAMPLE WARRANTY FORM





3.126-1 Sample warranty form

WARRANTY

1. *What is covered by this warranty*

The ABC Company (ABC) warrants, to the original purchaser only, that the product that is the subject of this sale (a) conforms to ABC's published specifications and (b) is free from defects in material or workmanship. This warranty expires 1 year from the date of delivery. If the buyer discovers within this period a failure of the product to conform to specifications, or a defect in material or workmanship, the buyer must promptly notify ABC in writing. In no event may that notification be received by ABC later than 13 months from the date of delivery. Within a reasonable time after notification, ABC will correct any failure of the product to conform to specifications or any defect in material or workmanship, with either new or used replacement parts. Such repair, including both parts and labor, will be performed at ABC's expense. All warranty service will be performed at service centers designated by ABC. If ABC is unable to repair the product to conform to the warranty after a reasonable number of attempts, ABC will provide, at its option, one of the following: a replacement product or a full refund of the purchase price. These remedies are the purchaser's only remedies for breach of warranty.

2. *What is not covered by this warranty*

ABC does not warrant (a) any product, components, or parts not manufactured by ABC; (b) defects caused by failure to provide a suitable installation environment for the product; (c) damage caused by use of the product for purposes other than those for which it was designed; (d) damage caused by disasters such as fire, flood, wind, and lightning; (e) damage caused by unauthorized attachments or modifications; (f) damage during shipment; or (g) any other abuse or misuse by the purchaser.

3. *Warranty of title and against claims of infringement*

In addition to the warranties set forth in the previous paragraphs, ABC warrants that it has good title to the product free of any encumbrance and that the product will be delivered free from the rightful claim of any third person for infringement of patent, trademark, or copyright. ABC will defend the buyer against any claim of infringement and will pay resulting costs, damages, and attorney fees finally awarded, provided that (a) the buyer promptly notifies ABC in writing of any claim, and (b) ABC has sole control of the defense and all related settlement negotiations. If a claim arises, the buyer will allow ABC, at ABC's option and expense, to procure the right for the buyer to continue using the product, to replace or modify it so that it becomes noninfringing, or to grant the buyer a refund of the purchase price in exchange for return of the infringing product.

4. *DISCLAIMER OF WARRANTY*

THE FOREGOING WARRANTIES ARE IN LIEU OF ALL OTHER WARRANTIES, EXPRESS OR IMPLIED, INCLUDING BUT NOT LIMITED TO THE IMPLIED WARRANTIES OF MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE.

5. *LIMITATION OF REMEDIES*

IN NO EVENT WILL ABC BE LIABLE FOR ANY SPECIAL, INCIDENTAL, OR CONSEQUENTIAL DAMAGES BASED ON BREACH OF WARRANTY, BREACH OF CONTRACT, NEGLIGENCE, STRICT TORT, OR ANY OTHER LEGAL THEORY. DAMAGES THAT ABC WILL NOT BE RESPONSIBLE FOR INCLUDE, BUT ARE NOT LIMITED TO: LOSS OF PROFITS; LOSS OF SAVINGS OR REVENUE; LOSS OF USE OF THE PRODUCT OR ANY

ASSOCIATED EQUIPMENT; COST OF CAPITAL; COST OF ANY SUBSTITUTE EQUIPMENT, FACILITIES, OR SERVICES; DOWNTIME; THE CLAIMS OF THIRD PARTIES, INCLUDING CUSTOMERS; AND INJURY TO PROPERTY. THIS LIMITATION DOES NOT APPLY TO DAMAGES CAUSED BY BREACH OF THE WARRANTY OF TITLE AND AGAINST INFRINGEMENTS OR TO CLAIMS FOR PERSONAL INJURY.

6. ***Time limit for bringing suit***

Any action for breach of warranty must be commenced within 15 months following delivery of the product.

7. ***No other warranties***

Unless modified in a writing signed by both parties, this agreement is understood to be the complete and exclusive agreement between the parties, superseding all oral or written prior agreements and all other communications between the parties relating to the subject matter of this agreement, including statements made by salespersons. No employee of ABC or any other party is authorized to make any warranty in addition to those made in this agreement. The buyer is warned, therefore, to check this agreement carefully to see that it correctly reflects those terms that are important to the buyer.

8. ***Allocation of risks***

This agreement allocates the risks of product failure between ABC and the buyer. This allocation is recognized by both parties and is reflected in the price of the goods. The buyer acknowledges that it has read this agreement, understands it, and is bound by its terms.

Comment: The well-drafted warranty should contain at least the following key elements, all of which are incorporated into the above form:

- An express warranty against defects that is carefully limited regarding scope and duration;
- A primary remedy of repair or replacement of defective parts;
- A set of backup remedies (replacement of the unit or refund of the buyer's purchase price) in case the primary remedy fails of its essential purpose;
- A clear statement of what is not covered by the warranty, focusing on buyer misuse of the goods;
- Separate treatment of the warranty of title (and against infringement);
- A conspicuous disclaimer of implied warranties;
- A separate paragraph insulating the seller from liability for consequential damages; although not required, it is good practice to make this provision conspicuous (see §3.97);
- A paragraph addressing the statute of limitations;
- A merger clause;
- An express allocation of risk paragraph; and
- A paragraph containing a requirement that the buyer notify the seller in case of breach.

If the sale involves goods subject to the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312, the above form would need to be adapted to comply with Federal Trade Commission rules and would require additional language. Any limitations on the duration of implied warranties, disclosed on the face of the warranty as provided in 15 USC §2308 and/or any exclusions of or limitations on relief such as incidental or consequential damages must be accompanied by the following statement (16 CFR §701.3(a)(7)-(9)):

Some States do not allow limitations on how long an implied warranty lasts, so the above limitation may not apply to you.

This warranty gives you specific legal rights, and you may also have other rights which vary from State to State.

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4

Formation of Sales Contracts: Open or Indefinite Terms

Barbara L. Borden

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§4.1 I. INTRODUCTION; SCOPE OF CHAPTER

A commercial sales contract is often comprised of more than its express written terms. Terms may be derived not only from the written contract but also from the parties' tacit understandings that develop during the course of the contract's performance or during the course of the parties' dealings with each other. Terms also may be derived from usage of trade and from the "open term" or "gap-filling" provisions of the Commercial Code. Whether an indefinite or incomplete written agreement is enforceable depends on the intent of the parties and the ability of the courts to fashion an appropriate remedy.

Although not all indefinite or incomplete agreements will be enforced, the open term provisions of the Code often protect parties from their own oversights. More importantly, the open term provisions give parties the flexibility to enter into binding longer term arrangements that deliberately leave indefinite until a future time even essential terms such as price or quantity. Absent this flexibility, merchants and buyers may be unwilling to assume the risk of fluctuating and uncertain demand and price inherent in a longer term arrangement.

Thus, the open term provisions facilitate commercial transactions by (a) reducing the risk of unenforceability caused by the unintentional omission of terms and (b) allowing parties to reduce or eliminate certain risks of longer term contracts by including indefinite terms.

This chapter discusses the Commercial Code's treatment of contract terms left indefinite or open by the parties. The following topics are covered:

- Open price terms (see Com C §2305, discussed in §§4.3-4.20);
- Requirements, output, and exclusive dealing contracts (see Com C §2306, discussed in §§4.22-4.55);
- Open delivery terms (see Com C §§2307-2309, discussed in §§4.56-4.70);
- Open payment terms and credit arrangements (see Com C §2310, discussed in §§4.71-4.78);
- Contract duration and termination provisions (see Com C §2309(2)-(3), discussed in §§4.79-4.85);
- Options and cooperation regarding performance (see Com C §2311, discussed in §§4.86-4.93); and
- Course of performance, course of dealing, and usage of trade (see Com C §1303, discussed in §§4.94-4.104).

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II. OPEN TERM PROVISIONS

§4.2 A. Effect of Indefiniteness on Sales Contract

A sales contract that is indefinite or silent about price, quantity, delivery, payment, duration, or other basic terms (including standards of performance) is not invalidated for indefiniteness if the parties "intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy." Com C §2204(3). Whether a contract was intended is a question of fact that a court will resolve by examining, among other things, the agreement's language and surrounding circumstances. See generally CC §§1636-1656. The parties' intent to form a contract may be brought into question if open terms are numerous. Official Comment to UCC 2-204 (Official Comment 3 to UCC 2-204 (2003)).

If a sales contract is enforceable but indefinite about the performance required or silent about basic terms, the standards of performance or basic terms may be supplied by implication from the parties' course of performance, course of dealing, or usages of their trade. Com C §1303. See §§4.94-4.104. If those sources do not supply the missing terms, the Commercial Code's "open term" provisions (for price, quantity, delivery, payment, and duration) may be used to fill the gaps in the agreement between the parties.

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B. Open Price Contracts

§4.3 1. Overview

Despite the fact that price may be the most important term of a contract, the Commercial Code recognizes the validity of contracts that intentionally defer setting the price. See Com C §2305(1). Open price contracts are useful in long-term contractual arrangements, such as requirements or output contracts, when the seller or buyer is unwilling to bear the risk of market fluctuations. Open price contracts are also useful in transactions calling for a single delivery, such as the sale of a crop at harvest, when the contract is formed well in advance of the scheduled delivery date and the market price on that date cannot be accurately predicted.

Whether a contract with an open price term is formed, or no contract is formed because of lack of agreement about price, depends on the parties' intent as manifested in the written agreement, their conduct, or other credible evidence. If the parties intended to form a binding agreement without a fixed price, the contract is enforceable. If the parties did not intend to form a binding agreement unless and until the price was fixed, there is no contract. Com C §2305(4). See, *e.g., California Lettuce Growers, Inc. v Union Sugar Co.* (1955) 45 C2d 474, 289 P2d 785; *In re BTS, Inc.* (Bankr WD Mo 1989) 104 BR 1009; *Quaker State Mushroom Co. v Dominick's Finer Foods, Inc.* (ND Ill 1986) 635 F Supp 1281. Explicit expression of intent can avoid litigation.

If a contract is formed that is silent about price or how the price should be fixed, the price is what is reasonable at the time of delivery. Com C §2305(1); *North Cent. Airlines v Continental Oil Co.* (DC Cir 1978) 574 F2d 582 (failure of agreed standard; reasonable price held to be applicable standard).

The Commercial Code does not indicate how a reasonable price should be determined. Courts have held that the seller's invoiced price is not presumptively reasonable. *Swift Agric. Chems. Corp. v Muller* (App Div 1982) 448 NYS2d 72. Nor is the prevailing market price determinative. *TCP Indus., Inc. v Uniroyal, Inc.* (6th Cir 1981) 661 F2d 542; *Spartan Grain & Mill Co. v Ayers* (5th Cir 1975) 517 F2d 214.

In *Spartan,* for example, the court reasoned that, even though the prices charged by the seller for chicken feed were higher than those of its competitors, that did not make the prices "unreasonable," because the seller had committed to purchase and market *all* the buyers' eggs. Buyers logically would pay more for a guaranteed market, which was not offered by the seller's competitors. 517 F2d at 217. The court recognized that when other means are not available, a court may examine the seller's markup over its cost in deciding a reasonable price. However, the court in *Spartan* found such evidence of markup inadmissible because there were other means of proof available. 17 F2d at 217. A court may allow expert testimony concerning the value of the goods at issue and consider industry standards, catalogs, price lists, market data, replacement or reproduction cost, or any other appropriate evidence offered by either party.

If a contract calls for the price to be fixed by a method other than the parties' agreement, such as a third party appraisal (see §4.12) or a resale of the goods (see §4.17), and the price is not fixed due to one party's fault, the other party may treat the contract as canceled or fix a reasonable price itself. Com C §2305(3); *Weisberg v Handy & Harman* (7th Cir 1984) 747 F2d 416. "Cancellation" is a term of art in the Commercial Code, which involves terminating the unperformed part of a contract because of breach by the other party while retaining any available remedy for breach of the whole contract or the unperformed balance. See Com C §2106(3)-(4). If the aggrieved party chooses not to cancel the contract, it has "reasonable leeway" to fix a reasonable price. See Official Comment 5 to UCC §2-305.

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§4.4 2. Contracts Silent About Price

The primary issue when a contract is silent about price is whether the parties intended to be bound by the contract absent an agreement about price. See, for example, *Alamo Clay Prods., Inc. v Gunn Tile Co.* (Tex Ct App 1980) 597 SW2d 388. In situations in which a discussion of the open price term would ordinarily be expected, the fact that the contract is silent may be used as evidence that the parties did not intend a binding contract to be formed. For example, in *Esteve Cotton Co. v Hancock* (Tex Ct App 1976) 539 SW2d 145, the seller was not obligated to sell cotton of a higher grade than the range provided in its contract. Because the contract included prices for a specific range of grades of cotton, the court ruled that it was reasonable to conclude that the contract would have explicitly indicated whether an open price contract was intended for other grades of cotton.

Even when neither custom nor circumstance supports an expectation of a fixed price term in the contract, a court may be reluctant to find that a contract exists if a price term is absent. Leaving price terms open in volatile markets can invite litigation unless the contract includes a clear statement of the parties' intent to form a contract. Alternatively, the contract may specify mechanisms for setting an as-yet indeterminable price.

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3. Contracts Leaving Price to Be Agreed

§4.5 a. Agreements to Agree

The Commercial Code rejects the general contract principle that an agreement to agree on an essential term in the future is fatally uncertain and unenforceable, if the term to be fixed in the agreement is the price. See 1 Witkin, Summary of California Law, *Contracts* §147 (10th ed 2005); Official Comment 1 to UCC §2-305. If the parties leave the price for later agreement and then fail to agree, the price is the reasonable price at the time of delivery, unless the parties did not intend a contract to arise until they had fixed the price. Com C §2305(1). The primary legal issue is the parties' intent.

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§4.6 b. Form: Agreement to Agree on Price

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4.6-1 Agreement to agree on price

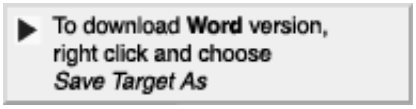
This contract will bind the parties on its execution, even though the price to be paid will not then be fixed. The parties will agree on the price _ _[*e.g., on or before* _ _[*date*]_ _*/within* _ _[*number*]_ _ *days after delivery*]_ _**. If they do not agree on a price by that time, the price will be** _ _[_ _[*dollar amount*]_ _*/specify method of fixing price*]_ _**.**

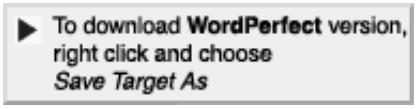
Comment: This provision indicates the parties' intention to form a binding agreement even though the price has not been fixed. See Com C §2305(1), (4). The attorney should include this statement in the contract to avoid problems of proof and litigation over the issue of intent. For a form stating the parties' intention to be bound only if and when the price is fixed or agreed, see §4.20.

Methods for fixing the price if the parties fail to agree are discussed in §§4.8-4.12. The attorney may specify more than one alternative method. If all specified methods fail, then the price is a reasonable price at the time of delivery (Com C §2305), as determined by a court or arbitrator (assuming arbitration is called for and the arbitrator has jurisdiction over price disputes).

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§4.7 c. Form: Agreement to Agree (Maximum and Minimum Price)





4.7-1 Agreement to agree (maximum and minimum price)

In no event may the price be greater than _ _[*specify maximum price*]**_ _ or less than _ _**[*specify minimum price*]**_ _.**

Comment: If the price is left to future agreement, the parties may state a maximum or minimum price, or both, to set the parameters of price negotiations and presumably limit the range of prices that may be imposed as reasonable in the event they fail to agree. See *Marquette Co. v Norcem, Inc.* (NY App Div 1985) 494 NYS2d 511 (refusal to consider any price but maximum was evidence of refusal to negotiate in good faith); *Oregon-Washington Vegetable & Fruit Growers Ass'n v Sunset Packing Co.* (Or 1969) 456 P2d 1002 (inclusion of maximum and minimum prices shows contemplation of good faith negotiations to establish actual price within the range).

A maximum/minimum price provision may also be used in conjunction with an independent price-fixing method (see §§4.8-4.12) or a provision allowing one of the parties to fix the price (see §§4.13-4.19).

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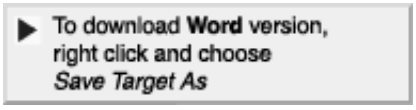
4. Independent Price-Fixing Standards

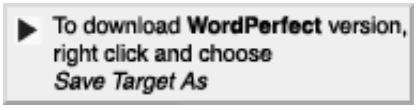
§4.8 a. Permissible Price

The Commercial Code permits the price "to be fixed in terms of some agreed market or other standard as set or recorded by a third person or agency." Com C §2305(1)(c). If the price is not fixed in accordance with the market or other standard, the price is a reasonable price at the time for delivery. Com C §2305(1)(c). A number of arrangements are possible for tying the contract price to a standard independent of either party, *e.g.,* the price in a stated market or as published in a particular price index, the price set by a named appraiser, the price offered by a party's competitors, or the manufacturer's suggested retail price. See, *e.g., Sedmak v Charlie's Chevrolet, Inc.* (Mo Ct App 1981) 622 SW2d 694 (price of Corvette tied to manufacturer's suggested retail price). In some industries, tariff schedules or other regulatory price-setting mechanisms may exist. The attorney should investigate the mechanisms available for making the price determinable, rather than leaving it to future determination.

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§4.9 b. Form: Open Price Tied to Market Price





4.9-1 Open price tied to market price

The price per _ _[*unit of quantity*]_ _ **of the** _ _[*describe goods*]_ _ **will be the** _ _[*highest/lowest*]_ _ **closing market price of like goods at** _ _[*city or place of delivery*]_ _ **on** _ _[*date of delivery or other date*]_ _ _ _[*as specified in* _ _[*specify published source*]_ _]_ _**.**

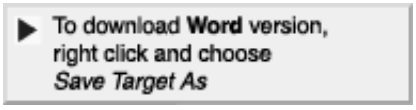
Comment: This provision presupposes a readily ascertainable market price at the time and place specified in the contract. Published market quotations are admissible price evidence for goods regularly bought and sold on that market. Com C §2724. Under Com C §2723(2), if no market report is readily available for the place or time specified, the market price may be provable by establishing the price prevailing within any reasonable time before or after the time described or at any other place that in commercial judgment or under usage of trade would serve as a reasonable substitute. The market price also includes proper allowance for the cost of transporting the goods to or from the reasonable substitute location. Com C §2723(2).

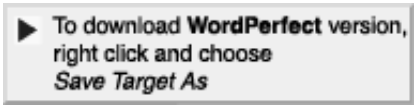
It should be noted, however, that the party intending to use evidence of a substitute market price must give the other party "such notice as the court finds sufficient to prevent unfair surprise." Com C §2723(3). On proof of market price generally, see §18.61.

Even if market quotations are readily available, the attorney should consider industry practices and the likelihood of a range of market prices. In the absence of a specified method of averaging or otherwise determining the price when a range of market quotations exists, the price may be the reasonable price determined by arbitration or litigation. See, *e.g., Schmieder v Standard Oil Co.* (Wis 1975) 230 NW2d 732.

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§4.10 c. Form: Price Keyed to Published Index





4.10-1 Price keyed to published index

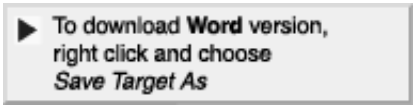
The base price of the _ _[*describe goods*]_ _ is _ _[*dollar amount*]_ _. The price to be paid for the _ _[*describe goods*]_ _ under this contract will be the base price increased or decreased by the percentage change in the index figure of the _ _[*identify index*]_ _, using _ _[*specify index figure in effect when contract is executed*]_ _ as the base against which the percentage change is measured. This price adjustment will be made _ _[*monthly/annually*]_ _, based on the latest index figure available when the adjustment is made.

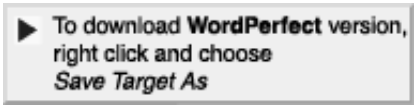
Comment: Tying prices to a recognized price index, such as the wholesale or consumer price indexes published in the Monthly Labor Review (Bureau of Labor Statistics, United States Department of Labor), is recognized as a legitimate pricing device. See *Department of Water & Power v Okonite-Callender Cable Co.* (9th Cir 1950) 181 F2d 375. That case illustrates the importance of specifying the exact index to be used. The parties' contract provided for price adjustments based on a government index of wholesale prices for metals; litigation was required to determine that the adjustment was to be based on the individual indexes for lead and copper (the metals in the cable being sold), not on the group index for metals.

Use of a price index entails the risk that the index will be discontinued or its form altered during the life of the contract. Because an index is a compiled or averaged number, another risk associated with its use is that it will not accurately reflect changes in the value of a particular commodity. The commodity may increase or decrease sharply in value while the index, which also factors in the values of other commodities, shows a lesser degree of change.

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§4.11 d. Form: Price Adjusted to Seller's Competitors' Prices





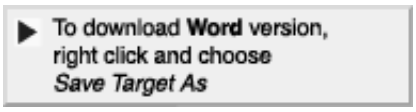
4.11-1 Price adjusted to seller's competitors' prices

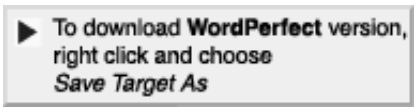
If on the date set for delivery _ _[*name of competitor*]_ _, _ _[*name of another competitor*]_ _, or _ _[*name of another competitor*]_ _ is offering generally to the market to sell the _ _[*describe goods*]_ _ at a price lower than the price set in this agreement for the _ _[*describe goods*]_ _ of a similar quality, in similar quantities, and under like terms and conditions, the agreement price will automatically be decreased to the amount of the lowest price offered.

Comment: In many commercial settings, a large diffuse group of buyers purchase goods from a select group of sellers (*e.g.,* building contractors purchasing steel girders). A seller that has only a few competitors may agree to match the competition's price, thereby assuring the buyer of the best available price. This type of arrangement is generally regarded as a valid independent price determinant. See *United Lumber Yards v Modesto Irr. Dist.* (1937) 23 CA2d 130, 72 P2d 221.

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§4.12 e. Form: Appraiser or Arbitrator to Set Price





4.12-1 Appraiser or arbitrator to set price

The seller will have _ _[*name of appraiser or arbitrator*]_ _ appraise the price of the _ _[*describe goods*]_ _ _ _[*specify deadline for appraisal, e.g., within ten days before the scheduled date of delivery*]_ _. The price of the goods will be the appraised value. The _ _[*appraiser/arbitrator*]_ _ will not be required to hold any hearing, or invite or take evidence from either party, but will make a fair and objective appraisal based on an examination of the goods and _ _[*his/her*]_ _ expert knowledge, experience, and judgment. The cost of the appraisal will be divided equally between the parties.

[*Add if appropriate*]

[*Option 1: Statement of reasons required*]

The _ _[*appraiser/arbitrator*]_ _ will accompany _ _[*his/her*]_ _ opinion with a statement setting forth the essential reasons for the price determination.

[*Option 2: No statement of reasons required*]

The _ _[*appraiser/arbitrator*]_ _ will not be required to disclose to either party the reasons for _ _[*his/her*]_ _ opinion.

Comment: Title 9 of the Code of Civil Procedure on arbitration (CCP §§1280-1294.2) expressly covers agreements providing for valuations, appraisals, and similar proceedings. CCP §1280(a). Absent an agreement to the contrary, there must be a formal evidentiary hearing under the procedures set forth in the statute. CCP §1282.2. This clause waives the statute's formal hearing provision and related procedural provisions by giving the appraiser or arbitrator express permission to proceed informally, without taking evidence from the parties. Nevertheless, awaiting an arbitrator's decision can be costly, particularly when significant sums are involved and the seller suffers delay in receiving payment.

Presumably, the appraisal called for in this clause will be subject to judicial confirmation, enforcement, correction, or vacation under CCP §§1285-1287.6 unless the parties expressly agree otherwise.

In drafting a provision for determination of price by an appraiser, arbitrator, or other third party, the attorney should raise the following additional issues with the client:

- If the appraiser or arbitrator does not determine the price of the goods within the agreed period, should the contract be canceled? Should it remain in effect, with the time being extended a reasonable amount?
- Should there be a method for selecting another appraiser or arbitrator? For example, the client could apply to the superior court for appointment of an appraiser or arbitrator.
- Should the qualifications of the appraiser or arbitrator be spelled out in the agreement? For example, the provision could require the arbitrator or appraiser to be certified by a particular professional group such as the American Arbitration Association or the Appraisal Institute.
- Is the client willing to accept the appraiser's or arbitrator's price determination as binding? Does the client want a mechanism for appealing the determination without being in breach of the contract?
- Does the client want the price determination to bind the other party?

In making these choices, the client should consider the cost of delay and the time value of money.

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5. Price Set by Seller or Buyer

§4.13 a. Good Faith Requirement

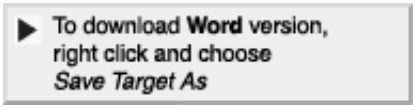
Contracts to sell goods at a price to be set by the seller or buyer are enforceable if the price is set in good faith. Com C §2305(2). "Good faith" means honesty in fact and the observance of reasonable commercial standards of fair dealing. Com C §1201(b)(20).

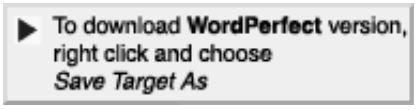
In normal situations, a seller's or buyer's "given price," "price in effect," "posted price," "market price," or similar standard will satisfy the good faith requirement. Official Comment 3 to UCC §2-305. See *Richard Short Oil Co. v Texaco* (8th Cir 1986) 799 F2d 415 (defendant oil company satisfied good faith requirement of Com C §2305(2) in charging plaintiff its "posted price" (the price charged to all its nationwide distributors)). See also *Columbus Milk Producers' Coop. v Department of Agric.* (Wis 1970) 180 NW2d 617 (good faith requires conduct that does not deprive other party of its reasonable price expectations).

Failure to set the price in good faith entitles the other party to cancel the contract or to fix a reasonable price itself. Com C §2305(3). See §4.20.

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§4.14 b. Form: Same Price as Given Others





4.14-1 Alternative: Price of goods is listed or posted price

The price of the _ _[*describe goods*]_ _ will be the regularly _ _[*listed/posted*]_ _ price in effect for sales of the goods at the time and place scheduled for delivery under this contract.

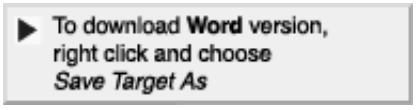
4.14-2 Alternative: Price of goods is party's general price, not listed or posted price

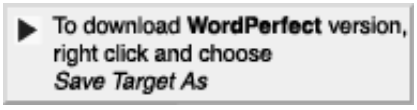
The price of the _ _[*describe goods*]_ _ will be the price that the goods are being sold by the seller to _ _[*describe other parties, e.g., dealers*]_ _ in the market generally at the time and place scheduled for delivery under this contract.

Comment: Under this form of agreement, the seller agrees to sell at the same price that it is selling to others under similar conditions. The seller may be required under the Robinson-Patman Act (15 USC §§13-13c, 21a) to grant uniform pricing. A party that fixes an unreasonable price by manipulating the prices that others are paying fails to meet the good faith standard of Com C §2305(2), entitling the other party to cancel the contract or fix a reasonable price itself. Com C §2305(3).

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§4.15 c. Form: Price Fixed in Bad Faith





4.15-1 Refixing price fixed in bad faith

To _ _[*name and address of party fixing price*]**_ _:**

The price you fixed for the _ _[*describe goods*]**_ _ to be sold and purchased under our contract dated _ _**[*date*]**_ _ was not fixed by you in good faith in that _ _**[*provide facts supporting claim of bad faith*]**_ _.**

[*Option 1: Contract canceled*]

Consequently, we refuse to be bound by that price and hereby cancel the contract.

[*Option 2: Alternative price fixed*]

Consequently, we hereby fix the contract price at _ _[*dollar amount*]**_ _.**

[*Continue*]

Date: _ _ _ _ _ _ __[*Signature of other party to contract*]__
_ _[*Typed name*]_ _

Comment: This form may be used when the other party has not acted in good faith in fixing the price. See Com C §2305(3).

PRACTICE TIP: If a court later determines there was no bad faith, the letter may be considered an anticipatory repudiation under Com C §2610.

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§4.16 d. Price Dependent on Cost

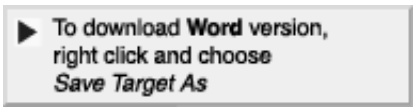
Price may be made dependent on the seller's cost of production or acquisition. This pricing method is used in many government procurement contracts. Determining which cost elements to include in the price and how they should be allocated among the seller's other customers presents a fertile field for complex litigation. See, *e.g., Pacific Portland Cement Co. v Food Mach. & Chem. Corp.* (9th Cir 1949) 178 F2d 541. Pricing on the basis of the seller's costs, however, may result in the buyer being responsible for the cost of the seller's inefficiencies.

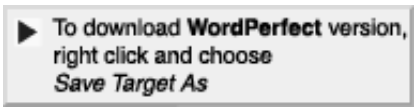
PRACTICE TIP: To avoid disputes, the contract should specify the permissible component costs, the method of their calculation, and the accounting methods or procedures to be used in making any adjustments. For example, adjustment may be permitted only for changes in certain taxes, shipping rates, wage scales, or prices of materials supplied by third parties.

In addition, the contract may (1) require advance written notice from the seller for any price increase, (2) permit the buyer or an agreed accountant to make a periodic review or audit of costs, and (3) provide for arbitration of disputes by independent certified public accountants.

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§4.17 e. Form: Price Dependent on Resale





4.17-1 Price dependent on resale

The price under this contract of any _ _[*commercial unit*]**_ _ of the goods resold or leased within _ _**[*specify time period, e.g., 3 months after delivery to Buyer*]**_ _ must be the invoiced resale or lease price (not including freight and taxes, which will be separately billed) less _ _**[$_ _[*amount*]**_ _***/percentage of resale or lease price***]**_ _. Buyer must use reasonable efforts in good faith to resell the _ _**[*describe goods*]**_ _ or lease them under a commercial finance lease. No deduction or offset may be made by Buyer for costs of collection or for allowances or commissions of any kind. The price of any _ _**[*commercial unit*]**_ _ of the goods not resold or leased will be _ _**[$_ _[*amount*]**_ _***/describe method of determining price***]**_ _.**

[*Add if sale or return*]

At Buyer's option, Buyer may return to Seller at _ _[*address*]**_ _ by _ _**[*describe method of delivery*]**_ _ any unsold _ _**[*commercial unit*]**_ _ in substantially its original condition within _ _**[*e.g., 10*]**_ _ days after the end of the period for resale. On doing so, Buyer will be relieved of any obligation to pay for the _ _**[*commercial unit*]**_ _ returned. _ _**[S***eller/Buyer*]**_ _ will bear all risks of loss or damage to the goods while they are in transit.**

Comment: The amount of money received or obtainable by the buyer on resale is a recognized standard for setting price. See, *e.g., L. C. Morgan Co. v Christensen* (1924) 65 CA 474, 224 P 141. If the price will be established by resale, the attorney should consider who bears the collection risks on the resale. Will the price of the goods be based on their invoiced price or on the price collected? This provision puts the collection burden on the buyer.

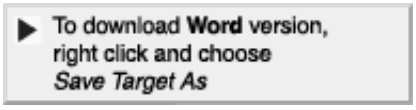
Because the buyer's resale normally occurs after the principal sale, making the price in the principal sale dependent on a future event, it is essential to provide for the nonoccurrence of that event, *i.e.,* for goods not resold. This clause provides for the disposition of goods that the buyer is unable to resell despite the buyer's best efforts. If a failure to resell is the buyer's fault, the seller may treat the contract as canceled or the seller may fix a reasonable price. Com C §2305(3).

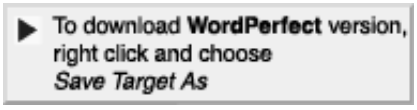
The seller should also consider including a clause (1) requiring the buyer to furnish documentation of the resale that establishes the price or (2) giving the seller the right to audit the buyer's books to obtain that information.

The optional sale or return arrangement in the clause is governed by Com C §§2326-2327.

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§4.18 f. Form: Price Set at Discretion of Contract Party





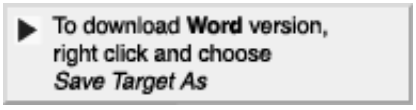
4.18-1 Price set at discretion of contract party

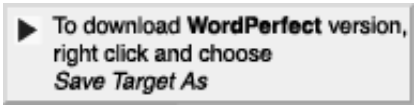
_ _[*Specify time, e.g., At the time of delivery*]_ _**,** _ _[*Seller/Buyer*]_ _ **will set a price that is commercially reasonable** _ _[*but not* _ _[*more/less*]_ _ *than* _ _[*dollar amount*]_ _]_ _**. The price set will be binding on** _ _[*Buyer/Seller*]_ _**.**

Comment: The Commercial Code imposes an obligation on the party fixing the price to fix it in good faith. If that party is a merchant, good faith includes the observance of reasonable commercial standards of fair dealing. See Official Comment 3 to UCC §2-305. Both merchants and nonmerchants are subject to the rule that, when a contract leaves price to the discretion of an interested party, the price must be the reasonable monetary value of the object of the contract. CC §1611. Note also that, under CC §§1448-1451, a contract could give the buyer a choice between two prices.

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§4.19 g. Form: Price Increased at Discretion of Seller





4.19-1 Alternative: Price increased at discretion of seller (notice required)

Seller may _ _[*specify limits on frequency, e.g., at any time during the term of this contract*]_ _ increase the price of the _ _[*describe goods*]_ _ by giving Buyer written notice of the increase at least _ _[*specify notice period*]_ _ days before its effective date. Buyer's failure to deliver a written objection to Seller at least five days before the effective date of the increase constitutes acceptance of the new price. If the increase is not accepted, Seller may either continue to supply Buyer at the contract price and terms then in effect, or cancel this contract as of the effective date of the proposed price increase or at any later date by mailing notice of the cancellation to Buyer.

4.19-2 Alternative: Price increased at discretion of seller (no notice required)

The _ _[*describe goods*]_ _ will be sold to Buyer at _ _[*specify seller's list price or bona fide wholesale price*]_ _ in effect on the date on which Seller accepts Buyer's order. The price is subject to change from time to time without advance notice.

Comment: These provisions give the seller a procedure for raising prices when, for example, the seller's cost of doing business increases during performance of a long-term contract for successive deliveries of goods. The first alternative allows the buyer to accept or reject the proposed increase. The second alternative, used typically in wholesale distribution agreements, does not require prior notice and does not expressly limit or condition the change in prices; the seller, however, is required to act in good faith. Com C §2305(2).

Both alternatives eliminate the difficult problem of drafting a formula to adjust prices in accordance with changes in costs, discussed in §4.16. A buyer may demand the right to cancel the contract if the seller is given and exercises the right to change the price, or even if the contract sets the price based on some fluctuating standard such as the seller's list price. The more discretion given to a seller in such a provision, the more likely the buyer will object and want limits set on the exercise of that discretion.

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§4.20 6. Form: No Sale If Price Not Set

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4.20-1 No sale if price not set

If the price is not fixed in the manner and within the time required by paragraph _ _[*number*]_ _ of this contract:

(1) Buyer will, within _ _[*specify time period*]_ _ of receipt of Seller's demand, return at Buyer's own risk and expense any _ _[*describe goods*]_ _ already received. The goods must be in the same condition as they were when received by Buyer.

(2) Seller will return any amounts that Buyer has paid for the goods _ _[*specify refund time, e.g., on receipt of the returned goods*]_ _, and the contract will be terminated for all purposes.

If Buyer fails to return the goods as specified above, it shall be liable to Seller for their reasonable value at the time Buyer received them, and Seller will have the right to withhold the return of any amounts paid on the price until the amount of the reasonable value is established through agreement of the parties or, in the absence of agreement, through arbitration. Seller will then have the right to apply any amounts paid on the price toward the payment of that reasonable value.

[*Add if appropriate*]

If the price was not fixed due to the fault of either party, the other party may treat the contract as canceled but may not reinstate the contract by fixing a reasonable price or otherwise. Nor will such fault affect a party's obligation to return the goods, the liability for payment of the reasonable value of the goods, or the obligation to return payments made on the price.

Comment: This provision expresses the parties' intention not to be bound by a sales contract unless the price is fixed in an agreed manner. The provision may be used whether the method of fixing the price is agreement between the parties (see Com C §2305(1)(b); §§4.5-4.7), use of an independent standard (see Com C §2305(1)(c); §§4.8-4.12), or use of a standard more or less dependent on the conduct of one of the parties (see Com C §2305(2); §§4.13-4.19).

The provision essentially tracks Com C §2305(4), but it also preserves the right of either party to treat the contract as "canceled" (Com C §2106(3)-(4)) and thus to claim damages for breach if failure to set the price is the other party's fault. However, it prohibits reinstatement, which would otherwise be allowed by Com C §2305(3). Section 2305(3) gives the party not at fault the option of treating the contract as canceled or fixing a reasonable price.

The buyer is made responsible for any depreciation, damage, or loss of the goods regardless of whether (a) the goods conformed to the contract and (b) the seller was at fault for failure to fix the price. The parties may, of course, allocate the risk of loss in any way they choose. See Com C §§2303, 2509(4). On risk of loss generally, see Com C §§2509-2510. See also §§16.40-16.50, 16.53. As a practical matter, the seller is unlikely to return any of the buyer's payments until the buyer returns the goods. This provision makes explicit that the seller is not obligated to do so.

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C. Open Quantity

§4.21 1. Introduction

The Commercial Code expressly recognizes two types of "open quantity" contracts: requirements contracts and output contracts. See Com C §2306(1).

In both types of contracts, the quantity of goods subject to the contract is not numerically quantified but is expressed with reference to the buyer's needs or the seller's production. Typically, requirements and output contracts are long-term arrangements (one or more years) and involve more than one shipment of goods.

The primary legal issue in drafting and interpreting requirements and output contracts is the range in quantity permitted under the contract. The Commercial Code's standards for determining the quantity subject to these contracts are intended to allow elasticity in the quantity term.

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2. Requirements Contracts

§4.22 a. Overview

A requirements contract typically provides for the sale and purchase of the quantity of goods that the buyer actually needs in good faith from time to time, subject to the limitation that the quantity demanded cannot be unreasonably disproportionate to any stated estimate or, if no estimate was made in the contract, to any normal or otherwise comparable prior requirements. Com C §2306(1). The buyer is obligated to purchase all of its requirements exclusively from the seller. A contract that does not expressly or impliedly obligate the buyer to purchase all or a specified portion of its requirements exclusively from the seller is not a requirements contract for Commercial Code purposes. See Anno, *Establishment and Construction of Requirements Contracts Under §2-306(1) of UCC*, 94 ALR5th 247.

A requirements contract may be advantageous to a buyer because of the following:

- The buyer wants to be able to respond to uncertain or fluctuating market demand for its product without having to carry excess inventory or risk inadequate supply;
- The buyer desires a guaranteed supply at a fixed price or at an adjusting price that includes volume or other discounts;
- A fixed price requirements contract shifts the risk of increases in market price or production costs to the seller;
- The buyer desires a standardized product with quality assurance.

Sellers may find requirements contracts advantageous because of the following:

- The contract secures a guaranteed market for a product, thereby reducing or limiting marketing and distribution expenses.
- The seller may be able to charge a higher price for assuming the risk of quantity fluctuations. The risk assumed by the seller depends on the length of the contract and the nature of the buyer's business, including whether it is an established business with known requirements, a new business with unknown requirements, or a single project (*e.g.,* a government contract, which may be subject to cancellation). However, the seller can limit the quantity fluctuation risk through contract provisions that establish maximum and minimum requirements. See §§4.35-4.37.

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§4.23 b. Validity of Requirements Contracts

Under pre-Code law, the validity of requirements and output contracts was often challenged on the grounds that they lacked both a definite indication of quantity and a mutuality of obligation. See, *e.g., Andersen v La Rinconada Country Club* (1935) 4 CA2d 197, 40 P2d 571. Requirements contracts are considered sufficiently definite for purposes of the Commercial Code because the quantity of goods to be sold is measured by the buyer's actual requirements. See Official Comment 2 to UCC §2-306. Requirements contracts are not subject to attack for lack of mutuality because the Commercial Code imposes a duty on the buyer who will determine quantity to operate its plant or conduct its business in good faith. Official Comment 2 to UCC §2-306. Moreover, the buyer is barred from purchasing the same item from any other supplier.

Although the Commercial Code expressly recognizes the validity of contracts formed with reference to a buyer's "requirements," contracts using subjective terms such as all that the buyer "wishes," "desires," "will take," "orders," or "requests" may still be vulnerable to challenge for lack of mutuality because the buyer has not surrendered any future freedom of choice. A document using such terms may be held to be merely a continuing offer from the seller, which the buyer converts into a contract for the quantity ordered each time it places an order. See *Bartlett Springs Co. v Standard Box Co.* (1911) 16 CA 671, 117 P 934; 1 Witkin, Summary of California Law, *Contracts* §227 (10th ed 2005). If the quantity to be sold is expressed objectively, in terms of the "requirements" or "needs" of the buyer's business, the contract contains mutually binding obligations and therefore is valid, because not only is the seller required to sell, but the buyer is obligated to purchase as long as it has requirements. *El Rio Oils (Canada), Ltd. v Pacific Coast Asphalt Co.* (1949) 95 CA2d 186, 213 P2d 1. Even if the buyer may have no requirements during the contract period, the buyer's surrender of the right to purchase elsewhere is legally a detriment and thus is sufficient consideration to support a bilateral contract. *Andersen v La Rinconada Country Club, supra*.

The attorney should bear in mind two other validity issues:

(1) A written contract that does not evidence the existence of a requirements contract may not be enforceable under the Commercial Code's statute of frauds, which requires the quantity term to be in writing. Com C §2201. See, *e.g., Zayre Corp. v S.M. & R. Co.* (7th Cir 1989) 882 F2d 1145 (alleged requirements contract unenforceable); *Thomas J. Kline, Inc. v Lorillard, Inc.* (4th Cir 1989) 878 F2d 791 (distributorship agreement unenforceable). See also §6.11. But see *Seaman's Direct Buying Serv. v Standard Oil Co.* (1984) 36 C3d 752, 206 CR 354, overruled in part on other grounds in *Freeman & Mills, Inc. v Belcher Oil Co.* (1995) 11 C4th 85, 88, 44 CR2d 420, and further disapproved on other grounds in *Della Penna v Toyota Motor Sales, U.S.A., Inc.* (1995) 11 C4th 376, 393, 45 CR2d 436 (existence of requirements contract may be implied; if contract evidences a dealership arrangement, court may assume that wholesaler will supply what dealer requires).

(2) Because requirements contracts foreclose the seller's competitors from supplying goods to the buyer, they are subject to challenge under federal and state antitrust laws (including Sherman Act §1 (15 USC §1; unreasonable restraint of trade), Clayton Act §3 (15 USC §14; substantial lessening of competition), and Federal Trade Commission Act §5 (15 USC §45; unfair methods of competition)) and may be used as evidence of a violation of Sherman Act §2 (15 USC §2; attempts to monopolize and monopolization). Note that the penalties for antitrust violations were significantly increased by the Antitrust Criminal Penalty Enhancement and Reform Act of 2004 (Pub L 108-237, 118 Stat 665) (amending 15 USC §§1-3 and 16, and appearing in part as notes to 15 USC §§1 and 16).

Requirements contracts are subject to a "rule of reason" analysis; *i.e.,* the fact finder weighs all the circumstances of the case to determine whether a restrictive practice should be prohibited because it imposes an *unreasonable* restraint on competition. See *Continental T.V., Inc. v GTE Sylvania, Inc.* (1977) 433 US 36, 53 L Ed 2d 568, 97 S Ct 2549, for a good example of such an analysis.

When analyzing a requirements contract for its anticompetitive effect, the court will consider the structure of the relevant market and the scope and duration of the exclusive arrangement. See *Jefferson Parish Hosp. Dist. No. 2 v Hyde* (1984) 466 US 2, 45, 80 L Ed 2d 2, 34, 104 S Ct 1551 (exclusive dealing is unreasonable restraint of trade only when significant fraction of buyers or sellers is frozen out of market by exclusive deal); *Tampa Elec. Co. v Nashville*

Coal Co. (1961) 365 US 320, 5 L Ed 2d 580, 81 S Ct 623 (20-year coal requirements contract held not to violate Clayton Act §3 (15 USC §14)). See also California Business Litigation, chap 5 (Cal CEB 2002). On the validity of exclusive dealing agreements under California law, including requirements contracts, see Bus & P C §16727; 1 Witkin, Summary, *Contracts* §§589-593 (10th ed 2005).

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§4.24 c. Changes in Requirements

The terse provisions of Com C §2306(1) are intended not only to give meaning to "requirements" as a quantity term but also to resolve complex problems that may arise if the buyer's requirements expand, contract, or evaporate. Instead of resolving these problems, the Commercial Code's terse language has created uncertainty and shifted the resolution of these problems to litigation or the drafting of additional contract provisions. This uncertainty has increased the transactional costs of negotiating and entering into requirements and output contracts. See Comment, *And Then There Were None: Requirements Contracts and the Buyer Who Does Not Buy*, 64 Wash L Rev 871 (1989).

Under Com C §2306(1), there are three limitations on the quantity under a requirements contract:

(1) The requirements must be "actual";

(2) The actual requirements must occur in "good faith"; and

(3) The requirements may not be unreasonably disproportionate to any stated estimate in the contract or, if no estimate is stated, to "any normal or otherwise comparable prior… requirements."

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§4.25 (1) Actual Good Faith Requirements

The requirements of the buyer must be actual requirements occurring in good faith. Goods that the buyer intends to sell outside the normal scope of its business (*e.g.,* a manufacturer selling raw materials or stockpiling materials for speculation or future needs) are not "actual" requirements. Supplies or inventory maintained in quantities consistent with established commercial practices, industry standards, or within the parties' course of dealing or course of performance, however, should be considered actual requirements. See *Eastern Air Lines, Inc. v Gulf Oil Corp.* (SD Fla 1975) 415 F Supp 429, 436 (plaintiff did not manipulate its requirements for fuel through underfueling or overfueling at defendant's stations; variations in fueling needs of airlines were industry norm, affected by weather, scheduling changes, aircraft load, availability of fueling facilities, and other factors).

A much more difficult question is whether the actual requirements occur in good faith. Good faith means "honesty in fact and the observance of reasonable commercial standards of fair dealing." Com C §1201(b)(20). One court has stated that the Commercial Code definitions of "good faith" do not seem applicable to requirements contracts. See *Empire Gas Corp. v American Bakeries Co.* (7th Cir 1988) 840 F2d 1333, discussed in §4.27. The good faith standard demands, however, that the quantity required must "approximate a reasonably foreseeable figure" measured at the time the contract was executed. See Com C §2306; Official Comment 2 to UCC §2-306. Bad faith has been described by one court as occurring when one party acts to exploit changing economic conditions to secure gains that exceed those reasonably expected at the time of contracting. *Allapattah Servs. v Exxon Corp.* (SD Fla 1999) 61 F Supp 2d 1300, citing *Orange & Rockland Utils. v Amerada Hess Corp.* (App Div 1977) 397 NYS2d 814 (buyer fixed requirements in bad faith).

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§4.26 (a) Increased Requirements

If a buyer's requirements expand as a result of normal business growth, the expanded requirements occur in good faith and the seller will be responsible for supplying the increased quantities unless they are "unreasonably disproportionate." Official Comment 3 to UCC §2-306. One of the purposes of a requirements contract is to allow for increases related to foreseeable business growth.

A sudden expansion in requirements in response to unanticipated events may fail the good faith test. Official Comment 2 to UCC §2-306. For example, if a buyer suddenly increases its requirements to take advantage of a substantial rise in market prices and resell the goods at a profit, a court is likely to consider this action to be taken in bad faith. See *Orange & Rockland Utils. v Amerada Hess Corp.* (App Div 1977) 397 NYS2d 814. If market prices are rising, the requirements of distributors, dealers, or other intermediate suppliers may be subject to greater scrutiny because they are in a better position than manufacturers to capitalize on market-contract price differentials.

Expansion in response to a substantial increase in demand for the buyer's product may be considered in good faith if the expanded requirements were reasonably foreseeable when the contract was executed. See *Johnston Pie Co. v Acme Egg & Poultry Co.* (1946) 74 CA2d 376, 168 P2d 762 (supplier was obligated to fill buyer's daily frozen egg orders, which increased from 240 pounds per day to 810 pounds per day after two thirds of contract had been performed; demand for buyer's pies had increased substantially). See Official Comments 1-2 to UCC §2-306. These considerations place important limitations on the utility and flexibility of requirements contracts.

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§4.27 (b) Decreased and Disappearing Requirements

When requirements buyers artificially reduce their requirements by, *e.g.,* buying the contract goods from another supplier or closing the business and reorganizing under another guise, they do so in bad faith.

NOTE: Buying from other suppliers is a breach of the requirements contract itself, not simply a violation of the duty of good faith.

A requirements buyer may eliminate or substantially reduce its requirements for legitimate business reasons, however, without its actions being characterized as bad faith. See Comment, *And Then There Were None: Requirements Contracts and the Buyer Who Does Not Buy*, 64 Wash L Rev 871 (1989). A requirements buyer should be able to reduce or eliminate its requirements for any legitimate business reason other than the desire to purchase substitute goods at a better price. The buyer has bargained for a flexible rather than a fixed quantity term, and the seller can protect itself from this risk by bargaining for a minimum quantity term or for covenants requiring the buyer to use the technology or process generating the requirements during the entire contract term. The buyer should consider including a provision in the contract that allows it to reduce its requirements by a specified amount.

Empire Gas Corp. v American Bakeries Co. (7th Cir 1988) 840 F2d 1333, 1338 (applying Illinois law) examines in depth the Commercial Code's good faith standard as it applies to requirements contracts. In *Empire,* the buyer contracted to purchase its requirements of (1) propane converters to convert its gas-powered truck fleet to propane and (2) propane for the converted fleet. Before it ordered any converters, the buyer decided not make the conversion. When the buyer failed to introduce evidence of the reasons for its decision, the court concluded that the buyer had acted in bad faith and thus was liable to the seller for the seller's lost profits of $3,255,000. But see the dissenting opinion of Kanne, J, which criticizes the majority for shifting the burden of proof from the seller to the buyer on the issue of bad faith.

The court held that the buyer's decision was motivated by "a reassessment of the balance of advantages and disadvantages under the contract," reasoning that (840 F2d at 1340)

> [t]he essential ingredient of good faith in the case of the buyer's reducing his estimated requirements is that he not merely have had second thoughts about the terms of the contract and want to get out of it.

The court viewed the requirements contract as a sharing of risk between the seller and buyer (840 F2d at 1340):

> The seller assumes the risk of a change in the buyer's business that makes continuation of the contract unduly costly, but the buyer assumes the risk of a less urgent change in his circumstances….

The court admitted that the application of this standard is uncertain. In this case, the court seemed to be influenced by the fact that (1) the buyer never placed a single order and (2) the buyer's financial problems were not dire. In addition, the buyer provided no evidence of any "urgent change" that would allow it to reduce its requirements. "[A] buyer cannot arbitrarily declare his requirements to be zero." 840 F2d at 1341. The court noted, however, that a buyer would be allowed to reduce its requirements to zero if it were acting in good faith. But see Official Comment 2 to UCC §2-306, which notes that a shutdown by a requirements buyer for lack of orders might be permissible but that a shutdown merely to avoid losses would not.

It is unclear to what extent the "good faith" requirement allows flexibility in business judgment. This issue is particularly problematic when requirements are reduced because of technological improvements of the buyer's facility or the buyer's substitution of more efficient goods. In *Southwest Natural Gas Co. v Oklahoma Portland Cement Co.* (10th Cir 1939) 102 F2d 630 (cited in Official Comment 2 to UCC §2-306), the court allowed a cement company buyer to reduce its requirements for natural gas when it replaced worn-out equipment with more gas-efficient equipment. It is not clear, however, whether a court would allow a requirements reduction if the replaced equipment is in good working condition. Presumably, even the court in *Empire Gas Corp. v American Bakeries Co., supra,* would permit a requirements reduction if the buyer's decision to upgrade its plant and equipment were not motivated by the economics of the requirements contract.

The more the buyer's requirements are affected by factors outside the buyer's control, the more likely a reduction or complete elimination of requirements will be found to occur in good faith. Thus, the government's cancellation of a contract justifies the buyer's cancellation of a subcontract for lack of requirements (*R.A. Weaver & Assocs. v Asphalt Constr.* (DC Cir 1978) 587 F2d 1315; see also *Tennessee Valley Auth. v Imperial Prof. Coatings* (ED Tenn 1984) 599 F Supp 436 (TVA no longer had requirements for protective coating paint for nuclear power plants under requirements contract after it made good faith decision to defer construction of plants)), and a drop in demand for the buyer's product will probably justify a reduction in demand for raw materials (see Official Comment 2 to UCC §2-306).

No California court has implied a covenant to remain in business into a requirements or output contract. See 1 Witkin, Summary of California Law, *Contracts* §806 (10th ed 2005). But see *Lippman v Sears Roebuck & Co.* (1955) 44 C2d 136, 280 P2d 775 (covenant of continued operation implied in percentage lease).

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§4.28 (2) "Unreasonably Disproportionate" Limitation

The buyer is allowed to demand more than estimated or normal contract requirements as long as the increased demand is not so disproportionate to the estimated or normal requirements that it is unreasonable. Com C §2306(1).

Although a seller cannot be compelled to tender any quantity that is unreasonably disproportionate, it has the option to accept or reject the buyer's demand. If the buyer anticipates that the seller may be entitled to reject the buyer's demands as being unreasonably disproportionate, the buyer should demand advance notice of the seller's ability and willingness to supply the quantities demanded. See Official Comment 3 to UCC §2-311. This demand is different from a demand for assurances under Com C §2609, because the seller's failure to respond is not necessarily a repudiation. See Com C §2609(4). The seller's failure to give the requested response, however, should enable the buyer to make arrangements with other suppliers for the quantities it reasonably anticipates the seller may refuse to supply.

PRACTICE TIP: Nothing in Com C §2306 precludes the buyer from purchasing its excess requirements from another supplier without giving the seller the option to fill the excess, if the buyer is confident that the excess requirements are unreasonably disproportionate. The attorney should review the contract, however, to see whether this point is addressed. If the seller states in advance that it will sell a certain excess quantity, the seller waives the right to later object to that quantity as excessive. See Com C §2209(4)-(5).

There is an excellent discussion of the meaning of "unreasonably disproportionate" in *Orange & Rockland Utils. v Amerada Hess Corp.* (App Div 1977) 397 NYS2d 814. In *Orange,* the court listed the following factors to be considered in determining the reasonableness of the variation in quantity:

- The amount by which the requirements exceed the contract estimate;
- Whether the seller had any reasonable basis on which to forecast or anticipate the requested increase;
- The amount, if any, by which the market price of the goods exceeds the contract price;
- Whether such an increase in market price was itself fortuitous; and
- The reason for the increase in requirements.

On the basis of these considerations, the court held that an increase in requirements of more than double the contract estimate was "unreasonably disproportionate." 397 NYS2d at 819. Compare *Orange & Rockland Utils. v Amerada Hess Corp., supra,* with *Shea-Kaiser-Lockheed-Healy v Department of Water & Power* (1977) 73 CA3d 679, 140 CR 884 (requirements that exceeded parties' 20-percent "elasticity limit" (discussed in §4.30) found unreasonably disproportionate).

The majority of cases have held that the limitation that a change in requirements may not be unreasonably disproportionate does not apply when the buyer's requirements fall short of the stated estimate or other normal amount. See, *e.g., Empire Gas Corp. v American Bakeries Co.* (7th Cir 1988) 840 F2d 1333; *Angelica Uniform Group v Ponderosa Sys.* (8th Cir 1980) 636 F2d 232; *R.A. Weaver & Assocs. v Asphalt Constr.* (DC Cir 1978) 587 F2d 1315. The Alabama Supreme Court has held to the contrary, however, finding that UCC §2-306(1) and Official Comment 3 to UCC §2-306 also prohibit unreasonably disproportionate decreases from stated estimates of a buyer's requirements even if the buyer acted in good faith. *Simcala, Inc. v American Coal Trade, Inc.* (Ala 2001) 821 So2d 197 (purchase of 7200 tons of coal was unreasonably disproportionate to stated estimate of 17,500 tons).

Absent an agreement to the contrary, the only limitation on the buyer's ability to place smaller orders (or even no orders at all) is the condition that the requirements be actual and occur in good faith. See §4.25. If filling small orders will be burdensome to the seller, it should bargain for a minimum quantity per order provision. See §4.30.

If an estimate of the buyer's requirements is included in the contract, the seller is obligated to fill orders at least up to that estimated quantity for actual requirements occurring in good faith. The seller is also obligated to meet the buyer's requirements in excess of the estimate if the excess requirements are not unreasonably disproportionate to the estimated quantity. See *Shea-Kaiser-Lockheed-Healy v Department of Water & Power, supra*.

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§4.29 (3) Basis of Comparison in Contracts Without Stated Estimates

If a requirements contract does not include a stated estimate, the maximum quantity that the seller is obligated to tender is determined with reference to normal or otherwise comparable prior requirements. Com C §2306(1). On stated maximum or minimum, see §4.30. For a going business, the comparison is presumably to be made with the buyer's previous requirements. If the contract is to supply a new business, the basis of comparison is presumably found in the requirements of similar existing enterprises.

The Commercial Code and existing case law do not clarify whether the comparison is made at the time of contract formation or whether the base changes during the period of performance. Under the course of performance principles of Com C §1303, the seller's continuing response, without objection, to steadily increasing requirements may alter the base of comparison for determining the implied maximum quantity in the contract. See *Ehrenworth v George F. Stuhmer & Co.* (NY 1920) 128 NE 108 (bread requirements increased over eight-year period from 50-60 to 3000-4000 loaves per week; contract enforced). The parties may want to set these parameters themselves to avoid uncertainties and the attendant risks and cost of a dispute.

If the buyer's business is sold during the contract term, and the contract is assigned, the base of comparison should remain the same as it was before the sale. The sale itself is not grounds for a sudden expansion or decrease in requirements. Official Comment 4 to UCC §2-306. The parties (or at least the seller) may be well advised, however, to insist on a contractual provision that deals with this possibility.

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§4.30 (4) Stated Maximum or Minimum and Other Limitations

If a contract contains an estimate of the buyer's requirements and also includes a minimum quantity that the buyer must purchase, a court may use those two figures to imply a maximum quantity that the seller is obligated to supply. The Official Comments state that any minimum or maximum set by the agreement shows a clear limit on the intended elasticity. The agreed estimate is regarded as a center around which the parties intend the variation to occur. Official Comment 3 to UCC §2-306.

PRACTICE TIP: The attorney should inform a client who is about to become a party to a requirements contract of the possibility that a court could impose such a ceiling.

Thus, if the contract estimates the buyer's requirements to be 100 tons of concrete but obligates the buyer to purchase at least 80 tons, the "elasticity limit" may be considered to be 20 tons (or 20 percent of the total estimated requirements). Consequently, a court would most likely consider 120 tons of concrete to be the maximum that the seller would be obligated to furnish under the contract; any amount above that would be "unreasonably disproportionate" to the estimated requirements. This was the approach taken by the court in *Shea-Kaiser-Lockheed-Healy v Department of Water & Power* (1977) 73 CA3d 679, 140 CR 884.

A seller who is planning to devote significant production capacity to meet a particular buyer's requirements may want assurances that a minimum quantity of goods will be ordered in a specified period regardless of the buyer's actual need for them. Similarly, to limit the risk that the buyer's requirements will increase beyond the seller's capacity to meet them, the seller may want a maximum quantity term in the contract. If a minimum or maximum quantity provision, or both, is included, the contract does not measure quantity solely by the buyer's requirements and, to that extent, is not governed by Com C §2306(1). A stated minimum or maximum, unlike a stated estimate (see §4.34), sets an absolute limit on variations of quantity. If actual requirements vary beyond these limits, the contract is for the stated minimum or maximum. See Official Comment 3 to UCC §2-306; *City of Louisville v Rockwell Mfg. Co.* (6th Cir 1973) 482 F2d 159.

DRAFTING CONSIDERATIONS: Stating a maximum limit in the contract probably implies agreement that quantities within the limit are not unreasonably disproportionate. See Official Comment 3 to UCC §2-306. However, it is best to express this agreement in the contract. Parties may agree on an "unreasonably disproportionate" standard as long as it is not "manifestly unreasonable." Com C §1302(b).

The parties can limit variations in quantity by other methods such as allowing only a certain percentage increase each year or raising the unit price as required quantities become smaller. These provisions will accommodate gradual long-term changes in the buyer's business needs but prevent disputes over which quantities must be excluded as unreasonably disproportionate. See Note, *Requirements Contracts: Problems of Drafting and Construction*, 78 Harv L Rev 1212 (1965). For forms of maximum and minimum limitations, see §§4.35-4.37 (requirements contracts), 4.46-4.47 (output contracts).

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§4.31 d. Breach

A buyer breaches a requirements contract by obtaining its requirements elsewhere (see, *e.g., Wilson v Corrugated Kraft Containers, Inc.* (1953) 117 CA2d 691, 256 P2d 1012) or acquiring its own source of supply (see, *e.g., Andersen v La Rinconada Country Club* (1935) 4 CA2d 197, 40 P2d 571).

PRACTICE TIP: The attorney should remind a prospective requirements buyer that the option of becoming its own source of supply is foreclosed for the duration of the contract.

A buyer also breaches a requirements contract by fraudulently ordering more than its actual good faith requirements. Com C §2306(1).

A seller breaches a requirements contract by refusing to deliver actual good faith requirements that are not unreasonably disproportionate. See, *e.g., Shea-Kaiser-Lockheed-Healy v Department of Water & Power* (1977) 73 CA3d 679, 140 CR 884.

Some requirements contracts may also be installment contracts. On the right of cancellation for breach of an installment contract, see Com C §2612(3). See also §9.55. Faced with a prospective breach, the attorney for an aggrieved party that wishes to keep the contract alive should consider demanding assurances under Com C §2609. See §§16.3-16.17.

The remedy of specific performance is available for breach of requirements contracts involving a particular or peculiarly available source or market. See Official Comment 2 to UCC §2-716. For discussion of specific performance generally, see §18.47.

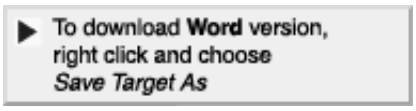
On other remedies for breach, see chap 18.

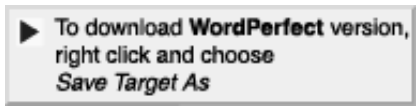
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Source: Business Law/California UCC Sales and Leases/4 Formation of Sales Contracts: Open or Indefinite Terms/ e. Requirements Contract Provisions/§4.32 (1) Form: Description of Requirements

e. Requirements Contract Provisions

§4.32 (1) Form: Description of Requirements





4.32-1 Requirements contract provision (description of requirements)

During the term of this agreement and subject to its terms, Seller agrees to sell to Buyer, and Buyer agrees to order and purchase from Seller, _ _[_ _[*number*]_ _ *percent/all*]_ _ of the _ _[*describe goods*]_ _ required by Buyer for

[*Option 1: Goods are raw material for manufacturing*]

the manufacture of _ _[*specify products*]_ _ at _ _[*describe plant and address*]_ _.

[*Option 2: Goods are supplies to be consumed in business*]

the operation of Buyer's _ _[*describe business*]_ _ at _ _[*address*]_ _.

[*Option 3: Goods are materials for construction job*]

the construction of _ _[*describe job, including general contractor's agreement with owner*]_ _ at _ _[*address*]_ _.

[*Option 4: Goods are for resale by distributor, jobber, or dealer*]

resale to _ _[*describe class of customers, e.g., jobbers, retail dealers, or retail customers*]_ _ _ _[*at _ _[address*]_ _*/in _ _[describe territory*]_ _]_ _.

[*Continue*]

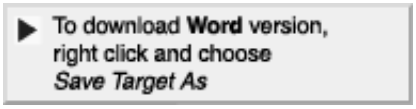
The goods will be considered required by Buyer only when they are needed, at the time of order or delivery, for _ _[*immediate use/sale*]_ _ _ _[*or for _ _[stock/inventory on hand*]_ _ reasonably necessary to meet _ _[current/short-term*]_ _ *needs*]_ _. If Buyer orders any quantity of goods from Seller that are not required under this agreement, Buyer will give Seller notice of that fact before or with the order.

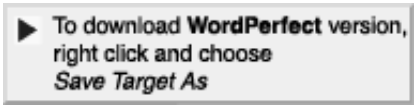
Comment: Requirements contracts are considered sufficiently definite because the quantity of goods to be sold is measured by the buyer's actual good faith requirements. See Official Comment 2 to UCC §2-306. The quantity to be sold may nevertheless be in doubt unless the parties' agreement clearly specifies the purpose of the requirements, which may determine:

- Whether the buyer is in breach for purchasing its requirements elsewhere or for overstating its requirements in orders to the seller; and
- Whether the seller is in breach for failing to deliver requirements ordered by the buyer.

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§4.33 (2) Form: Recital for New Business





4.33-1 Requirements contract provision (recital for new business)

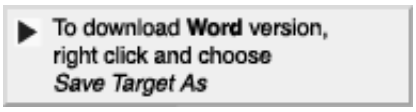
As a material inducement to entering into this contract, Buyer has represented to Seller that Buyer will _ _[*construct/lease/purchase*]_ _ **an approximately** _ _[*specify*]_ _ **square-foot facility** _ _[*insert geographic location if known or if location is important*]_ _ **to manufacture** _ _[*describe product*]_ _ **and will begin manufacturing the product at the facility on or before** _ _[*date*]_ _**.**

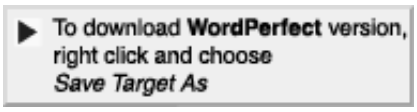
Comment: A requirements contract may be advantageous for a new business because of the unpredictability of the demand for its product or because the buyer needs a secure supply source. To be valid, a contract to supply the requirements of a new business must provide a "reasonably certain basis for giving an appropriate remedy." Com C §2204(3). There must be a means of fixing damages if the seller fails to deliver or the buyer refuses in bad faith to establish its enterprise. If the amount of the damages is proved with reasonable certainty, California courts permit recovery of contract damages based on operations that the enterprise would have carried on had the contract been performed. 1 Witkin, Summary of California Law, *Contracts* §§879-882 (10th ed 2005). Unless the parties have agreed on an estimate of the buyer's requirements under the contract, those requirements cannot be proved without showing the nature and size of the planned enterprise. Thus, the validity of the contract under Com C §2204(3) may depend on how definite the buyer's plans were at the time of contracting.

There may also be a question of how much time the buyer can take to go into business, if the contract does not cover that point. From the seller's point of view, the question is how long it must wait before it is free to contract for disposition of its product to other sources. The answer presumably is a reasonable time. See Com C §2309(1). A requirements seller faced with a buyer who delays establishment of its enterprise may also be able, by demanding assurances, to force the buyer to commit itself to a specific date for the opening of its establishment. See Com C §2609.

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§4.34 (3) Form: Stated Estimate





4.34-1 Requirements contract provision (stated estimate)

Buyer's estimates that Buyer's _ _[*aggregate/annual/monthly/ weekly/daily*]_ _ **requirements during the term of this contract are** _ _[*specify number of units*]_ _**.**

[*Add if appropriate*]

[*Option 1: Estimate for specified period*]

Whether the quantity ordered by Buyer is "unreasonably disproportionate" within the meaning of California Commercial Code §2306(1) will be determined only with reference to Buyer's _ _[*aggregate/annual/monthly/weekly/daily*]_ _ **estimate of Buyer's requirements.**

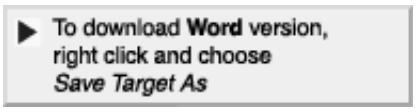
[*Option 2: Estimate for term of contract*]

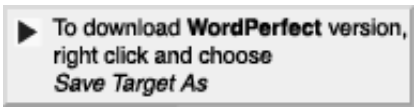
Whether the quantity ordered by Buyer is "unreasonably disproportionate" within the meaning of California Commercial Code §2306(1) will be determined only with reference to Buyer's aggregate estimate for the term of the contract.

Comment: To allow greater flexibility in ordering, the buyer may prefer that the contract have an estimate of the buyer's requirements rather than a maximum quantity. If an estimate is included, the seller should consider whether the estimate should be an aggregate estimate for the entire term or, if deliveries will be made on a periodic basis, an estimate for each period. The seller may prefer the latter provision if wide variances in the buyer's requirements may cause production problems. The buyer may prefer the former provision if the demand for its product varies significantly from week to week or month to month, because its requirements would become unreasonably disproportionate only when the aggregate estimate was exceeded. On "unreasonably disproportionate" limitation, see §4.28.

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§4.35 (4) Form: Maximum Quantity





4.35-1 Requirements contract provision (maximum quantity)

The maximum quantity of the _ _[*describe goods*]**_ _ that Seller must sell and Buyer must purchase for any _ _**[*unit of time, e.g., calendar month, calendar year*]**_ _ will be _ _**[*specify quantity*]**_ _. No quantity of Buyer's requirements within this maximum will be considered so large as to be "unreasonably disproportionate" within the meaning of California Commercial Code §2306(1).**

Comment: Specifying a maximum quantity in the contract is the best way to avoid disputes over whether the buyer's requirements are excessive under the "unreasonably disproportionate" standard. See Com C §2306. See also §4.28. When only an estimate of requirements is made, that dispute may arise. Use of a maximum quantity implies that any order up to that amount is not unreasonably disproportionate. This provision makes it explicit that the specified maximum quantity will not be considered unreasonably disproportionate.

A stated maximum quantity sets a definite ceiling on what the buyer can require from the seller. From the buyer's perspective, such a ceiling may or may not be desirable. Although the buyer is free to order goods within the limit established by the maximum, the buyer loses the flexibility to exceed that maximum. To remedy this problem, the parties might consider using a variable maximum, illustrated in §4.36.

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Source: Business Law/California UCC Sales and Leases/4 Formation of Sales Contracts: Open or Indefinite Terms/ §4.36 (5) Form: Variable Maximum Quantity

§4.36 (5) Form: Variable Maximum Quantity

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4.36-1 Requirements contract provision (variable maximum quantity)

The maximum quantity of the _ _[*describe goods*]_ _ **that Seller must sell and Buyer must purchase for any** _ _[*unit of time, e.g., calendar month, calendar year*]_ _ **will be the largest of the following three quantities:**

(1) _ _[*Fixed quantity*]_ _**;**

(2) _ _[*Number*]_ _ **percent more than Buyer's requirements delivered under this contract during the immediately preceding** _ _[*unit of time*]_ _**; or**

(3) _ _[*Number*]_ _ **more than the average of Buyer's requirements delivered under this contract during the** _ _[*number*]_ _ **immediately preceding successive** _ _[*units of time*]_ _**.**

Comment: The variable maximum quantity provision is especially desirable in contracts of extended duration because it permits adjustments for growth of the buyer's business.

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§4.37 (6) Form: Variable Minimum Quantity

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4.37-1 Requirements contract provision (variable minimum quantity)

[*Option 1: Minimum purchases required during contract term*]

Notwithstanding Buyer's actual requirements of the _ _[*describe goods*]**_ _ occurring in good faith, Buyer will purchase, and Seller agrees to sell, a minimum of _ _**[*quantity*]**_ _ during the term of this contract.**

[*Option 2: No delivery required unless minimum purchase made*]

Seller will not be required to deliver any order for the _ _[*describe goods*]**_ _ from the buyer unless that order totals _ _**[*state minimum quantity, e.g., one carload, 500 pounds*]**_ _. Orders smaller than the stated amount will be filled, but their delivery to Buyer will be at Buyer's expense.**

[*Option 3: Sliding prices apply to small orders*]

The price terms of this contract will apply only to orders for the _ _[*describe goods*]**_ _ of at least _ _**[*minimum quantity*]**_ _. For orders of less than the stated minimum, the price per _ _**[*e.g., unit, pound*]**_ _ will be increased by the following percentages:**

(1) For orders of less than _ _[*e.g., 500 pounds*]**_ _: 10 percent.**

(2) For orders of less than _ _[*e.g., 350 pounds*]**_ _: 20 percent.**

(3) For orders of less than _ _[*e.g., 200 pounds*]**_ _: 30 percent.**

Comment: The purpose of a minimum purchase obligation is to reduce the seller's risk that the buyer will be able in good faith to reduce the buyer's requirements to zero or below a quantity level that is economical for the seller. The minimum delivery provision aids a seller that would be unduly burdened in handling small orders. The buyer may not be able to order a minimum shipment, however, unless the goods are nonperishable and neither storage nor financing presents a serious problem. The third option may be more useful when the buyer cannot finance or store a larger order. In addition, that option compensates the seller for handling the small order by raising the price proportionately.

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§4.38 (7) Other Provisions

Because requirements contracts are typically intended to remain in effect for a long time, they should be adaptable to changing conditions. The price may be keyed to fluctuations in the market, so that neither party will be tempted by market changes to breach the contract or stretch the obligation of good faith to the breaking point.

The contract should ordinarily have a definite term. If the contract has no definite term, it should enable either party to terminate after a prescribed period by giving notice of termination or by declining to exercise an option to renew. On problems that may result from leaving the duration term unspecified, see §§4.79-4.82.

Given the long-term nature of their contractual relationship, the parties should consider to what extent they will permit assignment of the contract or delegation of contractual duties. See chap 11 on assignment and delegation.

For additional drafting suggestions, see Note, *Requirements Contracts: Problems of Drafting and Construction*, 78 Harv L Rev 1212 (1965).

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3. Output Contracts

§4.39 a. Overview

Output contracts measure the quantity of goods to be sold by the output of the seller. The seller is required to sell its output exclusively to the buyer unless the buyer is not obligated to accept tender or refuses to accept tender. The legal problems presented by output contracts are the same as those presented by requirements contracts. (The Commercial Code provides for both types of contracts in the same subsection: Com C §2306(1). Therefore, the following discussion (in §§4.40-4.47) is abbreviated by cross-references to the discussion in §§4.22-4.38 of similar issues with requirements contracts.)

Output contracts assure the seller of a market by shifting the burden of marketing and the risk of overproduction to the buyer. Such contracts are useful when:

- The seller's output is uncontrollable or unpredictable, and the buyer's business is large or flexible enough to absorb whatever the seller produces; or
- The nature of the product makes storage for future sale feasible and economical.

With an output contract, the buyer presumably receives a more advantageous price in exchange for assuming the risks of the seller's unpredictable output. Typical examples of output contracts include:

- Contracts by growers to sell their crops to processors, packers, or canners;
- Contracts to sell all natural gas or other power produced at a particular well or plant; and
- Contracts by manufacturers to sell their output of particular products to wholesale dealers.

See Anno, *Output Contracts Under §2-306(1) of Uniform Commercial Code*, 30 ALR4th 396.

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§4.40 b. Validity

As with requirements contracts, the most frequent pre-Code challenge to output contracts was that they lacked certainty and mutuality of obligation. For discussion of the parallel issues of certainty and mutuality of obligation in requirements contracts, see §4.23. On the validity of a contract for the output of a business that is not yet established, see the discussion of the analogous problem with respect to requirements contracts in §4.33.

Output contracts make the seller's output unavailable to the buyer's competitors, just as requirements contracts remove the buyer's requirements from the market available to the seller's competitors. Consequently, output contracts may present antitrust problems similar to those of requirements contracts. See §4.23.

Like requirements contracts, output contracts are subject to challenge under the Commercial Code's statute of frauds (Com C §2201). See §4.23.

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§4.41 c. Actual Good Faith Output; Decreasing and Disappearing Output

Determining whether a seller has produced output in good faith presents problems similar to those involved in determining whether a buyer's requirements are asserted in good faith. See §§4.25-4.27. The only Commercial Code Comment that deals with good faith output is Official Comment 2 to UCC §2-306, which states that the seller must "operate his plant or conduct his business in good faith" (as defined by Com C §1201(b)(20)) "so that his output… will approximate a reasonably foreseeable figure."

The good faith test determines whether a seller's decreased production is permissible under the output contract. See Official Comment 2 to UCC §2-306. Courts are likely to employ the same analytical method used to determine good faith in requirements contracts. See §§4.25-4.27. However, because the incentive in most circumstances is for the seller to increase production, this issue is not likely to arise unless the seller's financial condition or the differential between the contract price and production costs prompts curtailment of production or sale of the seller's business assets. The magnitude of the loss that the seller will suffer by continuing production, the seller's financial condition, and the timing of the seller's decision to halt or scale back production will likely be considered in assessing the seller's good faith. See *Feld v Henry S. Levy & Son* (1975) 335 NE2d 320, 323, 373 NYS2d 102 (business losses must be more than trivial to justify cessation of production).

In a number of pre-Code California cases, the courts considered whether a seller could avoid the output obligation by selling its business to someone not bound by the output contract. The sale of a herd of dairy cows and the sale of some orchards were found to be breaches of a milk output contract and fruit output contracts, respectively. See *Karales v Los Angeles Creamery Co.* (1918) 36 CA 171, 171 P 821; *Pratt-Low Preserving Co. v Evans* (1921) 55 CA 724, 204 P 241; *California Packing Corp. v Grove* (1921) 51 CA 253, 196 P 891. In other situations, however, the courts have found a contractual intent on the buyer's part to relieve the seller of its output obligation in a bona fide sale of the seller's business. See *Globe Oil Mills v Van Camp Sea Food Co.* (1921) 52 CA 781, 199 P 864 (ten-year obligation to sell waste by-product of fish cannery held terminated on sale of cannery); *William S. Gray & Co. v Western Borax Co.* (9th Cir 1938) 99 F2d 239 (ten-year exclusive sales agency agreement held not breached by discontinuance of business when profitable operation appeared impossible).

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§4.42 d. Unreasonably Disproportionate Output

The primary purpose of the "unreasonably disproportionate" exception in Com C §2306(1), as applied to output contracts, is presumably to prevent sellers from expanding capacity in quantities substantially greater than the buyer has been led to expect by the stated estimate or the normal or otherwise comparable prior output. The analysis used to determine the implied maximum quantity in a requirements contract applies equally to output contracts. See §4.28. Accordingly, the "unreasonably disproportionate" language of Com C §2306(1) does not apply to an output contract when the seller tenders less than the estimate, and the sole test in determining whether the seller breached the contract is the seller's good faith. *Canusa Corp. v A & R Lobosco, Inc.* (ED NY 1997) 986 F Supp 723. See generally Note, *UCC: Output Contracts and the Unreasonably Disproportionate Clause of section 2-306*, 59 Mo L Rev 1051 (Fall 1994).

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§4.43 e. Breach

An output buyer may breach the contract by refusing to take delivery at the contract price (see *Siquig v West Coast Pickle Co.* (1958) 161 CA2d 254, 326 P2d 596) or by refusing to cooperate as agreed, *e.g.,* furnishing boxes to deliver harvested grapes (see *Yeremian v Turlock Dehydrating & Packing Co.* (1938) 30 CA2d 92, 85 P2d 515).

An output seller may breach the contract by failure to deliver its entire output (see *Rosenberg v Rogers* (1919) 44 CA 196, 186 P 366) or, after the market price has dropped below the contract price, tendering goods purchased in the open market as if they were part of the output (see *Garcia & Maggini Co. v Sanfilippo* (1922) 56 CA 348, 205 P 74). For further examples of breach of agricultural output contracts, see Anno, *Validity, Construction, and Effect of Contract Between Grower of Vegetable or Fruit Crops, and Purchasing Processor, Packer, or Canner*, 87 ALR2d 732.

The references in §4.31 to remedies for breach of requirements contracts also apply to output contracts.

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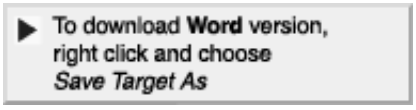
f. Output Contract Provisions

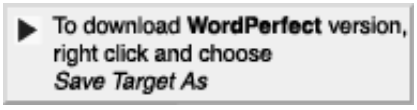
§4.44 (1) Overview

Because output contracts and requirements contracts are both governed by similar principles, the drafting problems are similar. The attorney who drafts an output contract should examine not only the provisions in §§4.45-4.47 but also the provisions and suggestions in §§4.32-4.37 for drafting requirements contracts.

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§4.45 (2) Form: Description of Output Subject to Contract





4.45-1 Output contract provision (description of output)

Subject to the terms of this contract, Seller agrees to sell and Buyer agrees to purchase from Seller _ _[*all/*_ _[*number*]_ _ *percent*]_ _ **of Seller's output of the** _ _[*describe goods*]_ _ **during the term of this contract. "Output" means goods produced by Seller at** _ _[*address of factory or parcel of farmland*]_ _ **that are** _ _[*describe, e.g., packaged for shipment as of* _ _[*date*]_ _]_ _**.**

Comment: This provision identifies the source whose "output" is the quantity measure and describes which goods will be considered the seller's "output." In the example offered in this provision, only goods that are packaged for shipment will be considered the seller's output; other goods in process, lacking the degree of readiness specified by the parties, will not be counted. The recital of the contract period may be accompanied by an option to renew or a provision for automatic renewal, subject to either party's right to terminate by giving notice. On the problems that may result from leaving the contract period unspecified, see §§4.79-4.82.

The parties may intend that the buyer take delivery of the seller's output (such as a crop) and have the option of rejecting whatever portion does not meet an agreed standard. If so, the contract should be explicit about which goods the seller must deliver and which goods the buyer must accept. Failure to make this distinction clear led to litigation in *Rosenberg v Rogers* (1919) 44 CA 196, 186 P 366 (seller sold its entire crop of figs to buyer, but contract required figs to be of certain grade and quality; because roughly one third of crop was mildewed, seller sold them to third party; buyer sued seller for undelivered quantity).

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§4.46 (3) Form: Maximum Quantity

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4.46-1 Output contract provision (maximum quantity)

The maximum quantity of Seller's output of the _ _[*describe goods*]_ _ that Buyer must purchase and Seller must sell for any _ _[*unit of time*]_ _ will be _ _[*quantity*]_ _. Output that does not exceed this limit may not be considered "unreasonably disproportionate" within the meaning of California Commercial Code §2306(1).

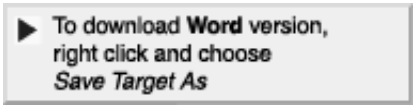
[*Add if buyer has option to buy more than maximum*]

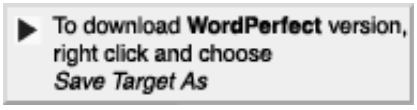
Whenever Seller has an output of goods in excess of the maximum for a given _ _[*unit of time*]_ _, Seller must tender the excess to Buyer for purchase at the price and on the terms of this contract. If Buyer rejects the tender, the parties' duties to sell or purchase excess output for that _ _[*unit of time*]_ _ will be terminated.

Comment: The purpose of this provision is not only to place a ceiling on the parties' quantitative obligations but also to prevent disputes over whether the output is unreasonably disproportionate under Com C §2306(1). This provision is similar to the maximum requirements limitation discussed in §4.30 and §4.35. The omission from this provision of the sliding-maximum alternative offered in §4.36 does not imply a legal obstacle to its use in an output contract. If "output" is substituted for "requirements" and "seller" is replaced with "buyer," the discussion in §4.36 also applies to output contracts.

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§4.47 (4) Form: Minimum Quantity





4.47-1 Alternative: Output contract provision (minimum quantity of seller's deliveries)

Each single delivery by Seller of Seller's output of the _ _[*describe goods*]**_ _ under this contract must be at least _ _**[*describe minimum quantity*]**_ _.**

4.47-2 Alternative: Output contract provision (minimum output guaranteed)

Seller agrees to deliver at least _ _[*describe minimum quantity*]**_ _ of the _ _**[*describe goods*]**_ _ each _ _**[*unit of time*]**_ _. Seller's failure to deliver the stated minimum quantity may be treated by Buyer as a breach of the whole contract under California Commercial Code §2612(3).**

Comment: These two alternative provisions are not mutually exclusive. The first alternative addresses the buyer's interest in keeping the per-unit shipping and handling costs as low as practical, because the buyer may not have an immediate need for the goods as they are produced and may not wish to pay the extra insurance and shipping costs for a small order. This alternative helps the buyer regulate the delivery of the seller's output.

The second alternative may be appropriate when the output buyer is a dealer who is dependent on the contract to meet customer demand. The second sentence of the provision avoids disputes over whether a lapse in performance by the seller "substantially impairs the value of the whole contract" under Com C §2612(3). See §§9.53-9.57.

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4. Exclusive Dealing

§4.48 a. Overview

Exclusive dealing provisions typically are included in distribution agreements between manufacturers, producers, or an intermediate supplier, as seller, and a representative or agent buying for resale. Often the right to resell the goods is limited to stated territorial boundaries. The arrangement may also prohibit the buyer from carrying competing lines of products. If only the seller agrees to exclusivity, the seller surrenders the right to sell to anyone except the buyer within the stated geographical or trade confines, but the buyer retains the right to resell products bought from the seller's competitors. If only the buyer agrees to exclusivity, the buyer must refrain from distributing competing goods within the stated territory or trade, while the seller remains free to designate others as distributors in competition with the buyer. See *California Beverage & Supply Co. v Distillers Distrib. Corp.* (1958) 158 CA2d 758, 323 P2d 517. All these arrangements may raise issues under California's Franchise Investment Law (Corp C §§31000-31516), the Federal Trade Commission's Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures (16 CFR pts 436-437), and the Seller Assisted Marketing Plan Act (CC §§1812.200-1812.221).

Unless the parties agree otherwise, a lawful exclusive dealing agreement imposes an obligation on the seller to use the seller's best efforts to supply the goods and an obligation on the buyer to use the buyer's best efforts to promote their sale. Com C §2306(2). The exclusive dealing provisions of Com C §2306(2) apply to agreements in which a seller (defined in Com C §2103(1)(d)) agrees to sell one or more products exclusively to a buyer (defined in Com C §2103(1)(a)), or in which a buyer agrees to buy exclusively from a seller.

The exclusive dealing provisions in Com C §2306(2) do not apply to arrangements in which a manufacturer's representative or agent does not buy the goods (*e.g.,* an agent selling on commission when delivery is made from the seller's warehouse). A dealer who accepts delivery without agreement that the supplier will retain title or will accept a return of the goods becomes a buyer liable for the price even if the dealer cannot make a resale. *Reiter v Anderson* (1927) 87 CA 642, 262 P 415. The arrangement with the supplier is governed by Commercial Code Division 2. If the arrangement includes an exclusive dealing agreement, it is subject to Com C §2306(2).

Even if the buyer has a contractual right to return goods not resold, the arrangement may be governed by Division 2 as a "sale or return." See Com C §§2326(1)(b), (3), 2327(2). See also §§10.28, 12.55. If the dealer takes delivery on consignment (*i.e.,* the supplier retains title), there is no sale under Division 2 (see Com C §2106(1)), but the goods may be subject to the rights of the consignee's creditors (Com C §2106(1)) and Division 9 governing secured transactions will apply (Com C §§1201(b)(35), 9109(a)(4)). See §§12.56-12.66; Secured Transactions in California Commercial Law Practice §1.29 (2d ed Cal CEB 2001). On the applicability of the sales statute of frauds and parol evidence rule to exclusive dealing arrangements, see §§7.25, 7.35.

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b. Validity

§4.49 (1) Antitrust Considerations

Exclusive dealing agreements may be challenged as illegal restraints of trade. The attorney should examine the possible antitrust consequences of any exclusive dealing arrangement. See §4.23 for a brief discussion of these issues in requirements contracts. See also California Business Litigation, chap 5 (Cal CEB 2002). Generally, exclusive distributorships, territorial restrictions, location clauses, and customer restrictions are subject to a "rule of reason" analysis, *i.e.,* the fact finder weighs all the circumstances of the case to determine whether a restrictive practice should be prohibited because it imposes an *unreasonable* restraint on competition. See *Continental T.V., Inc. v GTE Sylvania, Inc.* (1977) 433 US 36, 53 L Ed 2d 568, 97 S Ct 2549, for a good example of such an analysis. The rule of reason analysis is also used in instances of vertical price restraints. See *State Oil Co. v Khan* (1997) 522 US 3, 15, 139 L Ed 2d 199, 118 S Ct 275 (rejecting traditional rule that vertical price restraints were per se illegal).

On federal antitrust restrictions, see *State Oil Co. v Khan, supra*; *Business Elecs. Corp. v Sharp Elecs. Corp.* (1988) 485 US 717, 99 L Ed 2d 808, 108 S Ct 1515; *Monsanto Co. v Spray-Rite Serv. Corp.* (1984) 465 US 752, 79 L Ed 2d 775, 104 S Ct 1464; *Continental T.V., Inc. v GTE Sylvania, Inc., supra*. See also Anno, *Vertical Restraints on Sales Territory or Location as Violative of §1 of Sherman Act (15 USC §1)—Post-GTE Sylvania Cases*, 92 ALR Fed 436. On the validity of exclusive dealing agreements under California law, see Bus & P C §16727; 1 Witkin, Summary of California Law, *Contracts* §§588-593 (10th ed 2005).

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§4.50 (2) Mutuality of Obligation

The validity of supplier-dealer contracts may be challenged on the ground that no obligation sufficient to constitute consideration is imposed on the dealer. See, *e.g., Scott v Cline Elec. Mfg. Co.* (1930) 104 CA 122, 285 P 349 (dealer's promise to "push" sales held too indefinite). If, however, the dealer is obligated to do anything in addition to using its "best efforts," there will normally be adequate consideration to validate the contract. See, *e.g., Black Light Corp. v Ultra-Violet Prods.* (1961) 195 CA2d 473, 15 CR 852 (distributor agreed to use its best efforts to promote sale of defendant's products, to maintain adequate inventory to service all accounts, and to refrain from selling competing products); *Brunvold v Johnson* (1939) 36 CA2d 226, 97 P2d 489 (agent promised to promote business of defendant and to pay expenses incidental to selling defendant's products); *J. C. Millet Co. v Park & Tilford Distillers Corp.* (ND Cal 1954) 123 F Supp 484 (implicit in promise to use best efforts was obligation to maintain sales force, warehousing facilities, and inventory). On parties' best efforts, see §4.51.

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§4.51 c. Performance: Best Efforts and Good Faith

Unless the parties agree otherwise, the Commercial Code obligates the seller to use best efforts to supply the goods and the buyer to use best efforts to promote their sale. Com C §2306(2). "Best efforts" is not defined in the Commercial Code. Unless the contract includes standards for measuring whether the best-efforts obligation has been met (*e.g.,* a minimum sales volume), the issue of whether the seller or buyer has used its best efforts is one for litigation or arbitration. See §4.52 for a provision setting standards for measuring performance of the best-efforts obligation.

According to one court, "best efforts" does not require an exclusive agent to bankrupt itself or sell the exclusive product at a substantial loss; however, it does require the agent to explore alternative promotional efforts, not involving substantial losses, to prevent or slow the rate of decrease in the volume of the exclusive product sold. The agent cannot emphasize its own profits over the seller's volume of sales. *Bloor v Falstaff Brewing Corp.* (2d Cir 1979) 601 F2d 609.

Implicit in an exclusive dealing agreement is an obligation to perform in good faith, *i.e.,* honestly and according to reasonable commercial standards of fair dealing. Com C §§1201(b)(20), 1304. Unlike the best-efforts obligation, which may be modified or eliminated by the parties' agreement, the obligation to perform in good faith cannot be negated by agreement. Com C §1302(b). Whether a reduction in the quantity supplied or purchased or a termination of the seller's or buyer's effort is made in good faith will be judged using the same standards applicable to requirements and output contracts. See Official Comment 5 to UCC §2-306, which states that "[a]n exclusive dealing agreement brings into play all of the good faith aspects of the output and requirement problems of [UCC §2-306(1)]." See §§4.25-4.27, 4.41.

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Source: Business Law/California UCC Sales and Leases/4 Formation of Sales Contracts: Open or Indefinite Terms/ d. Contract Provisions/§4.52 (1) Form: Definition of 'Best Efforts' (Buyer's and Seller's Protection)

d. Contract Provisions

§4.52 (1) Form: Definition of "Best Efforts" (Buyer's and Seller's Protection)

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4.52-1 Alternative: Definition of "best efforts" (buyer's protection)

Buyer's purchase of _ _[*specify number of units*]_ _ of the _ _[*describe goods*]_ _ during _ _[*time period*]_ _ will be considered to satisfy Buyer's obligation to use Buyer's best efforts to promote the goods. The preceding sentence may not be construed as creating a minimum quantity term or creating a minimum standard for complying with the best-efforts obligation.

4.52-2 Alternative: Definition of "best efforts" (seller's protection)

Buyer will use Buyer's best efforts to _ _[*e.g., competitively price/advertise/market/promote/distribute/service/maintain good relations with purchasers of*]**_ _ the _ _**[*describe goods*]**_ _ within _ _**[*e.g., the specified territory*]**_ _.**

[*Add if standard for determining breach is appropriate*]

Failure to purchase _ _[*specify quantity*]**_ _ of the goods during _ _**[*time period*]**_ _ will be conclusive evidence of Buyer's failure to use Buyer's best efforts and will be cause for termination of the contract for breach under _ _**[*cross-reference to termination clause*]**_ _.**

Comment: The attorney for the exclusive agent, distributor, or dealer should consider whether the client would benefit from a stipulated standard (*e.g.,* a sales quota) to measure the client's best efforts. Without such a standard, the seller may have greater leeway to terminate the buyer's exclusive arrangement. The risk of including a volume standard as a measurement of best efforts is that the amount chosen might be considered a minimum quantity term for the client's purchase of goods. The second sentence of the first alternative clause is intended to minimize this risk by expressly negating the intention to have the clause create a minimum quantity term or minimum performance standard.

If the contract does not contain a minimum sales requirement, such as that provided in the second alternative, the seller may be concerned that it will be too difficult to establish that the buyer has failed to use its best efforts, thus preventing the seller from terminating the contract and finding a more diligent distributor. The Commercial Code recognizes the validity of a contractual standard measuring best efforts as long as the standard is not manifestly unreasonable. Com C §1302(b).

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§4.53 (2) Exclusive Dealing Distinguished From Requirements and Output Contracts

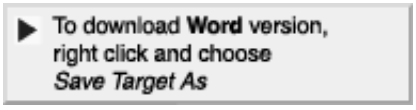
An exclusive dealing contract is subject to the same good faith test applied to requirements and output contracts. However, it is not subject to the quantity limitation that applies to requirements and output contracts (*i.e.,* the prohibition against quantities that are unreasonably disproportionate to normal trade practices or to the parties' estimate of the volume of goods they would be dealing), except to the extent that these may be used as benchmarks when "best efforts" becomes an issue. For discussion of the quantity limitation, see §§4.28-4.30, 4.34-4.37 (requirements contracts), 4.42, 4.44-4.47 (output contracts).

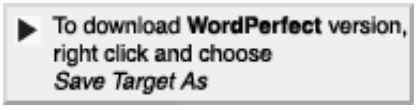
The essential purpose of an exclusive dealing contract is to promote the product and to expand its market (see Official Comment 5 to UCC §2-306); it would be inconsistent with this purpose to prohibit the sale of quantities unreasonably disproportionate to a stated estimate or to statistics of past performance. Instead, Com C §2306(2) imposes a best-efforts obligation. See §§4.51-4.52.

An exclusive dealing arrangement nevertheless may also involve a requirements or output contract. A supplier who gives a distributor the exclusive right to market a product in a particular territory may be held to have entered into an implied contract to supply the requirements of the distributor's business for the product. If the exclusive distributorship is geographically unlimited, the implied agreement may be that all the seller's output will be sold to the distributor. These exclusive dealing contracts may be governed by Com C §2306(1).

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§4.54 (3) Form: Nonexclusive Supply by Seller





4.54-1 Nonexclusive supply by seller

Seller will make good faith efforts to maintain facilities and staff for the timely production and fulfillment of orders for the _ _[*describe goods*]_ _. The parties recognize that the amount and timing of Buyer's demand for the goods is not certain or predictable; consequently, Seller may be unable to fill all Buyer's orders as they are received. Should demand for the goods exceed Seller's supply, Seller _ _[*in Seller's sole discretion*]_ _ may allocate the supply among all orders received in any manner _ _[*that Seller considers to be/that is*]_ _ fair and reasonable.

Comment: If the seller has multiple distributors and therefore is not dealing exclusively with the buyer, the seller may want (a) an express acknowledgment that supply may not always meet the demand of its buyers and (b) an express reservation of the right to determine how the supply should be allocated. Otherwise, the buyer may be able to argue that the contract is a requirements contract and establish a breach based on the seller's failure to tender the buyer's requirements. In any event, the buyer may wish to make this clause less one-sided by deleting the bracketed language that gives the seller sole discretion to decide what allocation of the goods is "fair and reasonable." See UCC §2-615(b) (2003).

Sellers may use periods of shortage to dismiss distributors they no longer wish to work with, while buyers may use periods of shortage to circumvent exclusivity requirements.

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§4.55 e. Other Drafting Issues

Exclusive dealing contracts raise some of the same drafting issues as requirements and output contracts. See §§4.32-4.38, 4.44-4.47. Distributorship agreements typically contain open price provisions, with the seller controlling the price and the terms of sale. See §§4.13-4.20.

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D. Open Delivery Terms

§4.56 1. Number of Deliveries

Unless otherwise agreed, all goods called for by a contract for sale must be tendered in a single delivery and payment is due on such tender; however, when the circumstances give either party the right to make or demand delivery in lots, the price, if it can be apportioned, may be demanded for each lot. Com C §2307. A "lot" is a parcel or a single article that is the subject matter of a separate sale or delivery, regardless of whether it is sufficient to perform the contract. Com C §2105(5).

It is unclear whether "circumstances" may authorize delivery in lots when the parties have an express agreement for single delivery. Official Comment 1 to UCC §2-307 strongly implies that the parties' agreement will override circumstances, by stating that Com C §2307 "applies where the parties have not specifically agreed whether delivery and payment are to be by lots…." Thus, an express agreement that delivery and payment will be in a single lot will probably be enforced regardless of the circumstances. This conclusion is consistent with the policy permitting contractual variation of Commercial Code provisions. See Com C §1302(a)-(b).

Although an agreement for single delivery probably makes Com C §2307 inoperative, multiple deliveries may become proper under Com C §2614, which authorizes substitute performance (see §9.69), or under Com C §2615, which deals with impracticability (see §§16.60, 16.78).

If circumstances do permit multiple deliveries, the buyer may not reject a partial shipment unless it has reasonable grounds to believe that the undelivered balance will not be forthcoming. The seller must complete delivery within a reasonable time; its failure to do so entitles the buyer to revoke acceptance of the initial shipment. Com C §2608. See §§10.32-10.34, 17.61-17.66. Revocation of acceptance is frequently an unsatisfactory and commercially impracticable remedy, however, coming long after performance was due and perhaps after use or resale of the goods. If the buyer suspects that the seller will fail to complete delivery, the most appropriate remedy ordinarily is to demand assurances of performance. See Official Comment 3 to UCC §2-307; Com C §2609. See also §§16.2-16.20. On rejection of installment deliveries and cancellation of installment contracts for breach, see Com C §2612. See also §§9.53-9.57.

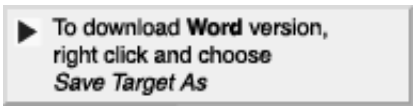
On payment for multiple deliveries under Com C §2307, see §§10.70-10.71.

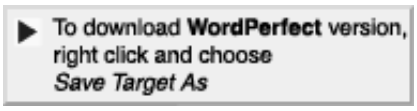
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2. Forms

§4.57 a. Form: Single Delivery





4.57-1 Single delivery

Notwithstanding any other provision of this agreement or applicable law, the _ _[*describe goods*]_ _ sold under this agreement will be _ _[*delivered/shipped*]_ _ in a single lot _ _[*on/between*]_ _ _ _[*date(s)*]_ _.

Comment: This provision should override any right to make or demand delivery in installments that could be derived from course of dealing, usage of trade, or other circumstances affecting either party. See §§4.94-4.104.

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§4.58 b. Form: Delivery in Lots

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4.58-1 Delivery in lots

The _ _[*describe goods*]_ _ sold under this agreement will be _ _[*delivered/shipped*]_ _

[*Option 1: Installment details are fixed*]

in _ _[*number*]_ _ lots of _ _[*quantity*]_ _ each, on _ _[*dates of delivery or shipment*]_ _. All lots will be separately invoiced and paid for when due. Seller's delay in delivery of any lot will not relieve Buyer of Buyer's obligation to accept deliveries of the remaining lot or lots.

[*Option 2: Installment details to be determined by one of the parties*]

in lots of size and number to be determined by _ _[B*uyer/Seller*]_ _, provided that no lot size will be _ _[*less than _ _[specify minimum quantity*]_ _/more than _ _[specify maximum quantity*]_ _]_ _, nor will delivery be made in _ _[*fewer than _ _[specify minimum number*]_ _/more than _ _[specify maximum number*]_ _]_ _ lots. Dates of delivery will be specified by _ _[*Buyer/Seller*]_ _. Notice of the date and size of each delivery must be _ _[*sent/received*]_ _ by _ _[*Buyer/Seller*]_ _ at least _ _[*period of time*]_ _ before the delivery. Performance of the entire contract must be completed by _ _[*date*]_ _.

Comment: Delivery of installment shipments may depend on the seller's schedule of production or procurement, available transportation, and the buyer's ability to receive the goods. Accordingly, the contract may leave the number, size, or timing of the installments to the determination of either the seller or the buyer. Details of number or size should usually be subject to maximum or minimum limits; details of timing should almost certainly be subject to an ultimate time limit for performance.

The party exercising the choice in these matters should be required to notify the other party of its decision. Note that giving this notice might not fulfill other notice requirements, *e.g.,* those in Com C §§2503(1) (notice of tender of delivery) and 2504(c) (notice of shipment).

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3. Place of Delivery

§4.59 a. Applicable Rules

If the parties have not agreed on a place of delivery, it is the seller's place of business or, if the seller has none, the seller's residence. Com C §2308(a). See *Home Indem. Co. v Twin City Fire Ins. Co.* (7th Cir 1973) 474 F2d 1081. However, if the contract is for the sale of "identified goods" (Com C §2501(1)), which the parties know at the time of contracting are at a location other than the seller's place of business, that location is the place of delivery. Com C §2308(b). See *Haken v Scheffler* (Mich Ct App 1970) 180 NW2d 206.

In most commercial sales, the delivery rules of Com C §2308(a)-(b) are superseded by terms specified by the parties or by other Commercial Code provisions governing the place for delivery in particular situations. Thus, if the contract requires or authorizes the seller to ship the goods by carrier but no particular destination is specified, the seller's delivery duties are governed by Com C §2504 instead of Com C §2308. See §§9.5-9.9. If the contract is a "destination" rather than a "shipment" contract, the seller's delivery duties are governed by Com C §2503(3). See §§9.3, 9.48. See also Official Comment 1 to UCC §2-308. Contracts with F.O.B., F.A.S., C.I.F., or other mercantile terms carry their own special rules on place of delivery. See Com C §§2319-2324. See also §§9.15-9.43 for discussion of these terms.

The parties' agreement on place of delivery also can be inferred from their course of performance, course of dealing, or the usages of their trade. See Official Comment 4 to UCC §2-308; Com C §§1201(b)(3), 1303; *Home Indem. Co. v Twin City Fire Ins. Co., supra*.

Delivery by shipment and delivery of goods in the possession of a bailee sometimes entail delivery of documents of title to the buyer. See Com C §§2503-2504. On documents of title generally, see chap 15. Unless otherwise agreed, those documents may be delivered through customary banking channels. Com C §2308(c). See Official Comment 3 to UCC §2-308. See also §§9.71-9.77. In the unusual situation in which identified goods that are deliverable at the premises of a bailee are sold without requiring delivery of documents, the seller must obtain the bailee's acknowledgment of the buyer's right to possession. See Com C §2503(4)(a); Official Comment 2 to UCC §2-308. See also §§9.45-9.46.

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b. Forms

§4.60 (1) Form: Place of Delivery

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4.60-1 Place of delivery

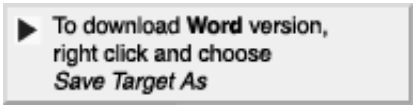
The _ _[*describe goods*]_ _ will be delivered _ _[*specify shipping terms*]_ _ at _ _[*address*]_ _.

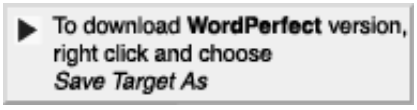
Comment: Unless the place of delivery is specified in the contract, or otherwise clearly fixed by its terms (*e.g.,* F.O.B. (free on board) or other mercantile term described in Com C §§2319-2324), the parties cannot be sure whether a court will (a) determine that the place for delivery is governed by Com C §2308(a)-(b) or (b) infer agreement on some other place from the circumstances surrounding the transaction, usage of trade, course of dealing, or course of performance. The following matters should be considered in drafting the delivery terms:

- **A description of the place of delivery.** For example, the contract may specify the business address of the seller, the buyer, the warehouseperson in possession, or the seller's supplier. The address may be supplemented by other references to location, such as a particular sales room or shipping room.
- **Options to designate the place of delivery.** The contract should state which party has the option to designate the place of delivery, how and when that party should communicate a decision to the other party, and the consequences of a failure to do so (such as that delivery will then be at a stated place).
- **Duties suggested by the place of delivery.** For example, if the place of delivery is a warehouse, the seller may be required to furnish the buyer with documents of title or to obtain the warehouseperson's written acknowledgment of the buyer's rights. Circumstances may require the buyer to furnish particular containers, vehicles, or facilities to receive the goods.
- **The party bearing the risk of loss and costs of transportation.** See Com C §§2319-2324.

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§4.61 (2) Form: Delivery of Goods in Possession of Third Party





4.61-1 Delivery of goods in possession of third party

On the date of this contract, the _ _[*describe goods*]_ _ are located in the _ _[*identify warehouse*]_ _ at _ _[*address*]_ _. Buyer will take delivery of the goods at that location, but delivery will not be considered complete until Seller tenders to Buyer a properly endorsed negotiable warehouse receipt issued for the goods by _ _[*name of warehouseperson*]_ _.

Comment: If the goods are in the possession of a bailee and will be delivered without being moved, the seller is required either to tender a document of title covering the goods or to procure the bailee's acknowledgment of the buyer's right to possession of the goods. Com C §2503(4)(a). A nonnegotiable document of title or a record directing the bailee to deliver is sufficient tender unless the buyer seasonably objects. Com C §2503(4)(b). See §§9.44-9.50 for further discussion of the seller's tender of delivery.

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4. Time for Delivery or Related Performance

§4.62 a. Applicable Rules

If the parties have not agreed on the time for delivery, shipment, or other contractual performance and the Commercial Code does not otherwise specify a time, the time for delivery or related performance is a reasonable time. Com C §2309(1); *Trubowitch v Riverbank Canning Co.* (1947) 30 C2d 335, 182 P2d 182. This rule is substantially the same as the first sentence of CC §1657, which governs contracts in general: "If no time is specified for the performance of an act required to be performed, a reasonable time is allowed." See 1 Witkin, Summary of California Law, *Contracts* §762 (10th ed 2005).

The performance most frequently governed by Com C §2309(1) will be delivery by the seller, although the "reasonable time" standard also may apply to the buyer's cooperation on delivery, such as a notification that the buyer is ready to receive the goods or to dispatch a vehicle to pick up the goods. See *Woodbine v Van Horn* (1946) 29 C2d 95, 173 P2d 17. In addition, a contract that contains imprecise or conflicting time terms may be construed using Com C §2309(1) to require performance at or within a reasonable time. See, *e.g., Kelley-Clarke Co. v Leslie* (1923) 61 CA 559, 215 P 699. Rarely will Com C §2309(1) apply to the time for payment, which ordinarily is related to the time of receipt or delivery. See Official Comment 2 to UCC §2-309. See also §§10.52-10.58.

If the time for performance is "agreed on," either expressly or impliedly through usage of trade, course of dealing, or course of performance, the "reasonable time" standard will not apply. See Official Comment 1 to UCC §2-309. If an agreed time term is nullified by waiver, however, the time for performance will be a "reasonable time." See Official Comment 5 to UCC §2-309.

An agreement regarding time may be reached separately from the main agreement. See Official Comment 2 to UCC §1-302. Any agreed time is enforceable unless it is "manifestly unreasonable." Com C §1302(b). Reasonableness is judged as of the time of contracting. Official Comment 1 to UCC §1-302.

The type of performance required, the nature of the goods subject to the contract, the extent of the performing party's knowledge of the other party's needs, transportation conditions, and market conditions are relevant in determining what time is reasonable. See *Anderson & Nafziger v GT Newcomb, Inc.* (Idaho 1979) 595 P2d 709, 715; Official Comment 1 to UCC §2-309. In addition, what is a reasonable time for taking any action depends on the nature, purpose and circumstances of such action. Com C §1205(a).

Thus, a reasonable time for delivery of growing crops may depend on when the crop is harvested, and a reasonable time for delivery of livestock may depend on when the animals have grown to the size specified in the contract or established by trade practices. See *Kuhn v Valley Meat Co.* (1937) 23 CA2d 25, 72 P2d 164; *Hougland v Roth Blum Packing Co.* (1929) 99 CA 631, 279 P 159. Similarly, a reasonable time for the delivery of harvesting machinery is likely to depend on when the buyer's purpose must be carried out, *i.e.,* when the crop is ready to be harvested. See *Kutner-Goldstein Co. v Workman* (1931) 112 CA 132, 296 P 313.

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§4.63 (1) Reasonable Notification of Proposed Time Limit

When the time of delivery is left open, the parties may have differing expectations about when it should be made. If both are silent for a long period, this tends to show a common understanding that delivery was contemplated somewhat later than usual. Thereafter, the seller cannot be considered in breach for failure to deliver unless the seller first receives "reasonable notification" that it is in default. The obligation of good faith requires that reasonable notification be given. Official Comment 5 to UCC §2-309.

A reasonable notification should set two time limits:

- **A time limit for performance.** This deadline does not have to be reasonable "in the unforeseeable judgment of a later trier of fact." See Official Comment 6 to UCC §2-309. Apart from this reference to the trier of fact, the Commercial Code and the Comments do not shed light on what is a reasonable deadline or indicate when the notification must be sent to be considered reasonable.
- **A reasonable time limit for reply to the notification.** This limit is not essential for the notification to be "reasonable," but it sets a definite time beyond which silence by the other party can be treated as acquiescence under the rule discussed in §4.64.

For a notification provision, see form 4.69-1.

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§4.64 (2) Failure to Reply as Acquiescence

A party's failure to reply to a notification of a proposed time limit for performance may establish its acquiescence in the proposal. Official Comment 6 to UCC §2-309. See *Schiavi Mobile Homes, Inc. v Gagne* (Me 1986) 510 A2d 236 (buyer's agreement to seller's proposed delivery date for mobilehome without objecting that 8 weeks had passed since contract was signed constituted acknowledgment that delivery occurred within reasonable time).

This principle of acquiescence is not expressly stated in Com C §2309; Comment 6 may have based this rule on waiver or on an analogy to the rules that make silence the equivalent of acceptance (see 1 Witkin, Summary of California Law, *Contracts* §§194-195 (10th ed 2005)). The duty to reply arises not merely on "reasonable notification" but also on "effective communication" of the time limit for performance. Thus, a party should not ignore a communication even of a time limit that has already expired or is so close to expiration that it cannot be met.

Comment 6 does not indicate whether a party's failure to reply to a counterproposal, received in response to its own proposal, establishes that party's acquiescence in the counterproposal. It is unclear whether the original proposal would be a sufficient advance statement of objection to discharge that party's duty of responding to the counterproposal.

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§4.65 (3) Tacit Extension of Time; Abandonment

If both parties let a contractually specified or reasonable time lapse in silence, without performing, the effect may be either to enlarge the time of performance or to terminate the contract by abandonment. Official Comment 5 to UCC §2-309. See *U.S. ex rel Shankle-Clairday, Inc. v Crow* (MD Tenn 1976) 414 F Supp 160, 165 (buyer's failure to terminate contract after seller's nonperformance on scheduled delivery date constituted waiver of express term; Com C §2309 required seller to deliver goods within reasonable time thereafter). If the time is extended by silence, tender of performance must be accepted without objection for lateness. See *Lyon v Goss* (1942) 19 C2d 659, 123 P2d 11. If the contract has been terminated by abandonment, neither party is required to accept later performance and neither party has the right to damages based on obligations executory on both sides at the time of the termination. See Com C §2106(3).

PRACTICE TIP: A party wishing to terminate a contract without liability on the grounds that there has been an unreasonable lapse of time without performance should be careful about assuming that there has been an abandonment of the contract by the other party. It is generally advisable in this circumstance to give written notice of a reasonable deadline for the other party's performance, specifying that, if the deadline is not met, the contract will be terminated without liability to either party for the unperformed obligations. For a suggested provision, see form 4.69-1. A party's failure to respond to such a notice will constitute acquiescence to the deadline if the deadline is reasonable (see §4.64). If the deadline is not met, the contract will be terminated.

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§4.66 (4) Unreasonably Early Offer or Demand

If the contract is indefinite regarding the time of performance, a seller's unreasonably early offer of delivery or a buyer's unreasonably early demand for delivery must be treated as a suggestion that the other party is invited to accept rather than as a final position that may create a breach. Official Comment 4 to UCC §2-309. In effect, Comment 4 states that the unreasonably early offer, order, or demand is not a repudiation, but nothing in the Commercial Code directly supports this statement.

PRACTICE TIP: Counsel cannot safely ignore the possibility that a court will consider a client's premature offer, order, or demand as a breach. To be prudent, however, the recipient's attorney should treat the premature communication not as a breach but as a proposal, to which the client risks being bound by failure to respond. See *Southern Util. v Jerry Mandel Mach. Corp.* (NC Ct App 1984) 321 SE2d 508 (buyer's failure to respond to seller's communications regarding payment bound buyer to proposed delivery and payment dates).

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§4.67 (5) Establishing Breach

A party receiving a communication of a proposed time limit apparently may not treat the communication as a breach even if it specifies an unreasonable time limit. According to Official Comment 6 to UCC §2-309, only when a party insists on undue delay or on rejection of the other party's reasonable proposal is there a question of "flat breach" under Com C §2309(1).

A receiving party that fails to reply to the communication may be held to have acquiesced to the proposal. See §4.64. If the receiving party simply rejects the proposal, that party may be held in breach if the proposal is later found to be reasonable. Therefore, unless the receiving party is confident that the proposal is unreasonable, it should couple a rejection with a reasonable counterproposal. For a suggested provision, see form 4.70-1. A conflict between proposals that are both reasonable may be resolved by the rules determining which party is entitled to choose between alternative performances. See §4.86.

If a party believes that the other party is in breach of contract, or would be committing a breach if that party's proposals or intentions were carried out, the insecure party may precipitate a showdown by demanding assurances on the ground of "insecurity." See Official Comment 6 to UCC §2-309; Com C §2609. See also §§16.2-16.18. If the party's insecurity is commercially justified and the other party fails to give reasonable assurances of due performance within a reasonable time (not exceeding 30 days), the other party may be treated as having repudiated and breached the contract. See Com C §§2609(4), 2610(b).

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b. Contract Provisions

§4.68 (1) Form: Time for Delivery

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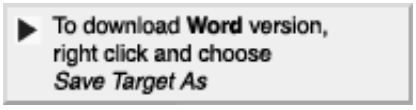
4.68-1 Time for delivery

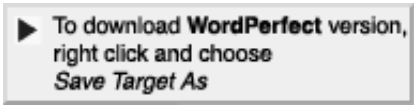
Delivery will be made on _ _[*or before*]_ _ _ _[*date*]_ _.

Comment: To avoid the problems of establishing a reasonable time for delivery under Com C §2309(1) (see §4.62), the attorney should specify a final delivery date in the contract. The optional language in this provision permits the seller to deliver on an earlier date.

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§4.69 (2) Form: Notification of Proposed Time Limit





4.69-1 Notification of proposed time limit

We propose that _ _[*describe performance, e.g., you deliver/you order delivery*]_ _ no later than _ _[*date*]_ _ under our contract dated _ _[*date*]_ _, for the _ _[*sale/purchase*]_ _ of the _ _[*describe goods*]_ _. If this time limit is not satisfactory to you, we must receive notice to that effect no later than the close of business on _ _[*date*]_ _.

[*Add if intention is to terminate without holding other party for breach*]

If we do not receive your notice by the date indicated or you do not _ _[*describe performance*]_ _ within our proposed time limit, we will consider the contract terminated without liability by either party for any unperformed obligations.

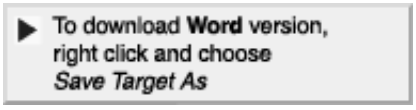
Comment: On the purpose and elements of this provision, see §§4.63-4.64. On its use in establishing breach, see §4.67. If the sending party wishes to terminate the contract without holding the other party liable for breach, the optional paragraph assures the other party that it will not risk liability by failing to reply or to meet the deadline. Termination does not affect liability, however, for obligations that have been performed on one side, such as the obligation to pay for goods already delivered. See Com C §2106(3).

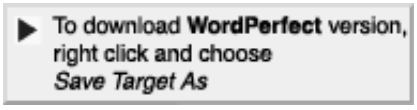
This provision gives the notification necessary to terminate the contract if the notice is "received" by the other party and the date for performance set forth in the notice is "reasonable." See Com C §2309(1), (3). See also §4.63. Unless "received" is defined in the parties' contract, notice is received when it either (a) comes to the attention of the party receiving the notice or, if the party receiving the notice is a business, (b) is duly delivered at the place of business or the place held out by the party for receipt of communications. Com C §1202(e)(1)-(2). Notice should be given in accordance with the notice clause of the contract. If the contract does not include a notice clause, notice should be hand-delivered or sent by registered or certified mail to verify its actual delivery to the party. A deadline to "notify us" would be met if the reply were simply sent, though not received, by the required date. See Com C §1202(d).

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Source: Business Law/California UCC Sales and Leases/4 Formation of Sales Contracts: Open or Indefinite Terms/ §4.70 (3) Form: Objection to Proposed Time Limit; Counterproposal

§4.70 (3) Form: Objection to Proposed Time Limit; Counterproposal





4.70-1 Objection to proposed time limit; counterproposal

In your _ _[*describe communication, e.g., letter*]_ _ **dated** _ _[*date*]_ _**, you proposed** _ _[*date*]_ _ **as the time limit for** _ _[*describe performance*]_ _ **under our contract dated** _ _[*date*]_ _ **for the** _ _[*sale/purchase*]_ _ **of the** _ _[*describe goods*]_ _**. Your proposal is** _ _[*unreasonable under the circumstances/unacceptable to us*]_ _ **for the following reasons:** _ _[*State reasons*]_ _**.**

We propose that the time limit for performance be _ _[*specify date*]_ _**. We must receive written notice from you no later than** _ _[*date*]_ _**, stating whether you assent to our counterproposal.**

Comment: This provision is a response to a notification of a proposed time limit (see form 4.69-1). The responding party avoids acquiescing to the other party's proposal through failure to reply and, by counterproposing a different time limit, avoids being held in breach for flat rejection of a "reasonable" proposal. See §4.67. On the significance of specifying that the responding party must "receive" a reply to its counterproposal, see Comment to form 4.68-1.

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E. Open Payment

§4.71 1. Delivery Not by Documents

Payment is due at the time and place at which the buyer is to receive the goods unless (a) the parties have agreed to other payment terms or (b) delivery is made by documents of title (see §§10.52-10.55). See Com C §2310. See also *Lewis v Hughes* (Md App 1975) 346 A2d 231; *Southwest Eng'g Co. v Martin Tractor Co.* (Kan 1970) 473 P2d 18. Ordinarily, the buyer does not "receive" the goods until it takes physical possession of them. Com C §2103(1)(c); Official Comment 2 to UCC §2-103 (Official Comment 8 to UCC §2-103 (2003)). If the goods have passed from the seller to a bailee, the buyer "receives" them either when it takes physical possession or when the bailee acknowledges to the buyer that it holds the goods for the buyer. Com C §2705; *Ceres, Inc. v ACLI Metal & Ore Co.* (ND Ill 1978) 451 F Supp 921.

Payment is due at the time and place of receipt of the goods, regardless of whether the contract is a "shipment" or "destination" contract. Under a shipment contract, the seller must (Com C §2504):

- Put the goods in the possession of a carrier;
- Make an appropriate contract for the safe transport of the goods;
- Tender the documents that the buyer will need to obtain possession of the goods at their destination; and
- Promptly notify the buyer that the shipment has been made.

At that point, the seller has tendered the goods, but the seller still is not entitled to payment until the goods have been received. Com C §2310. For further discussion of shipment contracts, see §§9.5-9.9. Under a destination contract, in which the goods must be delivered to the buyer, tender of the goods and payment normally will occur at the same time and place. For further discussion of destination contracts, see §§9.3, 9.48. Tender of delivery is a condition to the buyer's duty to pay in either event. Com C §2507(1). (For further discussion of tender, see §§9.44-9.50.) Likewise, tender of payment is a condition to the seller's duty to complete delivery. Com C §2511(1).

In addition, the buyer ordinarily must have a reasonable opportunity to inspect the goods before the buyer is required to pay for them. Com C §§2310(b), 2513(1). At that point, the buyer's failure to timely reject is deemed an acceptance (Com C §2606(1)(b)), and the buyer becomes obligated to pay the contract price (Com C §2607(1)).

In some situations, however, unless the parties agree otherwise, the buyer may not have the right to inspect the goods before payment is due, *e.g.,* when delivery is C.O.D. or when payment is made against documents of title. See Com C §2513(3)(a). On right of inspection generally, see §§10.3-10.18.

For further discussion of the buyer's payment obligation, see §§10.52-10.71.

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§4.72 2. Delivery by Documents of Title

If delivery is authorized and made through documents of title, payment is due regardless of where the goods are to be received (Com C §2310(c)):

- At the time and place at which the buyer is to receive delivery of tangible documents; or
- At the time the buyer is to receive delivery of electronic documents and at the seller's place of business or, if none, the seller's residence.

However, the parties may agree to other payment terms, or the seller may tender documents under Com C §2310(b), which permits the buyer to postpone payment until after inspection. Com C §2310(c). See *Frank Novak & Sons v Sommer & Maca Indus.* (Ill App 1989) 538 NE2d 700.

An example of a documentary sale is the C.I.F. (cost, insurance, freight) contract, described in Official Comment 12 to UCC §2-320 as follows:

> Under a C.I.F. contract the buyer… must pay the price upon tender of the required documents without first inspecting the goods, but his payment in these circumstances does not constitute an acceptance of the goods nor does it impair his right of subsequent inspection or his options and remedies in the case of improper delivery. All remedies and rights for the seller's breach are reserved to him. The buyer must pay before inspection and assert his remedy against the seller afterward unless the non-conformity of the goods amounts to a real failure of consideration, since the purpose of choosing this form of contract is to give the seller protection against the buyer's unjustifiable rejection of the goods at a distant port of destination which would necessitate taking possession of the goods and suing the buyer there.

See §§9.26-9.36 for discussion of C.I.F. contracts.

A contract for a documentary sale can be modified to permit inspection by the buyer before payment is due (*e.g.,* the contract could call for payment "on arrival of the goods"). With this type of modification, the seller is obligated to permit "such preliminary inspection as is feasible" before payment will be required. See Com C §2321(3); Official Comment 4 to UCC §2-310. The parties sometimes provide for third party inspection as the goods are loaded as a means of protecting the buyer who must pay against documents before the goods arrive.

On documents of title generally, see chap 15.

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§4.73 3. Shipments Under Reservation

When a shipment is made under reservation (see Com C §2505), the place of payment is determined by the tender of the documents, but the time for payment is determined by the buyer's inspection of the goods. Unless the reservation shipment is under a contract that affirmatively requires payment before inspection, the buyer may defer payment until the goods have arrived and the buyer has had an opportunity to inspect them. Com C §2310(b). See Official Comment 3 to UCC §2-310. Even a buyer who is contractually required to pay before inspection need not "accept" the goods until after inspection. Com C §2512(2). See §§9.13, 10.8.

A seller shipping under reservation may collect through a bank by a sight draft against an order bill of lading "hold until arrival; inspection allowed." Official Comment 2 to UCC §2-310. A sight draft is one payable at, or a stated number of days after, sight (*i.e.,* presentment to the drawee). If a draft accompanying documents of title calls for payment more than three days after presentation, the buyer may be able to obtain the documents, and thus the goods, in exchange for the buyer's acceptance of the draft, *i.e.,* for a written promise to pay rather than payment itself. Com C §2514.

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§4.74 4. Delivery in Lots

The contract or circumstances may authorize or require the seller to deliver the goods in installments or lots. See Com C §2307. If the price can be apportioned, a payment may be demanded for each lot. Com C §2307. The place and time for payment are determined as if each delivery were a separate sale. See *Kunian v Development Corp. of Am.* (Conn 1973) 334 A2d 427. The price may be apportioned even if the parties have not done so in the contract, if there is at least a rough basis for calculating a per-unit price. See Official Comment 2 to UCC §2-612.

A contract that authorizes or requires delivery in lots is considered to be an installment contract regardless of whether the price can be apportioned. See Com C §2612(1).

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§4.75 5. Agreement About Other Payment Terms

The parties may agree to payment terms that differ from those provided in Com C §2310. See §10.55. For example, they may agree (a) that payment is due before or at the time of delivery or shipment or (b) to the extension of credit. Agreement regarding other terms may be inferred from course of performance, course of dealing, or usage of trade as well as from express contractual terms. See *Cooper Alloy Corp. v E.B.V. Sys.* (RI 1973) 306 A2d 837 (usage of trade established that payment was due before delivery); *Frank Novak & Sons v Sommer & Maca Indus.* (Ill App 1989) 538 NE2d 700 (course of dealing established that payment was not due until buyer's receipt of seller's invoice).

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§4.76 6. Payment on Credit

If the seller ships the goods under an agreement that the price will be paid within a certain period and the agreement does not specify when the credit period begins, the credit period is measured from the latest of three dates: (1) the date of actual shipment, (2) the date of invoice, or (3) the date of actual dispatch of the invoice. See Com C §2310(d). The date on which the buyer receives the goods does not affect the credit period except, perhaps, if the shipment is so delayed that the period expires before the goods are received. See Official Comment 1 to UCC §2-310.

The Commercial Code's policy is based on a "common commercial understanding that an agreed credit period runs from the time of shipment" and that the invoice date is a representation of that time. Delay in sending the invoice extends the period so that the buyer is assured full notice of the due date. See Official Comment 5 to UCC §2-310.

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7. Forms

§4.77 a. Form: Time for Payment

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4.77-1 Alternative: Single delivery and payment

Buyer will pay the price within _ _[*specify number of days*]**_ _ after Buyer is notified that the _ _**[*describe goods*]**_ _ are available at _ _**[*address*]**_ _ for Buyer to inspect and take possession of them.**

4.77-2 Alternative: Each lot paid for as delivered

Buyer will pay _ _[*e.g., _ _*[*number*]**_ _** *percent of the price/the proportionate share of the price for the goods delivered/_ _*[*dollar amount*]**_ _]_ _ within _ _**[*specify number of days*]**_ _ after Buyer is notified that an installment delivery of the _ _**[*describe goods*]**_ _ is available at _ _**[*address*]**_ _ for Buyer to inspect and take possession of them.**

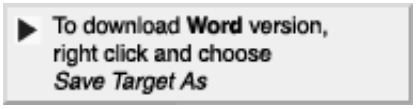
Comment: This provision assures the buyer that the credit period will not begin to run until the buyer has been notified that the goods are available for inspection and claim.

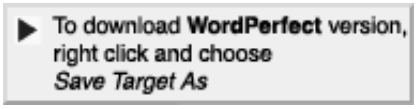
On payment for each lot when delivery is in installments, see Com C §2307. See also §§10.70-10.71.

If payment will be made in exchange for documents, the attorney should specify these documents in the contract. See §§9.13, 9.71-9.77.

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§4.78 b. Form: Right of Inspection Reserved by Buyer





4.78-1 Right of inspection reserved by buyer

Buyer reserves the right to inspect the goods before paying for them, without regard to the manner of shipment or the fact that the goods are shipped by Seller under reservation.

Comment: When the contract provides for payment against documents of title or for delivery C.O.D., the buyer has no right of inspection before payment unless the parties otherwise agree. This provision preserves the buyer's right to inspect the goods before payment.

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F. Open Duration

§4.79 1. Contract Valid for Reasonable Time

If a sales contract provides for successive performances but is indefinite in duration, the contract is valid for a reasonable time; however, unless otherwise agreed, it may be terminated at any time by either party. Com C §2309(2). See *Unterberger v Red Bull N. Am., Inc.* (2008) 162 CA4th 414, 75 CR3d 368 (contract to distribute energy drink in Caribbean was of indefinite duration and thus was terminable at will; plaintiff offered no evidence that parties agreed arrangement could only be terminated for good cause); *Varni Bros. Corp. v Wine World, Inc.* (1995) 35 CA4th 880, 890, 41 CR2d 740 (when "contract provides for successive performances but is indefinite in duration it is valid for a reasonable time but unless otherwise agreed may be terminated at any time by either party").

The reasonable time during which the contract is valid depends on the circumstances. If the contract is part of an active distributorship or other arrangement that the parties regard as permanent, the contract could remain valid indefinitely. See Official Comment 7 to UCC §2-309. The courts may construe the "reasonable time" of validity as continuing until the contract would be considered terminated by abandonment. See Official Comment 5 to UCC §2-309. See also §§4.63, 4.65.

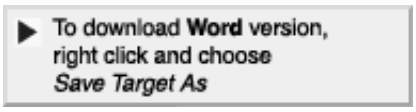
A contract is "indefinite in duration" if it fails to specify a termination date or an inevitable and nonwaivable event on which the contract will be terminated. See *Bradner v Vasquez* (1951) 102 CA2d 338, 227 P2d 559 (contract duration measured by life of contracting party); *Copylease Corp. of Am. v Memorex Corp.* (SD NY 1975) 403 F Supp 625, 632 (applying California law; contract could be renewed indefinitely if minimum purchases were made; purchase requirement made duration definite).

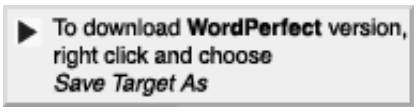
A provision that gives a party the power to terminate the contract does not make the contract one of definite duration, because the power may never be exercised. Furthermore, a contract that is terminable at the will of either party still requires that reasonable notice be given before termination. Com C §2309(3). See *Khoury v Maly's of Cal., Inc.* (1993) 14 CA4th 612, 17 CR2d 708 (although buyer did not allege specific duration of agreement, buyer's allegations were sufficient to plead cause of action for breach when seller terminated contract without reasonable notice). In contrast, a provision giving a date after which the assent of both parties would be required to extend the contract puts a definite limit on duration.

Only contracts that are both indefinite in duration and that provide for "successive performances" are subject to termination at any time by either party. Com C §2309(2). If a requirements contract (see §§4.22-4.38), output contract (see §§4.39-4.47), or exclusive dealing arrangement in the form of a sales contract (see §§4.48-4.55) is indefinite in duration, it is governed by Com C §2309(2). An installment sales contract that is indefinite in duration is likewise governed by Com C §2309(2). Despite the indefiniteness of a contract's duration, if it is for the sale of a definite quantity of goods, Com C §2309(2) may not apply. *Copylease Corp. of Am. v Memorex Corp., supra*. If Com C §2309(2) does not apply to the contract, the Commercial Code regulates duration by requiring only that the time for performance be a reasonable time. Com C §2309(1). See §4.62.

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§4.80 2. Form: Duration of Contract





4.80-1 Alternative: Definite duration

This contract will continue _ _[*until* _ _[*date*]_ _*/for a period of* _ _[*specify term*]_ _ *after the date of its execution*]_ _**.**

[*Add if subject to earlier termination*]

unless terminated sooner in accordance with paragraph _ _[*number*]_ _**.**

4.80-2 Alternative: Indefinite duration

This contract will continue until terminated in accordance with paragraph _ _[*number*]_ _**.**

Comment: This provision can be used to make the duration of the contract definite or to limit the circumstances under which it can be terminated if its duration is indefinite. Unless otherwise agreed, a contract of indefinite duration may be terminated at any time by either party. Com C §2309(2). See form 4.82-1.

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§4.81 3. Power to Terminate

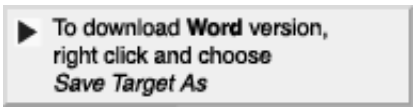
The power to terminate a sales contract can be created by agreement or by law. Com C §2106(3). The power to terminate also may be limited or negated by agreement (see, *e.g., Besco, Inc. v Alpha Portland Cement Co.* (5th Cir 1980) 619 F2d 447 (power to terminate conditioned on occurrence of one of two events)) or prohibited or limited by law. For instance, state franchise and specialized dealership laws may prohibit termination of contracts without cause. See, *e.g.,* Bus & P C §§20020-20021 (franchises), 20999.1 (gasoline dealerships or petroleum distributorships). An agreement limiting or negating the power to terminate may be found from course of dealing, course of performance, usage of trade, or surrounding circumstances. See Com C §1303. See also *Jack Rowe Assocs. v Fisher Corp.* (9th Cir 1987) 833 F2d 177 (evidence of oral promise concerning "for cause" termination admissible).

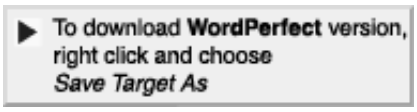
Either party to a sales contract calling for successive performances that is indefinite in duration may terminate the contract at will at any time unless otherwise agreed. Com C §2309(2). As long as adequate notice is given (see Com C §2309(3)), the Commercial Code permits a termination for any reason—even an arbitrary one. *Corenswet, Inc. v Amana Refrigeration, Inc.* (5th Cir 1979) 594 F2d 129. See also *Kolling v Dow Jones & Co.* (1982) 137 CA3d 709, 187 CR 797.

California courts, however, may limit the power to terminate an indefinite sales contract by imposing the pre-Code principle that a contract silent about duration must be in effect for a reasonable amount of time before it can be terminated. See *Aronowicz v Nalley's, Inc.* (1972) 30 CA3d 27, 106 CR 424 (exclusive distributor's abrupt termination of contract before it performed any distribution activities and after manufacturer had relied to its detriment violated principle that contract must be in effect for reasonable period before it is terminable).

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§4.82 4. Form: Power to Terminate





4.82-1 Power to terminate

_ _[*Either party/Buyer/Seller*]_ _ **may terminate this contract at will at any time on** _ _[*number*]_ _ **days' notice to the other party.**

Comment: This provision establishes a minimum period for notice of termination but does not limit the right of termination. Unless the minimum period is "manifestly unreasonable," it should be enforceable. See Com C §1302(b). Including the term "at will" or other language indicating a right to terminate without cause may be important to preclude the use of parol evidence to establish that termination for cause is required. See *Jack Rowe Assocs. v Fisher Corp.* (9th Cir 1987) 833 F2d 177. See also §§7.38-7.40.

This provision should be used in conjunction with a notice provision that specifies the procedure for giving notice and states when notice is considered to be received. The Commercial Code definitions of "gives" and "receives" notice may be incorporated into the contract but should be coordinated with any "boilerplate" notice provision. See Com C §1202(d)-(e).

The power of termination can be limited or conditioned on the passage of time, the occurrence of events, breach of the contract, or failure to perform covenants in the contract. For example, a distribution contract might provide that the manufacturer may not terminate unless the distributor (1) fails to cure a breach of the contract within a stated cure period or (2) fails to purchase a minimum quantity of goods within a certain period. The power to terminate may also be conditioned on the payment of a stated amount to compensate the nonterminating party for an estimated loss. See CC §1671; 1 Witkin, Summary of California Law, *Contracts* §§533-536, 540-541 (10th ed 2005).

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§4.83 5. Notice of Termination

Under Com C §2309(3), no party may terminate a sales contract unless:

- Reasonable advance notification of the termination is received by the other party;
- Notice of termination is given in accordance with the contract, and the contract provision is not manifestly unreasonable (Com C §1302(b)); or
- The contract dispenses with notification, and the operation of that provision is not unconscionable.

Section 2309 regulates the termination of all sales contracts, not just contracts of indefinite duration within the scope of Com C §2309(2).

Whether a notification of termination is reasonable depends on whether the notifying party has acted in good faith (Com C §1201(b)(20)) and whether the period between notice and termination is reasonable in view of the "nature, purpose and circumstances" of the termination (Com C §1205(b)). The Commercial Code Comments suggest only one specific test of reasonableness: The notification must "give the other party reasonable time to seek a substitute arrangement." See Official Comment 8 to UCC §2-309. Compare *Aronowicz v Nalley's, Inc.* (1972) 30 CA3d 27, 106 CR 424 (abrupt termination by exclusive distributor unreasonable when seller had no alternative means of distribution in place), with *Circo v Spanish Gardens Food Mfg. Co.* (WD Mo 1985) 643 F Supp 51 (conversation regarding changes almost one year before actual termination of distributorship agreement was adequate notice).

Under some circumstances, the nonterminating party may not be able to obtain a substitute arrangement; the reasonableness of the notice then may depend on whether that party is given a reasonable opportunity to liquidate supplies or inventory on hand that cannot be used in another venture. Compare *Superior Foods v Harris-Teeter Super Markets* (NC 1975) 217 SE2d 566 (termination reasonable because supplier was given opportunity to sell all unused packaging materials to new supplier), with *Pharo Distrib. Co. v Stahl* (Ky Ct App 1989) 782 SW2d 635 (six-day notice of termination of beer distributorship unreasonable as matter of law; terminated party not given opportunity to disperse inventory, adjust its work force, and explore probable alternatives).

Other circumstances can make the termination notice reasonable even though the notice period is short. For example, the terminating party may offer to purchase leftover packaging materials, supplies, or inventory. See *Superior Foods v Harris-Teeter Super Markets, supra*.

A contract may give one party an option to renew or to extend the contract's duration without the other's consent. The exercise of such an option requires reasonable notice. See *R.L. Pohlman Co. v Keystone Consol. Indus.* (ED Mo 1975) 399 F Supp 330. It is unclear whether a decision not to exercise the option would be considered a termination requiring reasonable notification under Com C §2309(3).

The parties can agree on the manner of giving the notice of termination. In the absence of an agreement to the contrary, the notice does not have to be in writing (*Circo v Spanish Gardens Food Mfg. Co.* (WD Mo 1985) 643 F Supp 51; Com C §1202(d)), but it must be received by the nonterminating party. The Commercial Code's definition of "receives" puts the communication risk on the terminating party. See Com C §1202(e). To shift this risk, the attorney may draft the contract to require that the notice be in writing.

The parties may agree to dispense with notification of termination unless the "operation" of such a provision would be unconscionable. Com C §2309(3). The term "operation" suggests that a court will examine the circumstances existing at the time of the purported termination to decide whether lack of notice was unconscionable. Some courts, however, have examined the unconscionability of provisions dispensing with notice as of the time the contract was made. See *Pennsylvania Tire Co. v Firestone (In re Pennsylvania Tire Co.)* (Bankr ND Ohio 1982) 26 BR 663 (termination of ten-year distributorship without notice upheld); *Sinkoff Beverage Co. v Schlitz Brewing Co.* (App Div 1966) 273 NYS2d 364 (termination of exclusive distributorship upheld). This analysis is consistent with UCC §2-302(1), which permits courts to invalidate a contract provision that was "unconscionable at the time it was made." (Although UCC §2-302(1) was not enacted as part of the Commercial Code in California, an identical statute was subsequently adopted in California as CC §1670.5.) If a provision dispensing with notice is held invalid, reasonable notification of

termination is required.

A contract provision that permits only one party to terminate at any time with little or no notice may lack mutuality of obligation even if the provision is not manifestly unreasonable or unconscionable. Including a reasonable notice period or conditioning termination on the occurrence of certain events, however, should remedy the mutuality issue. See 1 Witkin, Summary of California Law, *Contracts* §§234-235 (10th ed 2005).

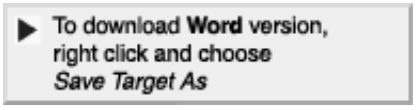
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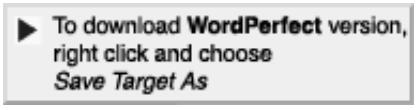
§4.84 6. Automatic Termination on Occurrence of Agreed Event

"Termination of a contract by one party except on the happening of an agreed event" requires reasonable notification. Com C §2309(3). Although this language seems to create an exception to the notice requirement whenever an agreed event gives a party the power or option to terminate, the exception probably only applies to a termination that automatically results when the agreed event occurs. According to Official Comment 10 to UCC §2-309, "event" is used in contrast with "option" or the like. The purpose of the notification requirement is to ensure communication of a party's decision to terminate. If termination results from the occurrence of the event itself, there is no decision to be communicated. See *Bradner v Vasquez* (1951) 102 CA2d 338, 227 P2d 559.

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§4.85 7. Form: Automatic Termination





4.85-1 Automatic termination

This agreement will terminate automatically, and without notice, on the occurrence of any of the following events:

(1) An assignment for the benefit of creditors by either party; application by either party for, or consent to the appointment of, a receiver with respect to any substantial part of the party's assets; appointment of a receiver; or an attachment or execution levied with respect to any substantial part of the assets of either party if the appointment is not vacated, or the attachment or execution is not released, within 30 calendar days after the date of appointment or levy;

(2) Commitment by Buyer or any principal of Buyer of any crime involving moral turpitude, dishonesty, fraud, or other act that adversely affects the business reputation of Buyer or Seller; or

(3) _ _[*Describe other events*]_ _.

Comment: This provision dispenses with notice as permitted by Com C §2309(3) and provides for automatic terminations on the occurrence of certain events. The Bankruptcy Code may prevent the enforcement of subparagraph (1). See 11 USC §§365(e), 541(c).

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G. Particulars of Performance Left to One Party

§4.86 1. Overview

If an agreement is definite enough under Com C §2204(3) to be a valid sales contract (see §2.2), the agreement is not invalidated by the fact that it leaves particulars of performance to be specified by one of the parties. Com C §2311(1). A party may obtain this power from express contract terms, course of dealing, usage of trade, or by implication from the circumstances. Official Comment 1 to UCC §2-311. The power to specify particulars of performance also may be provided by the open term provisions of the Commercial Code (Com C §2311(2)) or non-Code law (Com C §1103(b); CC §§1448-1451).

A party's specification of particulars of performance must "be made in good faith and within limits set by commercial reasonableness." Com C §2311(1). Commercial reasonableness requires that specification be "in accordance with commercial standards so that there is no surprise" to the other party. Official Comment 1 to UCC §2-311. If specification remains within these limits, some contracts that would have been void for uncertainty under pre-Code law may be held to present a sufficiently definite basis for enforcement to be valid under Com C §§2204(3) and 2311(1).

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§4.87 2. Quantity

A sales contract must include a quantity term, and a contract will not be enforced beyond the quantity of goods stated in the contract. Official Comment 1 to UCC §2-201. To leave quantity open for specification, a sales contract either may state a minimum and maximum or may insert "about," "more or less," or other language of approximation. See *Peterson v Chaix* (1907) 5 CA 525, 90 P 948. These approximations permit reasonable variation from the stated quantity. In their absence, the exact quantity specified in the contract must be purchased and sold.

NOTE: Amendments to Division 2 in 2003 added the following comment about the quantity term: "A term indicating the manner by which the quantity is determined is sufficient" (Comment 1 to UCC §2-201 (2003)). To date, however, neither California nor any other state has adopted the 2003 amendments to Division 2.

The Commercial Code states which party may specify particulars of assortment (the buyer) and shipment (the seller) (Com C §2311(2); see §§4.88-4.89) but is silent about which party may specify quantity and other particulars. Non-Code law therefore applies. Com C §1103(b). Under CC §1448, the party who is required to perform one of two alternative acts may choose between them unless otherwise agreed. See also CC §§1450-1451. Accordingly, the seller is usually considered to have the right to decide, within the permissible range of variation, the quantity that will be delivered. *New York Oversea Co. v Warfield-Pratt-Howell Co.* (1925) 70 CA 724, 234 P 405. However, if the open-quantity term is intended to accommodate the buyer (*e.g.,* if the buyer's storage capacity is uncertain at the time of contracting), the right to select the exact quantity belongs to the buyer. *Douglas Fir Exploitation & Export Co. v Comyn* (9th Cir 1922) 279 F 203, 208 (concurring opinion of Creswell, J.).

The choice of quantity, like other specifications of particulars, must be made in good faith and within the limits of commercial reasonableness. Com C §2311(1). See Official Comment 1 to UCC §2-311.

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§4.88 3. Assortment

Assortment of goods means (a) description of each item by, *e.g.,* size, color, grade, and style and (b) statement of the number of each kind making up the whole quantity being sold. Usually assortment determines total price because each size or grade often carries a different unit charge. Recognizing that assortment is usually more important to the buyer, the Commercial Code provides that specifications relating to assortment are at the buyer's discretion unless otherwise agreed. Com C §2311(2).

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§4.89 4. Shipping Arrangements

Unless otherwise agreed, specifications or arrangements relating to shipment are at the seller's discretion. Com C §2311(2).

Because assortment is at the buyer's option (see §4.88), shipping must be distinguished from assortment. Packaging of the goods may be a shipping specification if its function is protection during shipment, but packaging may be an assortment specification if its function is to serve the buyer's purposes after the buyer receives the goods. The functions of specifying assortment and shipment may both be allocated by express or implied agreement. See Official Comment 2 to UCC §2-311; Com C §1302(c).

Responsibility for shipping specifications may also depend on whether the contract is a "destination" or "shipment" contract (see §9.3) or is made under one of the mercantile shipment terms (see §§9.15-9.43).

Under a destination contract, the seller has complete responsibility for delivering the goods to their destination; if the goods arrive at the agreed time and place, the seller's means of getting them there is presumably not the buyer's concern.

Under a shipment contract, the seller must deliver the goods to a carrier, but the arrangements and circumstances under which the seller does so may affect the transportation charges and the risk of loss in transit, which are borne by the buyer. Despite this exposure of the buyer's interests, the buyer has no responsibility for shipment specifications under the Commercial Code, unless the contract calls for F.A.S. (free alongside) or F.O.B. (free on board) vessel; the buyer then must give necessary instructions on the name, loading berth, and sailing date. See Com C §§2311(2), 2319(1)(c), (2)(a), (3). See also §§9.16-9.25. Otherwise, the seller has the right and duty to decide on and make reasonable shipping arrangements. Com C §§2311(2), 2504. See §§9.5-9.9.

For further discussion of shipping and delivery, see chap 9.

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§4.90 5. Failure to Specify Particulars or to Cooperate

A party entitled to specify particulars of performance must communicate those specifications in time for the other party to perform. For example, a buyer entitled to specify assortment must notify the seller of the selection far enough in advance of the delivery date to enable the seller to fill the order within the agreed time. *Charles Boldt Co. v Julius Levin Co.* (1919) 41 CA 661, 183 P 200. This duty is an application of the implied contractual obligation to give the other party the cooperation necessary for its performance. See *Citron v Franklin* (1943) 23 C2d 47, 142 P2d 16; 1 Witkin, Summary of California Law, *Contracts* §851 (10th ed 2005).

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§4.91 a. Responses to Noncooperating Party

A party whose performance is materially affected by the other party's failure to specify details of performance or any other failure to cooperate may request that information or cooperation and delay its performance until it is provided. See Com C §2311(3)(a); Official Comment 3 to UCC §2-311; *Precise Tool & Gage Co. v Multiform Desicants, Inc. (In re Precise Tool & Gage Co.)* (ED Tenn 1984) 42 BR 677.

This right to delay performance exists in addition to all other remedies. Com C §2311(3). Thus, the affected party may also demand adequate assurances of the other party's performance. See Official Comment 3 to UCC §2-311; Com C §2609. See also §§16.2-16.18.

Alternatively, the party whose performance is materially affected may perform in any commercially reasonable manner. Com C §2311(3)(b). See Official Comment 3 to UCC §2-311. For example, if a buyer fails to specify the assortment of the goods the buyer wants to purchase, the seller may make up a commercially reasonable assortment and tender delivery.

Instead of making an inquiry, demand, or tender of performance to the noncooperating party, the aggrieved party may simply wait until the time has elapsed for a material part of its own performance and then treat the other party's failure to cooperate as a breach. Com C §2311(3)(b). A buyer who has failed to cooperate may be treated as if the buyer had refused to accept the goods, and a seller who has failed to cooperate may be treated as if the seller had not delivered.

NOTE: The limitation that the aggrieved party must wait until after the time for a material part of its own performance has elapsed is apparently intended to prevent the aggrieved party from putting the other party in breach before the aggrieved party suffered any prejudice. The delay also gives the other party an opportunity for second thoughts.

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§4.92 b. Exception for Commercial Impracticability

The rights and remedies given to a party when the other party fails to specify particulars of performance or to cooperate are displaced in certain situations (see Com C §2614):

- If, without the fault of either party, the agreed shipping facilities become unavailable or the agreed manner of delivery becomes commercially impracticable, but a commercially reasonable substitute is available, the substitute must be tendered and accepted. Com C §2614(1).
- If a party is contractually obligated to furnish agreed shipping or delivery facilities and cannot do so because the facilities are unavailable or using them is impracticable, the party is not subject to the consequences of Com C §2311(3) for failure to cooperate as long as it furnishes a commercially reasonable substitute. Even if the party obligated to furnish facilities fails to produce a substitute, the other party is presumably not entitled to invoke §2311(3) if that party could have suggested or proffered a substitute but failed to do so. For example, under an F.O.B. vessel contract, if the vessel specified by the buyer is unavailable and the buyer fails to specify a substitute, the seller may be required to suggest a substitute vessel before the seller can treat the buyer as being in breach for noncooperation under Com C §2319(3). See Official Comment 4 to UCC §2-311.
- If the seller's agreed performance becomes commercially impracticable and no substitute is available, the contract may be terminated or modified by the buyer. See Com C §§2615-2616. The same principles operate if the buyer's performance becomes impracticable. See §§16.60-16.78.

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§4.93 6. Form: Procedure for Specification of Particulars of Contract Provisions

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4.93-1 Specification of particulars

The parties agree to leave certain particulars of performance to be specified as follows:

(1) Seller will specify _ _[*e.g., the quantity of the* _ _[*describe goods*]_ _ *to be delivered/the timing of deliveries of the* _ _[*describe goods*]_ _]_ _ **and will make the specification(s) by** _ _[*e.g., notifying Buyer no later than* _ _[*number*]_ _ *days before the date for delivery*]_ _**.**

(2) Buyer will specify _ _[*e.g., the assortment of sizes/colors/grades/styles*]_ _ **of the** _ _[*describe goods*]_ _ **ordered and will notify Seller of Buyer's specifications no later than** _ _[*e.g.,* _ _[*number*]_ _ *days before the date for delivery*]_ _**.**

[*Add if seller will specify a time period and buyer will specify a definite time for delivery*]

Delivery will occur during a period of at least _ _[*e.g., two weeks*]_ _**, beginning no earlier than** _ _[*date*]_ _ **and ending no later than** _ _[*date*]_ _**. No later than** _ _[*days/hours*]_ _ **before the delivery is to be made, Buyer will specify the times for delivery within this period and the quantity of each delivery.**

[*Continue*]

If either party fails to receive a notice specifying required details of performance from the other party, it will notify the other party and the other party will have _ _[*number*]_ _ **days to supply the required information. The other party will not be held in default under California Commercial Code §2311(3) for failure to give the notice specifying details of performance until after that party fails to do so in response to the notice requesting the required information.**

Comment: This provision leaves certain particulars of performance to be specified by one party. See Com C §2311(1). The suggested examples leave quantity to be specified by the seller (see §4.87) and assortment to be specified by the buyer (see §4.88) but limit the time and manner of specification.

The optional paragraph of the provision is intended to alleviate the problem raised by perishable crops when the buyer (*e.g.,* a packer or canner) wants to regulate the time and rate at which it takes delivery, but the seller-grower wants to confine deliveries to the limited period during which the crop is ripe but not yet spoiled.

The requirement that the other party must be notified when the notice of specification is not received relieves both parties of risks of default through inadvertence or communication failure. On giving and receiving notice, see Com C §1202(d)-(e). The parties may include in their contract a procedure for giving notice and for determining when notice is considered to be received.

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III. COURSE OF PERFORMANCE, COURSE OF DEALING, AND USAGE OF TRADE

§4.94 A. General Principles

Parties to commercial agreements generally contract without specific reference in their agreement to their prior course of dealing or to the customs and usages of their trade. If the parties have an ongoing business relationship, a large part of their "contract" for a given transaction may simply be understood from previous dealings. From the parties' point of view, it would be an unnecessary waste of time to draft a formal written agreement each time there is a sale of goods between them. Likewise, the parties may neglect to mention in the agreement regularly observed customs of dealing in their trade.

Because the Commercial Code recognizes these commercial realities, it makes evidence of course of performance (*i.e.,* the parties' conduct in performing their contract), course of dealing (*i.e.,* the parties' prior dealings with each other), or usage of trade (*i.e.,* regularly observed trade practices) freely admissible when offered to explain or supplement the express terms of a written agreement. See *Nanakuli Paving & Rock Co. v Shell Oil Co.* (9th Cir 1981) 664 F2d 772 (applying Hawaii law). Such evidence is admissible even when the writing is a complete and exclusive statement of the terms of the transaction. See Com C §2202; Official Comment 2 to UCC §2-202. Course of performance, course of dealing, and usage of trade may also evidence the parties' understanding that the open terms of their agreement would not be filled by otherwise applicable Commercial Code provisions. On the priority of sources of missing terms, see §4.104. On course of performance, course of dealing, and usage of trade as they relate to parol evidence rule, see §§7.42, 7.48.

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B. Course of Performance

§4.95 1. Effect on Contract

If the parties operate under a sales contract for a period of time, their course of performance is regarded as an excellent guide to the meaning of any unclear terms and as relevant to their intent in matters left open by the contract. Com C §1303(d). A single act cannot establish a course of performance; there must be repeated occasions of conduct (Official Comment 4 to UCC §2-208) that are accepted or allowed with knowledge and an opportunity to object. See *Nanakuli Paving & Rock Co. v Shell Oil Co.* (9th Cir 1981) 664 F2d 772 (applying Hawaii law). See also *Comerica Bank v Whitehall Specialties Inc.* (CD Cal 2004) 352 F Supp 2d 1077 (buyer's receipt of invoices containing forum selection clause without objection over period of time created agreement about where disputes would be litigated).

Course of performance may also function as a modification or waiver. Com C §1303(f). See chap 6 for discussion of modification and waiver.

PRACTICE TIP: The attorney should advise clients of the effect of their conduct and ensure that the course of performance of a long-term sales arrangement is periodically reviewed. If there have been deviations from the original contract terms, the attorney and client should consider a clarification by supplemental agreement. Alternatively, the parties may agree at the outset that their course of performance will not modify or waive contractual terms and that any modification or waiver must be made in a separately signed writing. See also Com C §2209.

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2. Forms

§4.96 a. Form: Exclusion of Course of Performance

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4.96-1 Exclusion of course of performance

Any modification or waiver of any term of this contract must be made in a writing separately signed by the parties. No modification or waiver may occur through performance only.

Comment: Unless the parties provide otherwise in their contract, their manner of performance will be a source of implied agreement regarding missing or indefinite contractual terms. The course of performance will also provide evidence of how the parties interpreted their contract and may show their agreement to modify or disclaim certain of its terms.

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§4.97 b. Form: Sample Seller's Notice of Objection to Buyer's Course of Performance

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4.97-1 Objection to course of performance

_ _[*Date*]_ _

ABC Co.
_ _[*Address*]_ _
Dear Sir or Madam:

Please refer to the contract between us dated _ _[*date*]_ _, specifically to paragraph _ _[*number*]_ _, providing that all invoices are on a 2-percent ten, net-30 basis. We note that you have been taking the 2-percent cash discount even though none of your payments has been made within ten days of the invoice date and that many of your payments have been made after the maximum 30-day credit period. We are willing to waive your past infractions, but we object to this course of performance and refuse to accept it as a further waiver or as a modification of any term of the contract. From now on, we will require payment strictly in accordance with the contract. If you take any unauthorized cash discounts, we will treat that conduct as a breach of our agreement.

Very truly yours,

__[*Signature*]__
_ _[*Typed name*]_ _
XYZ Corporation

Comment: A notice such as this acts as both an objection to a course of performance, nullifying its effect (Com C §1303(a)(2)), and a notification that, despite an apparent waiver, strict performance will be required in the future (Com C §2209(5); see §§6.2-6.8, 6.12-6.18).

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C. Course of Dealing

§4.98 1. Effect on Contract

Course of dealing is the sequence of conduct by the parties toward each other before entering into an agreement, from which a common basis of understanding can be inferred to give the agreement particular or added meaning or to supply omitted or indefinite terms. Com C §1303(b). In giving this weight to course of dealing, the Commercial Code recognizes that merchants who deal with each other on a regular and continuing basis frequently enter into abbreviated contracts that expressly refer to earlier arrangements or that omit many terms or performance standards of the current contract in reliance on past dealings. See Official Comment 2 to UCC §1-303.

Course of dealing is like course of performance in that it examines the parties' conduct to ascertain their contractual understanding. Course of performance refers to earlier performance on an installment contract, while course of dealing refers to performance of contracts between the same parties. Although previous course of dealing supersedes any inconsistent usage of trade (Com C §1303(e)(3)), it may be superseded by the parties' later contrary course of conduct in performing the agreement (Com C §1303(e)(2); see §4.104).

Course of dealing cannot affect a contract unless it has been "between the parties." Com C §1303(b). Course of dealing evidence may supplement the parties' agreement by providing evidence of the parties' intentions, but it should not be used to create an agreement. *Expeditors Int'l, Inc. v Official Creditors Comm. of CFLC, Inc. (In re CFLC, Inc.)* (9th Cir 1999) 166 F3d 1012 (applying California or Washington law; UCC provisions identical in both states). However, a shipper's receipt of 47 invoices for 47 separate transactions over a 3-year period was sufficient to constitute a course of dealing and put the shipper on notice of the terms and conditions contained in the invoices; therefore, the court interpreted the oral agreement of the parties to include the provision in the invoice limiting the carrier's liability to $50 per shipment, even though the invoice for the particular shipment did not arrive until after the theft of the shipment. *Insurance Co. of N. Am. v NNR Aircargo Serv. (USA), Inc.* (9th Cir 2000) 201 F3d 1111 (applying California law).

For further discussion of course of dealing, see §§3.41 (warranties), 7.42, 7.48 (parol evidence rule).

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§4.99 2. Form: Incorporation or Exclusion of Course of Dealing

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4.99-1 Alternative: Course of dealing incorporated

The terms of this contract will be interpreted, supplemented, and qualified by the parties' course of dealing with each other in previous transactions.

4.99-2 Alternative: Course of dealing excluded

This contract will not be modified, supplemented, qualified, or interpreted by any prior course of dealing between the parties.

Comment: If one of the parties wishes to deviate from a prior arrangement (such as the extension of credit or the place of delivery) or to alter or formalize the standards for performance of any terms, the attorney should consider using the second alternative, which expressly excludes from the contract the effect of the parties' course of dealing. See Official Comment 2 to UCC §1-303. If the contract does not contain such an exclusionary clause, the court may admit evidence of a prior course of dealing as an aid to the contract's interpretation.

Including a general integration clause may be sufficient to exclude course of dealing as a source of additional agreement as opposed to a contract interpretation device. A court may ignore the integration clause, however, if the parties' prior practice was not to have fully integrated agreements even though those contracts included integration clauses. *Levien Leasing Co. v Dickey Co.* (Iowa Ct App 1985) 380 NW2d 748. See also *Nanakuli Paving & Rock Co. v Shell Oil Co.* (9th Cir 1981) 664 F2d 772 (applying Hawaii law; admissibility of consistent additional terms supplied by course of dealing and usage of trade).

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D. Usage of Trade

§4.100 1. Effect on Contract

A usage of trade is any practice or method of dealing observed so regularly in a place, vocation, or trade that it can reasonably be expected to be observed in a transaction absent an agreement not to observe the usage. Com C §1303(c). Usages may be modern and local, and used only generally in an industry, a trade, or a specific geographic area, if they have the requisite "regularity of observance." See Official Comments 4, 6 to UCC §1-303.

The role of usage is to "give particular meaning to and supplement or qualify terms of an agreement" (Com C §1303(d)) by, *e.g.,* imbuing words with special or technical meanings that may differ from their ordinary or popular meanings. When drafting sales agreements, the attorney must be thoroughly familiar with any special or technical meanings imposed by applicable trade usages. See, *e.g., Heggblade-Marguleas-Tenneco, Inc. v Sunshine Biscuit, Inc.* (1976) 59 CA3d 948, 131 CR 183 (by usage of trade, contract quantity understood to be estimate only).

Usage of trade must give way to any course of performance (see §§4.95-4.97) or course of dealing (see §§4.98-4.99) with which the usage cannot reasonably be reconciled. Com C §1303(e). However, usage of trade displaces the Commercial Code's open term provisions (Com C §§2305-2311), which supply terms that are not otherwise covered by the agreement (*e.g.,* price, delivery, payment). Usage cannot displace rules of law designed not to supplement agreements but to accomplish regulatory objectives by restricting contractual freedom. See Official Comment 3 to UCC §1-303; *Robertson v Dodson* (1942) 54 CA2d 661, 129 P2d 726.

Usage can be a powerful weapon in sales litigation by:

- Demonstrating that words with ordinary meanings were intended by the parties to express technical rather than conventional concepts (see CC §§1644-1645); or
- Supplying a missing contract term, such as price (see *Huber Tool Works v Marchant Calculators* (1962) 204 CA2d 822, 23 CR 10), the time for delivery and payment (see *Minaker v California Canneries Co.* (1902) 138 C 239, 71 P 110), or the proper place for inspection (see *San Francisco Milling Co. v Frye & Co.* (1934) 2 CA2d 563, 38 P2d 165).

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§4.101 2. Scope of Application

Usages of trade bind persons engaged in the particular trade or vocation. See Com C §1303(c); *Heggblade-Marguleas-Tenneco, Inc. v Sunshine Biscuit, Inc.* (1976) 59 CA3d 948, 131 CR 183. Their knowledge of the usage is presumed from the fact that they are in the business or occupation. *Correa v Quality Motor Co.* (1953) 118 CA2d 246, 257 P2d 738. No particular length of engagement in the industry or trade is required before a party is imputed with knowledge of its usages. *Heggblade-Marguleas-Tenneco, Inc. v Sunshine Biscuit, Inc., supra*. A party not engaged in the particular industry or trade will not be bound by a usage unless (a) the party is actually aware of it; (b) the party regularly deals with members of the relevant trade, so that it should be aware of the usage; or (c) the usage is "so commonly accepted that the public is presumed to recognize its existence." *Latta v Da Roza* (1929) 100 CA 606, 609, 280 P 711.

The extent of trade usage is ordinarily a question for a jury to decide. See *Nanakuli Paving & Rock Co. v Shell Oil Co.* (9th Cir 1981) 664 F2d 772 (applying Hawaii law). In this case, the Ninth Circuit Court of Appeals adopted an expansive approach to the meaning of "trade," holding that the entire asphaltic paving trade, rather than just asphalt dealers, was the basis for finding a usage of trade.

Because the usages of trade may vary by locality, the Commercial Code applies the usage prevailing in the locale where performance of the term being supplied or interpreted by the usage will occur. Com C §1303(d).

PRACTICE TIP: A client who buys or sells through agents at distant points may be required to perform or accept performance under the industry customs of those distant locations if the customs meet the requisite "regularity of observance" to constitute a usage of trade. See Com C §1303(d). Thus, the attorney should consider protecting the client from claims based on unfamiliar usages by limiting the usages that can apply. See §4.103.

On usage of trade and the parol evidence rule, see §§7.42, 7.48. See also Kastely, *Stock Equipment for the Bargain in Fact: Trade Usage*, *"Express Terms" and Consistency under Section 1-205 of the Uniform Commercial Code*, 64 NC L Rev 777 (1986).

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3. Contract Provisions

§4.102 a. Form: Usages of Trade Expressly Incorporated by Reference

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4.102-1 Usages of trade incorporated by reference

[*Alternative 1: Usage not embodied in industry, vocation, or trade code*]

Each of the usages of trade prevailing in _ _[*describe industry, vocation, or trade*]**_ _ in _ _**[*designate location*]**_ _**

[*Alternative 2: Usage embodied in industry, vocation, or trade code*]

Each of the usages of trade embodied in _ _[*title of industry, vocation, or trade rules or regulations or code*]**_ _ as it may be amended from time to time**

[*Continue*]

will be a part of this contract and will be used in interpreting all terms to which the usage applies, regardless of the place of performance.

Comment: This provision binds a party to trade usages even if the party is not engaged in the industry, vocation, or trade and does not have actual knowledge of the usages. See *Cisler v Ray* (1931) 213 C 620, 2 P2d 987. Because they are specified by the parties, usages of a particular locality control regardless of local usages in the place of performance that might otherwise apply under Com C §1303(c)-(d).

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§4.103 b. Form: Usage of Trade Excluded or Limited

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4.103-1 Usage of trade excluded or limited

This contract may not be modified, supplemented, qualified, or interpreted by any usage of trade

[*Add if usages are limited*]

not prevailing in _ _[*describe industry, vocation, or trade*]**_ _ in _ _**[*designate location*]**_ _ on the date of this contract.**

Comment: The purpose of this clause is to protect against the applicability of trade usages of which one of the parties is unaware. The exclusion of usage of trade becomes significant in light of *Heggblade-Marguleas-Tenneco, Inc. v Sunshine Biscuit, Inc.* (1976) 59 CA3d 948, 131 CR 183, in which the court interpreted a contract on the assumption that the parties took usages of trade for granted. The optional provision in this clause also excludes usages arising after the contract is made.

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§4.104 4. Priority of Sources for Unexpressed Terms

The express terms of an agreement and any course of performance, course of dealing, or usage of trade must be construed, when reasonable, as consistent with each other; however, when that construction is unreasonable, the express terms control. Com C §1303(e)(1). When the agreement is missing terms or contains ambiguous or deficient language, the Commercial Code prescribes the following order of priority of sources:

(1) Course of performance;

(2) Course of dealing;

(3) Usages of the parties' trade; and

(4) The gap-filling provisions of the Commercial Code (*e.g.,* the implied warranties and other open term provisions discussed in §§4.2-4.93).

See Com C §1303(e); Official Comment 1 to UCC §2-208; Official Comment 4 to UCC §2-308; Official Comment 1 to UCC §2-309; Official Comment 1 to UCC §2-311.

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5

Battle of the Forms

David V. Otterson

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§5.1 I. CHANGING TERMS IN ACCEPTANCE OR CONFIRMATION OF OFFER

Many, if not most, sales contracts are not fully negotiated agreements drafted by legal counsel. A contract for the sale of goods often is comprised of a series of telephone calls or conversations between the buyer and the seller, which may be followed by a variety of preprinted form documents (increasingly sent by facsimile transmission or computer transmissions (such as e-mail attachments)). These form documents generally contain "boilerplate" contract terms that may not be tailored for the sale at issue. The preprinted forms are often purchase orders sent by the buyer, terms and conditions set by the seller, acknowledgment or confirmation forms sent by the seller before shipping to confirm an oral or a written offer, invoices sent by the seller when the goods are shipped, or packing slips accompanying the shipped goods.

If one or more of the parties asserts a breach of contract, the various documents will be examined to determine the terms of the offer and acceptance for the sale of the goods. Because the boilerplate provisions on the seller's form often differ from those on the buyer's form, a "battle of the forms" may occur in any ensuing litigation. In such instances, a court will rely on the Commercial Code to ascertain whether a contract was formed and, if so, what the terms of the contract are. See Com C §2207.

PRACTICE TIP: As a general rule, the issues covered in this section will rarely be presented to the practitioner before the fact. Rather, in general, the attorney will be presented with competing forms and the attorney will be presented with the questions that arise when a dispute takes place. These questions are: Is there a contract, and what are the terms of that contract? That being said, this chapter addresses the manner in which an attorney at the outset can best control whether a contract is formed and what the terms are with an eye toward the likely scenario of parsing through the stack of already-transmitted documents and a client in the middle of a dispute.

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§5.2 II. CONTRACT FORMATION WHEN OFFER AND ACCEPTANCE VARY

The Commercial Code clarifies contractual relationships by recognizing the exigencies of the real business world. In the marketplace, "boilerplate" forms, usage of trade, and prior dealings between the parties often supplant formal written contracts. Commercial Code §2207 governs the manner in which contracts for the sale of goods are formed, modified, and performed by establishing the following principles:

- A contract may be formed even if the offeree's acceptance or confirmation includes terms that are additional to or different from those proposed by the offeror. Com C §2207(1). See §§5.4-5.7.
- Terms stated for the first time in an acceptance can be disregarded by an offeror who is not a merchant (see §1.24 for discussion of "merchant") but, in certain instances, can bind a merchant offeror. Com C §2207(2). See §§5.13-5.23.
- If the forms and other writings exchanged by the parties are not by themselves sufficient to make a contract, contract formation can be established by the parties' conduct. If so, the terms of the contract consists of terms on which the parties agree together with any supplementary terms incorporated under the Commercial Code provisions. Com C §2207(3). See §5.24.

PRACTICE TIP: The principles specified under Com C §2207 apply only to the actual formation of a sales contract. They do not apply if the parties negotiated a contract before the exchange of forms. *Olefins Trading, Inc. v Han Yang Chem. Corp.* (3d Cir 1993) 9 F3d 282.

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Source: Business Law/California UCC Sales and Leases/5 Battle of the Forms/§5.3 A. Does a Contract Exist?

§5.3 A. Does a Contract Exist?

Under Com C §2207, whether a contract exists and, if so, on what terms depends on a variety of factors, including the following:

- Do the terms of the offer and the terms of the acceptance differ? See §§5.4-5.7.
- Did the offeree expressly condition its acceptance on the offeror's assent to the precise terms of the acceptance? See §§5.8-5.9.
- Did the offeror assent to the new or additional terms, either expressly or by conduct? See §5.10.
- Are the parties "merchants" within the meaning of the Commercial Code? See §§5.11-5.13.
- Did the offeror expressly condition its offer on the offeree's acceptance of the precise terms of the offer? See §§5.14-5.15.
- Do the variations between the offer and the acceptance materially change the contract? See §§5.16-5.18.
- Did the offeror previously object to the new or additional terms, or object to those terms within a reasonable time after receiving notice of them? See §§5.19-5.23.
- If no oral or written contract exists, does the parties' conduct reflect the existence of a contract? See §5.24.

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B. Offeree Does Not Condition Acceptance on Assent to Offeree's Terms

§5.4 1. Statutory Requirements: Definite and Seasonable Expression

Under Com C §2207(1):

> A definite and seasonable expression of acceptance or a written confirmation which is sent within a reasonable time operates as an acceptance even though it states terms additional to or different from those offered or agreed upon, unless acceptance is expressly made conditional on assent to the additional or different terms.

Because the term "definite" modifies "expression" rather than "acceptance," an acceptance that has terms differing significantly from the terms in the offer (*e.g.,* an additional term that materially alters the contract; see Com C §2207(2)(b); §§5.16-5.18) may still be definite. *Steiner v Mobil Oil Corp.* (1977) 20 C3d 90, 107, 141 CR 157. See also *Arizona Retail Sys. v Software Link, Inc.* (D Ariz 1993) 831 F Supp 759. Accordingly, Com C §2207 rejects the common law "mirror image" rule, which requires an acceptor to give in return to the offeror's promise exactly the consideration that the offeror requests. Rather, the inquiry is on whether the parties intended to complete an agreement.

NOTE: In *Arizona Retail,* the buyer ordered a software system from the seller. The software arrived in a shrink-wrapped package, on which there was a printed license agreement specifying that a buyer accepted the terms of the license by opening the package. When the buyer sued the seller for the software's failure to perform as promised, the seller claimed that its acceptance of the buyer's purchase order had been conditional on the buyer's assent to the additional terms contained in the license agreement. The seller claimed that those terms (including limitations of the buyer's remedies) had become part of their contract under UCC §2-207 when the buyer opened and used the software. However, the court rejected the seller's claim. It considered a contract formed either when the seller agreed to ship the software, or when shipment occurred. Because the additional terms were material additions or modifications to the original contract, they would become a part of it only if the buyer expressly assented to them. See §§5.16-5.18.

To be a seasonable expression of acceptance, the offeree must respond at or within the time for acceptance expressly indicated by the offer or, if no time is indicated, then within a "reasonable" time after the offer. Com C §1205(b). Whether a response was made within a reasonable time depends on course of performance, course of dealing, usage of trade, and other factual circumstances of the transaction. Com C §1205(a). See Official Comment 2 to UCC §1-205. See also §§4.94-4.104.

PRACTICE TIP: To prevent the possibility that an acceptance that the offeror viewed as late or otherwise inappropriate may nevertheless be considered reasonable, the offeror should specify in its offer the time and manner in which the offer may be accepted. See Com C §§1302(b), 2206(1).

If the expression of acceptance (1) is definite and seasonable and (2) is not conditioned on the original offeror's assent to the additional or different terms, a contract is formed. For discussion of the terms of the contract, see §§5.11-5.23.

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§5.5 2. Form of Expression of Acceptance

The offeree's expression of acceptance may be made in any manner and by any medium that is reasonable under the circumstances (*e.g.,* return promise or performance) unless otherwise expressly stated in the offer. Com C §2206(1). See §2.24. The acceptance need not be made in the same manner as the offer. Instead, any reasonable manner of acceptance is allowed unless the offeror has made quite clear that it will not be acceptable. Official Comment 1 to UCC §2-206 (Official Comment 2 to UCC §2-206 (2003)).

A written confirmation of an oral agreement that is subject to the statute of frauds operates as an acceptance if the confirmation is sent within a reasonable time after the oral agreement. However, because the oral contract was previously formed and is merely accepted and validated by the subsequent written confirmation, the confirmation generally cannot vary the terms of the contract. If the offeror and offeree are both merchants, nonmaterial additional terms contained in the confirmation may be binding on the recipient. Com C §2207(2).

When the offer does not indicate who bears the risk if either the offer or the acceptance is not communicated effectively to the other party, the risk of a failure in communicating the acceptance is on the offeror as the person receiving the communication. This is because consent is deemed to be fully communicated between the offeror and offeree as soon as the offeree has put the acceptance in the course of transmission to the offeror. CC §1583. See §2.34. The offeror, however, can shift this risk to the offeree by stating in the offer that the offeror must actually receive the acceptance if it is to create a binding contract. See §2.35.

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§5.6 3. Statute of Frauds Requirements

Contracts for the sale of goods may be either oral or written. If the sales price for the goods exceeds $500, however, the contract must satisfy the statute of frauds by meeting one of the following criteria (Com C §2201):

- There must be a writing sufficient to indicate that a contract was made, and the party against whom enforcement is sought (or his or her authorized agent) must sign the writing (Com C §2201(1));
- If the parties are both merchants (see §1.24), one party must receive a written confirmation from the other within a reasonable time after contract formation and must not object in writing to the confirmation within 10 days of receipt (Com C §2201(2)); or
- One or both of the parties must act in a manner specified in Com C §2201(3) that indicates that a contract was formed.

For further discussion of the statute of frauds, see chap 7.

A written confirmation of an oral contract satisfies the statute of frauds if it is received within a reasonable time. "Reasonable time" depends on course of dealing, trade custom, course of performance, and other factual circumstances of the transaction. See Com C §1205(a); Official Comment 2 to UCC §1-205. The same standards for what constitutes a reasonable time apply to determine whether a confirmation operates as an acceptance. Com C §2207(1).

If the parties exchange confirmations using forms with conflicting terms, neither party is bound to a term that conflicts with its confirmation unless there was an oral agreement. Thus, the party seeking to enforce a contract on the basis of a written confirmation must prove that an oral contract relating to the disputed terms was made before the confirmation. Official Comment 3 to UCC §2-201 (Official Comment 4 to UCC §2-201 (2003)).

EXAMPLE: A seller refuses to sell with warranties and includes in the seller's confirmation a disclaimer of warranties. The buyer's confirmation insists that the goods are fully warranted. If the seller sells and the buyer accepts the goods, a contract was formed because the parties conducted themselves in such a manner as to recognize the existence of a contract. Com C §§2204(1), 2207(3).

In the aforementioned example, the issue of warranties is resolved in one of the following ways:

- The buyer may enforce a contract with warranties by proving that such a contract was entered into orally. See Com C §2202(b). See also §§7.41-7.50 (parol evidence rule).
- The seller could enforce a contract without warranties by proving that such a contract was entered into orally. See Com C §2202(b). See also §§7.41-7.30 (parol evidence rule).
- If neither party proves that there was an oral agreement regarding warranties, then, because the confirmations conflict on the warranty terms, the terms are considered to be objected to and are not part of the contract. The buyer is left with the warranty terms provided by the Commercial Code. Official Comment 6 to UCC §2-207. See *Quaker Alloy Casting Co. v Gulfco Indus.* (ND Ill 1988) 686 F Supp 1319, 1332. See also §§6.17, 5.24.

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Source: Business Law/California UCC Sales and Leases/5 Battle of the Forms/§5.7 4. Specifying Acceptable Form of Expression of Acceptance

§5.7 4. Specifying Acceptable Form of Expression of Acceptance

For language specifying a means for expressing assent, see §§2.26-2.27.

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§5.8 C. Offeree Conditions Acceptance on Assent to Offeree's Terms

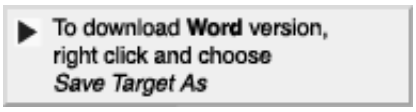
If the offeree expressly conditions acceptance on the offeror's assent to additional or different terms proposed by the offeree, no contract exists until assent is given. Com C §2207(1); *PMC, Inc. v Porthole Yachts, Ltd.* (1998) 65 CA4th 882, 76 CR2d 832. An acceptance is not expressly conditioned on assent if it merely proposes different or additional terms, contains a simple recital that the acceptance is "subject to" terms included in the acceptance, or includes a statement that the offeror is considered to have assented if the offeror does not object. *Dorton v Collins & Aikman Corp.* (6th Cir 1972) 453 F2d 1161, 1168; *Idaho Power Co. v. Westinghouse Elec. Corp.* (9th Cir 1979) 596 F2d 924, 926.

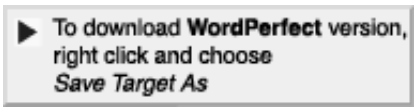
The additional and conflicting terms in the offeree's acceptance that require the offeror's assent are construed as proposals for additions to the contract. Com C §2207(2). See *Diamond Fruit Growers, Inc. v Krack Corp.* (9th Cir 1986) 794 F2d 1440; *Textile Unlimited, Inc. v A.bmhand Co.* (9th Cir 2001) 240 F3d 781, 787. The original offeror may accept the offer of additional terms, and may also add further terms provided they are not in conflict with and do not materially alter that offer. If the parties are both merchants (see §1.17 for discussion of merchants), the original offeree must either object to the original offeror's additional terms within a reasonable time or be bound by them. Com C §2207(2). See *Therma-Coustics Mfg. v Borden Inc.* (1985) 167 CA3d 282, 213 CR 611.

See form 5.9-1 for language conditioning acceptance on assent.

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§5.9 1. Form: Acceptance Conditional on Assent to Changes





5.9-1 Acceptance conditional on assent to changes

Some of the terms set forth in this acceptance may differ from those in your offer. Some may be new. We have accepted on the condition that you agree to all the terms in this acceptance.

[*Option 1: Acceptance not treated as counteroffer*]

Unless you assent to all the terms in this acceptance, this is a rejection of your offer.

[*Option 2: Acceptance treated as counteroffer that may be accepted only on set terms*]

This acceptance is a counteroffer. You may accept it only on the terms in this acceptance. Terms in your acceptance that are additional to or not identical with the terms of the counteroffer will not become part of the contract without our express written consent.

Comment: The optional provisions determine whether a contract will be formed if the original offeror includes nonmaterial variations in the offeror's response to the offeree's response. Under the first option, the offeree prevents a contract from being formed if the offeror "accepts" the offeree's differing terms but also adds nonmaterial variations. The final sentence of the second option gives the offeree the assurance that a contract will be formed and also the flexibility to decide whether to accede to the offeror's nonmaterial changes.

For discussion of the means by which the offeror can assent, see §5.10.

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§5.10 2. Offeror's Assent to Offeree's Terms

If the offeree expressly conditions acceptance on the offeror's assent to additional or different terms, then the offeror's assent must be overt, specific, and unequivocal. If the offeror's actions do not satisfy this standard but are considered by the offeree to be assent by the terms of the acceptance, then the offeree did not "expressly condition acceptance on the offeror's assent." *Dorton v Collins & Aikman Corp.* (6th Cir 1972) 453 F2d 1161, 1168. Silence on the part of the original offeror (*i.e.,* lack of objection), with or without performance, generally is not construed as assent. *Lockheed Electronics Co. v Keronix, Inc.* (1981) 114 CA3d 304, 170 CR 591.

The requirements for the offeror's assent to the offeree's terms parallel those for acceptance of an offer limited to the offeree's terms. See Com C §2207(2)(a). See also §§5.4-5.7. The assent need not be written unless expressly required by the acceptance. *Steiner v Mobil Oil Corp.* (1977) 20 C3d 90, 107, 141 CR 157, 168; *Diamond Fruit Growers, Inc. v Krack Corp.* (9th Cir 1986) 794 F2d 1440, 1445; *Frank M. Booth, Inc. v Reynolds Metals Co.* (ED Cal 1991) 754 F Supp 1441, 1447.

PRACTICE TIP: If the offeree does not prescribe the manner in which assent is to be expressed, assent may be expressed in any manner and by any medium reasonable under the circumstances, *e.g.,* by telephone or facsimile transmission. See Com C §2206(1)(a); Official Comment 1 to UCC §2-206 (Official Comment 2 to UCC §2-206 (2003)). Once assent is given to the terms of the acceptance, they become part of the contract.

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§5.11 III. TERMS OF CONTRACTS FORMED BY VARYING OFFER AND ACCEPTANCE

A definite and seasonable expression of acceptance by the offeree is sufficient to form a contract of sale even if it includes terms additional to or different from the offer, as long as the offeree has not expressly conditioned acceptance on the offeror's assent to the terms. Com C §2207(1). See §5.4.

Whether the offeree's terms are incorporated into the resulting contract depends in part on whether the contract is between merchants. An agreement is "between merchants" if both parties are charged with the knowledge or skill of a merchant, *i.e.,* they are commercially sophisticated persons. Com C §2104(1), (3). See §1.24 for further discussion of merchants.

If the parties are not both merchants, the additional or different terms are only proposals for additions to the contract. See §5.12. If the parties are both merchants, the additional or different terms may become part of the contract even without the express agreement of the offeror, unless the offer expressly limits acceptance to the terms of the proposal, the additional terms materially alter the terms of the offer, or notification of objection to the additional terms is given within a reasonable time. See §§5.13-5.23.

PRACTICE TIP: Because of the different treatment of merchants and nonmerchants under the Commercial Code, the safest course for the offeror is to assume that both parties are merchants and that the offeror must object to additional or different terms proposed in the acceptance that the offeror does not want to include in the contract. Conversely, the offeree should assume that either party may be a nonmerchant and that a contract could be formed without the terms proposed in the acceptance. The cautious offeror should take one of the precautions available to offerors (see Com C §2207(2)(a), (c)) and condition acceptance expressly on assent to the terms specified in the acceptance.

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§5.12 A. Contracts Not Between Merchants

If the contract is not between merchants (see §1.24 for discussion of merchants), then, unless the offeree's acceptance is expressly made conditional on the offeror's assent to such terms, the offeree's additional or different terms are simply proposals that do not become part of the contract unless the offeror expressly agrees to them. Com C §2207(2); *Steiner v Mobil Oil Corp.* (1977) 20 C3d 90, 141 CR 157.

NOTE: California is in the minority of states on this point. In most states, different and additional terms are treated differently. In those states, conflicting provisions "knock out" the provision, resulting in a void that is filled by the UCC or other applicable law.

Although Com C §2207(2) provides that only "additional" terms in the acceptance become proposals for additions to the contract, the *Steiner* court interpreted Com C §2207(2) to apply to "different" as well as "additional" terms. 20 C3d at 102 n5.

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§5.13 B. Contracts Between Merchants

Terms added in the offeree's acceptance become "proposals for addition to the contract." Com C §2207(2). If both the offeror and the offeree are merchants, these proposals become part of the contract, despite the lack of express consent to the proposals by the offeror, unless:

- The offer expressly limits acceptance to the terms of the offer (Com C §2207(2)(a); see §§5.14-5.15);
- The additional terms materially alter the terms of the contract (Com C §2207(2)(b); see §§5.16-5.18); or
- The offeror has already objected to the additional terms or objects to them within a reasonable time after receiving notice of them (Com C §2207(2)(c); see §§5.19-5.23).

NOTE: California courts apply Com C §2207(2) to "different" as well as "additional" terms. *Steiner v Mobil Oil Corp.* (1977) 20 C3d 90, 102 n5, 141 CR 157.

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1. Limiting Acceptance to Terms of Offer

§5.14 a. The Rule

If the offeror expressly limits acceptance to the terms of the offer, terms proposed by the offeree in the acceptance do not become part of the contract without the offeror's express assent, regardless of whether the offeror and offeree are merchants. Com C §2207(2)(a). This does not mean that an offeror who limits acceptance to the terms of the offer must completely reject an acceptance that is not a mirror image of the offer. Rather, the offeror is permitted to ignore newly proposed terms and may treat the offeree's acceptance as accepting the terms of the offer (unless the acceptance is conditioned on the offeror's assent to the proposed terms; see Com C §2207(1); §§5.8-5.10).

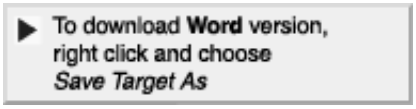
An offer stating that an acceptance will be effective only if it contains no varying terms will be enforced. See *Lockheed Electronics Co. v Keronix, Inc.* (1981) 114 CA3d 304, 170 CR 591. Thus, if the offer precludes an acceptance with varying terms from forming a contract, an offeree who wants to be sure that its acceptance is effective should carefully edit the acceptance to delete any terms that might be considered variations. See, *e.g., Diamond Fruit Growers, Inc. v Krack Corp.* (9th Cir 1986) 794 F2d 1440.

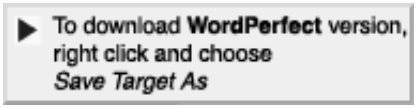
The offeror could partially limit the acceptance, forbidding the offeree to vary certain terms but permitting variations of other terms. The offeror can accomplish the same result after acceptance by objecting to some but not all of the offeree's proposed terms. For discussion of the offeror's objection to the offeree's terms, see §§5.19-5.23.

PRACTICE TIP: Even if the acceptance is ineffective because of the limiting language in the offer, a contract may be formed by the parties' conduct. Com C §§2204(1), 2207(3). For discussion of the terms of a contract formed by the parties' conduct, see §5.24.

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§5.15 b. Form: Acceptance Expressly Limited to Offer's Terms





5.15-1 Acceptance expressly limited to offer's terms

This offer may be accepted only on the terms set forth in the offer. Terms in your acceptance that are in addition to or not identical with the terms of this offer will not become part of the contract.

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§5.16 2. Material Alterations

Additional or different terms in the acceptance do not become part of the contract, even for a contract between merchants, if the terms materially alter the contract. Com C §2207(2)(b). Whether the offeror assents or objects to them is irrelevant.

Whether an additional term materially alters a contract is a question of fact to be resolved in light of the circumstances of each particular case. See *N & D Fashions, Inc. v DHJ Indus.* (8th Cir 1976) 548 F2d 722, 726. Materiality is judged from the offeror's viewpoint because the acceptance forms a contract on terms proposed by the offeror. Whether enforcement of a new term will lead to surprise or hardship is relevant in determining the materiality of the new term. Official Comments 4-5 to UCC §2-207; *National Controls, Inc. v Commodore Bus. Machs., Inc.* (1985) 163 CA3d 688, 695, 209 CR 636. Stated another way, an alteration is material if consent to it cannot be presumed. What is expected, and hence unsurprising, is not material. On the other hand, what is unexpected, and hence surprising, is material. See *Union Carbide Corp. v Oscar Mayer Foods Corp.* (7th Cir 1991) 947 F2d 1333, 1336.

It should be noted that Com C §2207(2)(b) refers to material alteration of the contract, not of the offer. A contract is the total legal obligation resulting from the parties' agreement, as affected by the Commercial Code and other applicable law. Com C §1201(b)(12). The agreement includes not only express terms but also those implied by course of performance, course of dealing, usage of trade, or other circumstances. Com C §1303. Gaps in the agreement are filled by terms supplied by the Commercial Code and the common law. See chap 4. Therefore, a term proposed in an acceptance or a confirmation may be excluded from the agreement if it materially alters:

- An explicit term of the offer;
- A term implied by course of performance, course of dealing, or usage of trade; or
- A term supplied by the Commercial Code and the common law.

PRACTICE TIP: If between merchants, even if the offeror does not object to a term that makes a material alteration, that term will automatically be excluded from the contract by Com C §2207(2)(b).

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§5.17 a. Terms That Materially Alter

Terms that are likely to be considered material alterations, and therefore likely to be treated only as proposals for addition to the contract under Com C §2207(2)(b), include the following:

- Disclaimers of standard warranties (see *Therma-Coustics Mfg. v Borden Inc.* (1985) 167 CA3d 282, 296, 213 CR 611);
- Provisions contrary to usage of trade (see Official Comment 4 to UCC §2-207);
- Provisions imposing unusual consequences on deviations from payment schedules (see Official Comment 4 to UCC §2-207);
- Limitations of complaint times to times materially shorter than customary or reasonable (see Official Comment 4 to UCC §2-207);
- Mandatory arbitration provisions (see *Windsor Mills, Inc. v Collins & Aikman Corp.* (1972) 25 CA3d 987, 995, 101 CR 347). Compare *Hunt v Up N. Plastics, Inc.* (D Minn 1997) 980 F Supp 1046 (arbitration clause held not to be material alteration, because no objection had been raised to clause in previous transactions between the parties);
- Forum selection clauses excluding the possibility of bringing suit in an expected forum (see *M.C.K. Equip. Co., Inc. v M.A.I.L. Code, Inc.* (D Kan 1994) 843 F Supp 679);
- Price modifications (see *Steiner v Mobil Oil Corp.* (1977) 20 C3d 90, 102, 141 CR 157); and
- Disclaimers of liability for damages (see *Altronics of Bethlehem, Inc. v Repco, Inc.* (3d Cir 1992) 957 F2d 1102.

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§5.18 b. Terms That Do Not Materially Alter

Provisions that are likely to be considered nonmaterial alterations, and therefore are likely to become part of the contract between merchants without the offeror's assent under Com C §2207, include for example, the following:

- Slight expansions of the seller's exemption from liability in the event of unexpected intervening events or the reasonable fixing of consequences of those events (see Official Comment 5 to UCC §2-207);
- Provisions for inspection in circumstances in which a request could be expected (see Official Comment 5 to UCC §2-207);
- Provisions establishing reasonable time limits for complaints (see *Therma-Coustics Mfg. v Borden Inc.* (1985) 167 CA3d 282, 296, 213 CR 611; *Shur-Value Stamps v Phillips Petroleum Co.* (8th Cir 1995) 50 F3d 592);
- Provisions for payment or credit terms within the range of trade practice and not in contravention of the bargain (see *Mid-South Packers, Inc. v Shoney's, Inc.* (5th Cir 1985) 761 F2d 1117, 1123);
- Provisions for late charges (see *Southwest Concrete Prods. v Gosh Constr. Corp.* (1990) 51 C3d 701, 709, 274 CR 404);
- Provisions for payment of attorney fees (see *Boyd v Oscar Fisher Co.* (1989) 210 CA3d 368, 380, 258 CR 473); and
- Provisions limiting remedies reasonably and within the range of trade practice (see Official Comment 5 to UCC §2-207; but see *Dale R. Horning Co. v Falconer Glass Indus.* (SD Ind 1989) 710 F Supp 693, in which the court discusses the split of authority on the issue of limitation of remedies as to whether the issue is treated as a matter of fact or as a matter of law).

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§5.19 3. Notification of Objection to Offeree's Terms

If the offeror has not limited acceptance to the terms of the offer and the offeree proposes varying terms, the offeror can prevent the inclusion of such terms in the contract by objecting before or within a reasonable time after receipt of notice of the varying terms. Com C §2207(2)(c). The contract then consists of the terms in the offer, the terms in the acceptance that were not objected to or did not materially alter the contract, and the terms supplied by law. For discussion of what alterations are likely to be considered material or nonmaterial, see §§5.16-5.18.

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§5.20 a. Previous Notification of Objection

A conflict between terms in the offer and terms in the acceptance constitutes notification of objection already given, sufficient to satisfy the requirements of Com C §2207(2)(c). In this instance, the offeror is not required to object further to keep the terms out of the contract. Official Comment 6 to UCC §2-207; *Lounge-A-Round v GCM Mills, Inc.* (1980) 109 CA3d 190, 196, 166 CR 920.

PRACTICE TIP: There is an unresolved issue of whether, by definition, an offeror has previously objected to any term different from the offer. For example, if the seller disclaims warranties, has the seller "previously notified" the buyer that it objects to the inclusion of warranties? If the offer is silent on the issue, has the seller "previously notified" the buyer that it is relying on the Commercial Code's implied warranties (see §§3.21-3.41) and objects to any different warranty provisions?

To protect its interests, the offeror should not rely on the previous notification provision, but should expressly notify the offeree in writing of its objection immediately after receiving the acceptance. See §5.21. The offeree should condition acceptance on assent to the proposed terms if they are essential to the offeree. Com C §2207(1). See §§5.8-5.10.

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§5.21 b. Notification After Learning of Offeree's Terms

If the offeror does not want a new term in an acceptance to become part of the contract, the offeror must notify the offeree of his or her objection to the new term, unless (1) the acceptance was not conditioned on assent (see §§5.4-5.7), and (2) the term is nonmaterial (see §5.18). The offeror must notify the offeree by taking such steps as may be reasonably required to inform the offeree in ordinary course, whether or not the offeree actually comes to know of it. Com C §1202(d). The risk that the notice is not effectively communicated is on the offeree. Neither failing to comply with the additional terms nor refusing to discuss the terms is enough to provide notice of an objection under Com C §2207(2)(c). *Kawasho Int'l v Lakewood Pipe Serv.* (1983) 152 CA3d 785, 792, 201 CR 640.

For a notification of objection to be effective, the offeror must notify the other party of the objection to the terms proposed in the acceptance within a reasonable time after receiving notice of the terms. Com C §2207(2)(c). The parties' course of performance, course of dealing, usage of trade, and other factual circumstances of the transaction may determine the time that is reasonable. See Com C §§1205, 1303; Official Comment 2 to UCC §1-205. A notice of objection made after the parties terminate their dealings is not made within a reasonable time. *Kawasho Int'l v Lakewood Pipe Serv., supra*.

The offeror receives a notice when (Com C §1202(e)):

- It comes to his or her attention;
- It is delivered at the place of business through which the contract was made (*e.g.,* the generating branch office); or
- It is delivered at another place held out by the offeror as the place for the receipt of communications.

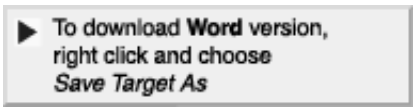
DRAFTING CONSIDERATIONS: In certain situations (*e.g.,* a branch office authorized to process an acceptance may not have discretion to approve or disapprove of newly proposed terms), the offeror may want to vary the Commercial Code provision establishing receipt of notification (as allowed under Com C §1302(b)) by stating in the offer the location where notices must be received.

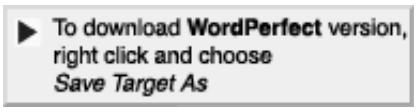
Although the requirement of receipt by the offeror burdens the offeree with the risk of a failure in communication of additional terms, the risk of failure in transmission of the acceptance is on the offeror. See §2.34. Thus, if notice of new terms in an acceptance has not been received by the offeror, an acceptance sent by the offeree forms a contract on the terms of the offer without inclusion of the new terms. Com C §2207(1), (2)(c).

If the offeror has limited acceptance to the terms of the offer, the offeror need not be concerned with objecting to different or additional terms within a reasonable time. No additions to the contract can bind the offeror without his or her express consent. Com C §2207(2)(a). See §§5.14-5.15.

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§5.22 c. Form: Objection to All Proposed Terms





5.22-1 Objection to all proposed terms

We object to the terms _ _[*describe terms*]_ _ in your acceptance of _ _[*date*]_ _ and to any other terms not contained in our offer dated _ _[*date*]_ _ for the _ _[*sale/purchase*]_ _ of _ _[*describe goods*]_ _. We do not agree to the inclusion of such terms in the agreement formed by your acceptance of our offer.

Comment: If the offeree conditioned its acceptance on assent to terms differing from those of the offer, the acceptance does not form a contract and this provision is not necessary. See Com C §2207(1). See also §§5.8-5.10. Similarly, if the offer expressly limited acceptance to the terms of the offer, other terms proposed in the acceptance are automatically rejected and this provision is not necessary. See Com C §2207(2)(a). See also §§5.14-5.15.

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§5.23 d. Form: Objection to Only Some Proposed Terms

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5.23-1 Objection to only some proposed terms

We accept the terms _ _[*describe terms*]_ _ in your acceptance of _ _[*date*]_ _ and agree to the inclusion of such terms in the agreement between us formed by your acceptance of our offer dated _ _[*date*]_ _ for the _ _[*sale/purchase*]_ _ of _ _[*describe goods*]_ _. We object to the terms _ _[*describe terms*]_ _ in your acceptance of _ _[*date*]_ _ and to any other terms not contained in our offer or accepted in this notice. We do not agree to the inclusion of such terms in the agreement formed by your acceptance of our offer.

Comment: If the offeree conditioned its acceptance on assent to terms differing from those of the offer, the acceptance does not form a contract and this provision is not necessary. See Com C §2207(1). See also §§5.8-5.10. Similarly, if the offer expressly limited acceptance to the terms of the offer, other terms proposed in the acceptance are automatically rejected and this provision is not necessary. See Com C §2207(2)(a). See also §§5.14-5.15.

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§5.24 IV. TERMS OF CONTRACTS FORMED BY CONDUCT

Parties who intend to make a written contract may fail to do so for certain reasons. For example, if the offeree conditions acceptance on assent to the offeree's terms and the offeror does not assent, the writings fail to establish a contract. If both parties then proceed with performance and otherwise conduct themselves as if a contract existed, however, there is a contract. *C. Itoh & Co. (Am.) v Jordan Int'l Co.* (7th Cir 1977) 552 F2d 1228, 1236. See §§5.2-5.3. For discussion of conduct sufficient to recognize the existence of a contract, see §§2.2, 2.24, 2.39.

The terms of a contract created by the parties' conduct consist of the following (Com C §2207(3)):

- *Terms supplied by the writings*. Terms expressly stated in both writings become part of the contract. Terms stated in one of the writings on which the other is silent may also be included.
- *Terms supplied by the Commercial Code*. If the parties have failed to provide necessary terms or if their terms conflict, those terms may be supplied by Code provisions, such as the following:
- Com C §2207(2) (nonmaterial terms not objected to and not prohibited by the offer; see §5.11);
- Com C §1303 (course of performance, course of dealing, and usage of trade; see §§4.94-4.95, 4.98-4.101);
- Com C §§2305-2311 (open terms; see §§4.3-4.85); and
- Com C §§2312-2315 (warranties—detailed forms are particularly likely to conflict with respect to warranties); see §§3.8-3.41).

If the terms in the writings conflict, the court may disregard the conflicting terms and neither will become a part of the contract. See, *e.g., Lockheed Electronics Co. v Keronix, Inc.* (1981) 114 CA3d 304, 312, 170 CR 591; *Transwestern Pipeline Co. v Monsanto Co.* (1996) 46 CA4th 502, 53 CR2d 887.

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Source: Business Law/California UCC Sales and Leases/5 Battle of the Forms/§5.25 V. APPLICATION OF COMMERCIAL CODE PRINCIPLES TO NON-GOODS SITUATIONS

§5.25 V. APPLICATION OF COMMERCIAL CODE PRINCIPLES TO NON-GOODS SITUATIONS

By its terms, Division 2 of the Commercial Code applies to transactions in goods and has not been extended further to security transactions. Com C §2102. However, although investment securities are expressly excluded from the definition of "goods," the UCC principles dealing with sales of goods may be applied to transactions of investment securities if such transactions are not covered under Division 8 of the Commercial Code. See Official Comment 1 to UCC §2-105.

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6

Modification, Rescission, and Waiver

David V. Otterson

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II. MODIFICATION OF SALES CONTRACTS
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  - 1. Good Faith §6.3
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- E. Retraction of Waiver
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§6.1 I. CHANGING TERMS IN CONTRACT

Parties to sales contracts can change the terms of performance in several ways (Com C §2209):

- By express bilateral agreement, *i.e.,* modification (see §§6.2-6.8);
- By bilateral agreement to abandon the contract, *i.e.,* rescission (see §§6.9-6.11); or
- By words or deeds of one party that waive either enforcement of that party's rights or partial performance by the other party, *i.e.,* waiver (see §§6.12-6.22).

Another method of changing terms in a contract is by novation. A "novation" differs from a modification in that it terminates a preexisting contract and substitutes a new one, rather than merely changing the preexisting contract. CC §§1530-1532; *Davies Mach. Co. v Pine Mountain Club, Inc*. (1974) 39 CA3d 18, 24, 113 CR 784. Novation, a concept not covered by the Commercial Code, is not discussed in detail in this book. See §11.3.

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II. MODIFICATION OF SALES CONTRACTS

§6.2 A. Requirements for Effective Modification

Under contract law outside the Commercial Code, one party's contractual obligations cannot be increased or decreased unless supported by consideration. See CC §§1550, 1605-1615. Parties that attempt to change a contract without consideration, even if the change is for a mutually agreeable reason, run the risk that the change will be held to be a one-sided, and thus unenforceable, modification.

In commercial transactions, however, one-sided modifications may be desirable to both parties, regardless of whether the benefits to the party whose rights are being modified constitute adequate legal consideration. For example, a buyer of goods may be notified that the seller's costs have increased to a point where the contract is no longer profitable for the seller. The buyer may be willing to adjust the contract price in order to enhance or protect a valued business relationship with the seller. Similar considerations may come into play when the seller is the buyer's sole source for the contracted goods.

Recognizing these business realities, the Commercial Code allows business people to make mutually acceptable modifications of their sales contracts, even if the modifications appear to benefit only one party: "An agreement modifying a contract within this division needs no consideration to be binding." Com C §2209(1). See Official Comment 1 to UCC §2-209; *T & S Brass & Bronze Works, Inc. v Pic-Air, Inc*. (4th Cir 1986) 790 F2d 1098, 1105.

Two requirements must be met for the modification to be valid:

- The party proposing the modification must act in good faith. Official Comment 2 to UCC §2-209. See §6.3.
- The parties must comply with any formalities required either by the statute of frauds or by their contract. Com C §2209(2). See §§6.4-6.5.

After modification, the parties look to the contract as modified for questions regarding performance, enforcement, and remedies. *Fratelli Gardino, S.p.A. v Caribbean Lumber Co*. (5th Cir 1979) 587 F2d 204, 207 (damages based on difference between market price at time of breach and price in modified contract).

If the parties have attempted to modify the sales contract but have not satisfied the requisite formalities (see §§6.3-6.5), their conduct nevertheless can operate as a waiver (see §6.17). Com C §2209(4).

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§6.3 1. Good Faith

The good faith requirement is not expressly mentioned in Com C §2209, but it does appear in Official Comment 2 to UCC §2-209. This requirement protects against one party's obtaining a modification by coercion, extortion, or duress. It applies even if the modification is supported by consideration.

"Good faith" involves both a subjective element of honesty in fact and an objective element of the observance of reasonable commercial standards of fair dealing. Com C §1201(b)(20). See Official Comment 2 to UCC §2-209.

For modifications between merchants, the courts examine whether the party seeking the modification did so for a legitimate commercial reason. To satisfy the burden of proving that a modification was sought in good faith, a court may, but need not, require an objectively demonstrable reason for seeking a modification, *i.e.,* a reason that was not foreseen and was outside the control of the person seeking the modification. *T & S Brass & Bronze Works, Inc. v Pic-Air, Inc*. (4th Cir 1986) 790 F2d 1098, 1105 (delay in shipment was caused by party seeking modification of delivery date; modification not enforceable); *Roth Steel Prods. v Sharon Steel Corp*. (6th Cir 1983) 705 F2d 134, 147 (unforeseen economic exigencies justified modification).

Increased costs or a market shift that makes performance uneconomical may provide such a reason, even if such unforeseen difficulties would not legally excuse performance. Official Comment 2 to UCC §2-209. See *American Exploration Co. v Columbia Gas Transmission Corp*. (6th Cir 1985) 779 F2d 310, 314 (change in market conditions must relate to goods sold by contract); *Roth Steel Prods. v Sharon Steel Corp., supra*.

Similarly, a buyer that is unable to handle its expanded business may be willing to modify its agreement to reduce its area of territorial exclusivity. If the buyer *were* able to handle the expanded business, however, a seller's threats that it may not be able to supply the buyer adequately unless the buyer reduced its territory might indicate coercion.

A party that refuses to perform unless the other party agrees to modify the contract has acted in bad faith. A modification also is not made in good faith if the modifying party inserts a modifying clause limiting the buyer's remedies on the reverse side of an invoice sent after delivery of goods. *Morgan Bros., Inc. v Haskell Corp*. (Wash Ct App 1979) 604 P2d 1294, 1299.

The good faith test focuses on whether the modification was *sought* in good faith. A party's conduct indicating assent to a modification, undertaken in bad faith, raises a different issue. One party is not permitted to lead the other party to believe that it acquiesced to the modification and then refuse to perform in accordance with the modification by claiming that the modification was made in bad faith. *U.S. ex rel Crane Co. v Progressive Enters*. (ED Va 1976) 418 F Supp 662, 664. The party that does not want to be bound by the modification must object to the terms of the modification in some way. See §6.8.

PRACTICE TIP: The parties should save all documents relating to the transaction, including those negotiated before signing the agreement, in the event such evidence is later necessary to prove good faith or bad faith modification.

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§6.4 2. Application of Statute of Frauds

In the absence of a contract clause requiring that a modification be in writing (see §6.5), contracts for the sale of goods not within the scope of the statute of frauds can be modified in writing, orally, or by the conduct of the parties. See, *e.g., U.S. ex rel Trans-Colorado Concrete, Inc. v Midwest Constr. Co*. (D Colo 1987) 653 F Supp 903, 907 (delivery site orally changed; parties charged and paid extra costs without reservation). The courts examine the parties' course of performance to decide whether the contract was orally modified. Com C §1303(f).

The modification must satisfy the statute of frauds, however, if "the contract as modified is within its provisions." Com C §2209(3). Statute of frauds provisions are intended to protect a party against false allegations of oral modifications. Official Comment 3 to UCC §2-209. Although seemingly straightforward, Com C §2209(3) has been interpreted to apply to the following diverse circumstances:

- If the contract does not fall within the scope of the statute of frauds before modification, but after modification would fall within that statute, the requirements of the statute must be satisfied.
- If the modification falls within the scope of the statute of frauds on its own, the requirements of the statute must be satisfied.
- If the contract before modification falls within the scope of the statute of frauds, but after modification does not, the contract is enforceable as modified even if the contract and modification both were oral. Official Comment 3 to UCC §2-209.
- If the contract falls within the scope of the statute of frauds before modification and the parties satisfied the requirements of the statute, it is unclear whether the modification must be in writing. Some commentators argue that, if there is a writing, parol evidence should be admissible to prove the terms of the modification because it is admissible to prove the terms of the original contract.

See Murray, *The Modification Mystery: Section 2-209 of the Uniform Commercial Code*, 32 Vill L Rev 1, 21 (1987).

PRACTICE TIP: It is good practice for all modifications to be in writing so that there is no issue about whether the statute of frauds applies or about the terms of the modification.

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§6.5 3. "No-Oral-Modification" Clause

A signed agreement that excludes modification except by a signed writing cannot be otherwise modified. Com C §2209(2); *Marlowe v Argentine Naval Comm'n* (DC Cir 1986) 808 F2d 120, 123; *Wisconsin Knife Works v National Metal Crafters* (7th Cir 1986) 781 F2d 1280, 1288. Such limitations on the manner of modifying an agreement, if included on a form supplied by a merchant to a nonmerchant (see §1.24 for discussion of "merchant"), must be separately signed by the nonmerchant. If both parties are merchants, however, no separate signature is required. Com C §2209(2).

Commercial Code §2209(2) is intended to protect against false allegations of oral modifications. Official Comment 3 to UCC §2-209. A "no-oral-modification" clause imposes, in effect, a contractual or private statute of frauds, regardless of whether the Commercial Code's statute of frauds (Com C §2201) applies. Such a clause can provide more protection than the statute, because although actions other than a writing could satisfy Com C §2201, they will not modify a contract with a no-oral-modification clause. *Marlowe v Argentine Naval Comm'n, supra*. But see Murray, *The Modification Mystery: Section 2-209 of the Uniform Commercial Code*, 32 Vill L Rev 1, 32 (1987), arguing that all means of satisfying the statute of frauds should also satisfy a no-oral-modification clause. See chap 7 for further discussion of the statute of frauds.

The "no-oral-modification" clause, like the other clauses of the contract, can be waived by the parties either expressly or by conduct. *Kropp v Ziebarth* (8th Cir 1979) 601 F2d 1348, 1356. The courts examine course of performance, course of dealing, and trade usage to determine whether the contractual statute of frauds was waived. Com C §1303(f). See *Green Constr. Co. v First Indem. of Am. Ins. Co*. (D NJ 1990) 735 F Supp 1254, 1262, aff'd without published opinion (3d Cir 1991) 935 F2d 1281; *Stinnes Interoil, Inc. v Apex Oil Co*. (SD NY 1985) 604 F Supp 978, 982.

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B. Modification Forms

§6.6 1. Form: Prohibition of Oral Modification or Rescission

To download **Word** version, right click and choose *Save Target As*

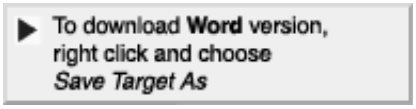
To download **WordPerfect** version, right click and choose *Save Target As*

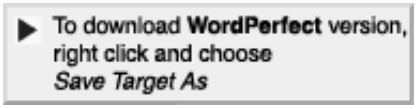
6.6-1 Prohibition of oral modification or rescission

This contract may not be modified, amended, or rescinded except by a writing signed by all parties to this contract or their duly authorized agents.

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§6.7 2. Form: Modification Increasing Contract Price





6.7-1 Modification increasing contract price

By agreement dated _ _[*date*]_ _**, the seller agreed to sell and the buyer agreed to buy** _ _[*quantity of commercial units, e.g., 100 gross*]_ _ **of** _ _[*describe goods*]_ _ **at** _ _[*dollar amount*]_ _ **per** _ _[*commercial unit*]_ _**. As a result of** _ _[*e.g., price increases of raw materials*]_ _ **since the date of the agreement, the seller would incur substantial losses in the performance of the agreement. The seller and buyer agree to modify the agreement to increase the price to** _ _[*dollar amount*]_ _ **per** _ _[*commercial unit*]_ _**, leaving all other terms of the agreement unchanged and in full force and effect.**

The seller and buyer agree and affirm that it is in their mutual interests to modify the agreement, that neither party exercised any duress or made any unreasonable demands in the negotiation of this modification, and that the parties observed reasonable commercial standards of fair dealing in the trade when negotiating this modification.

Comment: The modification is often much more complicated than a simple price increase and may include several changes. All changes should be described in detail in the clause. A recital of the reasons for the modification can be of probative value if litigation ensues.

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§6.8 C. Objections to Modification

If one party to a contract refuses to perform unless the contract is modified, but the proposed modification is unacceptable to the other party, the party that finds the modification unacceptable may object and resort to contract remedies. See Com C §2610.

A party forced by circumstances to accept a modification can contend that the consent was coerced. The coerced party must object to the terms of the modification in some way, however, *e.g.,* by informing the other party that it is accepting the modification only because no other alternative exists, by reserving the right to sue for overcharges or underpayments, or by sending a notice of protest. *Kelsey-Hayes Co. v Galtaco Redlaw Castings Corp*. (ED Mich 1990) 749 F Supp 794, 797 (modification may have been entered into under duress; summary judgment denied); *U.S. ex rel Crane Co. v Progressive Enters*. (ED Va 1976) 418 F Supp 662, 664 (defendant agreed to modification with secret intent not to comply; modification enforced). The modification could then be found unenforceable either because it was exacted in bad faith (Com C §1304; see §6.3) or because it was unconscionable (CC §1670.5).

The aggrieved party should document any objections to the modification as early as practicable. Objections should be expressed in a writing addressed to the party proposing the modification, referring to the terms modified and the conversations of the parties.

A party that assents to a demanded performance with explicit reservation of rights does not prejudice the reserved rights. Words such as "without prejudice" or "under protest" can act as a reservation of rights. Com C §1308(a).

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III. RESCISSION

§6.9 A. Definitions and Distinctions

"Rescission" has several meanings. As applied in the Commercial Code, however, rescission refers only to a consensual abandonment of the contract. Official Comment 3 to UCC §2-209. This meaning, which is used in this chapter, should be distinguished from unilateral "termination" and "cancellation," terms that describe situations in which one party ends the contract under a power to do so or for breach by the other. Com C §2106(3)-(4). See Official Comment 3 to UCC §2-209. Thus, a prohibition on rescission does not affect a party's right to terminate or cancel a contract.

PRACTICE TIP: When referring to parties' rights, the attorney should be precise in using the term "rescission," rather than "termination" or "cancellation," to denote a consensual abandonment, if that is the parties' intent.

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§6.10 B. Requirements of Rescission

Generally, a rescission can be in writing, oral, or manifested by the conduct of the parties. See *Pennel v Pond Union Sch. Dist*. (1973) 29 CA3d 832, 837, 105 CR 817 (rescission may be oral or manifested by conduct that is positive, unequivocal, and inconsistent with contract). A signed writing is required, however, if the agreement prohibits rescission except by a signed writing. Com C §2209(2). See form 6.6-1 for a prohibition clause. If the prohibition on rescission is contained in a form provided by a merchant to a nonmerchant (see §1.24 for discussion of "merchant"), the clause must be separately signed by the nonmerchant. Com C §2209(2).

PRACTICE TIP: If the parties attempt to rescind a contract orally when a writing is required (Com C §2209(2)), the attempt can operate as a waiver in the same manner that an ineffective modification can operate as a waiver. See §6.17. Even if a writing is not legally required, it is good practice to document the rescission to minimize any later disputes.

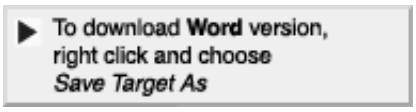
Consideration is necessary to support rescission. *Grant v Aerodraulics Co*. (1949) 91 CA2d 68, 74, 204 P2d 683. If neither party has completely performed its duties under the contract, however, the parties' mutual cancellation of executory rights is sufficient consideration. *Jura v Sunshine Biscuits, Inc*. (1953) 118 CA2d 442, 447, 258 P2d 90.

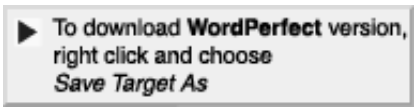
A factual mistake by one party to a contract, or unilateral mistake, provides a ground for rescission in some circumstances. Civil Code §1577 states in relevant part that "[m]istake of fact is a mistake, not caused by the neglect of a legal duty on the part of the person making the mistake, and consisting in … [a]n unconscious ignorance or forgetfulness of a fact past or present, material to the contract…." See *Donovan v RRL Corp.* (2001) 26 C4th 261, 109 CR2d 807 (dealer's error in not noticing automobile advertised at incorrect price provided grounds for rescission when consumer tendered advertised price).

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Source: Business Law/California UCC Sales and Leases/6 Modification, Rescission, and Waiver/§6.11 C. Form: Rescission of Written Contract

§6.11 C. Form: Rescission of Written Contract





6.11-1 Rescission of written contract

The undersigned, having on _ _[*date*]_ _ entered into an agreement _ _[*for the sale of* _ _[*describe goods or otherwise identify contract*]_ _]_ _, rescind the agreement.

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IV. WAIVER

§6.12 A. Requirements for Effective Waiver

Changes in performance can be accomplished by waiver. Waiver is one party's intentional relinquishment of a known right by words or conduct. See *Waller v Truck Ins. Exch. Inc.* (1995) 11 C4th 1, 55, 44 CR2d 370; *Brookview Condominium Owners' Assoc. v Heltzer Enters.-Brookview* (1990) 218 CA3d 502, 513, 267 CR 76. A party can perform under the contract or accept performance by the other party, without waiving any rights, by explicitly reserving rights. Com C §1308; *Shea-Kaiser-Lockheed-Healy v Department of Water & Power* (1977) 73 CA3d 679, 690, 140 CR 884.

Waiver, as used in Com C §2209, refers to a waiver of performance obligations in an executory contract. A waiver can result from an ineffective modification or rescission, unless the contract contains a "no-oral-waiver" clause. Com C §2209(4). See §6.14. A waiver can also be accomplished by conduct, unless the agreement states that all waivers must be in writing. Com C §1303(f); *Cassidy Podell Lynch, Inc. v Snydergeneral Corp*. (3d Cir 1991) 944 F2d 1131 (repeated acquiescence to late payments was course of performance establishing waiver of payment terms). But see *Zoeller v Schneider* (1956) 141 CA2d 684, 297 P2d 40 (defendant breached contract and could not rely on plaintiff's failure to obtain loan as waiver); *Marlowe v Argentine Naval Comm'n* (DC Cir 1986) 808 F2d 120, 124 (course of dealing not sufficient to establish waiver under former Com C §2208(3)). See §6.18.

PRACTICE NOTE: Any party waiving performance of the other party's contractual obligations should document the waiver and limit its effect to the particular failure to perform. This practice protects against future claimed waivers of compliance or waivers of "no-oral-modification" or "no-oral-waiver" clauses.

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§6.13 B. Contractual Clauses Limiting Waiver

The parties can include in their contract a "no-oral-waiver" clause (see §6.14) or a clause restricting the effect of any waiver (see §6.15). *South Hampton Co. v Stinnes Corp*. (5th Cir 1984) 733 F2d 1108, 1117 ("no waiver" clause enforced). These clauses, however, are subject to waiver and modification to the same extent as other contract clauses. *Westinghouse Credit Corp. v Shelton* (10th Cir 1981) 645 F2d 869, 872; *Kropp v Ziebarth* (8th Cir 1979) 601 F2d 1348, 1356.

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Source: Business Law/California UCC Sales and Leases/6 Modification, Rescission, and Waiver/§6.14 1. Form: Prohibition of Oral Waiver

§6.14 1. Form: Prohibition of Oral Waiver

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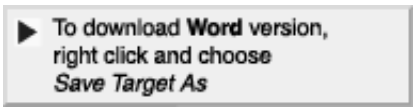
6.14-1 Prohibition of oral waiver

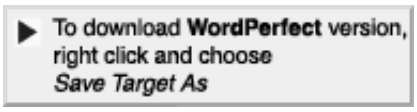
No waiver of any claim or right arising under this agreement will be effective unless the waiver is in writing and signed by the waiving party.

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Source: Business Law/California UCC Sales and Leases/6 Modification, Rescission, and Waiver/§6.15 2. Form: Limitation on Application of Waiver

§6.15 2. Form: Limitation on Application of Waiver



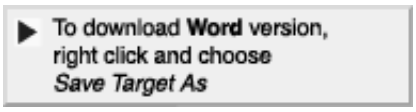


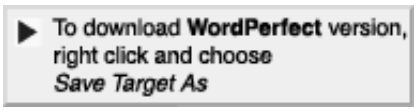
6.15-1 Limitation on application of waiver

Waiver by either party of any element of performance by the other party of any clause of this agreement will not be considered to be a waiver of future compliance with that clause or a waiver of compliance with any other clause of this agreement. All clauses of this agreement will remain in full force and effect regarding future performances.

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§6.16 3. Form: Express Waiver





6.16-1 Express waiver

The undersigned, _ _[*name of party*]_ _, waives _ _[*specify clause waived*]_ _ of the agreement between _ _[*name of party*]_ _ and _ _[*name of other party*]_ _, dated _ _[*date of agreement*]_ _. The undersigned does not waive future compliance with this clause and does not waive compliance with any other clause of the agreement. No future waiver of any claim or right arising under the agreement will be effective unless the waiver is in writing and signed by the waiving party.

Comment: By repeating the "no-oral-waiver" language at the end of this clause, the waiving party is taking precautions to prevent a modification or waiver of any "no-oral-waiver" language in the original agreement.

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§6.17 C. Waiver Resulting From Ineffective Modification or Rescission

A contract cannot be orally modified or rescinded if either (1) the express language of the contract requires that modifications or rescissions be signed and in writing (Com C §2209(2); see §§6.5-6.6) or (2) the statute of frauds requires that modifications or rescissions be signed and in writing (Com C §2209(3); see §6.4). An ineffective oral modification or rescission, however, can operate as a waiver. Com C §2209(4); *J. T. Jenkins Co. v Kennedy* (1975) 45 CA3d 474, 483, 119 CR 578. See also *Double-E Sportswear Corp. v Girard Trust Bank* (3d Cir 1973) 488 F2d 292, which limited "waiver," as used in Com C §2209(4), to the waiver of the right to assert the statute of frauds as a defense, thereby allowing oral modification of the agreement.

There is controversy over the interpretation of Com C §2209(4), which provides that an ineffective modification can operate as a waiver but not that it necessarily does. If all oral modifications that are ineffective (because they are not in writing, as required by law or the contract) were construed as waivers, then the statutory provisions that certain agreements can be modified only in writing (Com C §2209(2)-(3)) would have no practical effect.

When does an ineffective modification operate as a waiver? Some jurisdictions require reliance. See *Wisconsin Knife Works v National Metal Crafters* (7th Cir 1986) 781 F2d 1280, 1285. Other jurisdictions require only factual evidence that an oral agreement for modification was reached. See *Double-E Sportswear Corp. v Girard Trust Bank, supra*. Neither the California state courts nor the Ninth Circuit federal courts have addressed this issue. But see *U.S. v Humboldt Fir, Inc. (In re Humboldt Fir, Inc.)* (ND Cal 1977) 426 F Supp 292, 297, aff'd without opinion (9th Cir 1980) 625 F2d 330 (waiver recognized because evidence showed intent to waive; no discussion of reliance).

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§6.18 D. Waiver by Conduct

A waiver can result from course of performance, course of dealing, or trade usage. Com C §1303(f). A party may waive a contractual condition of performance by performing or by indicating a willingness to perform despite the other party's failure to fulfill the condition. See, *e.g., Federal Express Corp. v Pan Am. World Airways, Inc*. (8th Cir 1980) 623 F2d 1297, 1302 (buyer obtaining training from third party waived seller's duty to provide training); *U.S. ex rel Trans-Colorado Concrete, Inc. v Midwest Constr. Co*. (D Colo 1987) 653 F Supp 903 (delivery site orally changed; parties charged and paid extra costs without reservation); *KLT Indus. v Eaton Corp*. (ED Mich 1981) 505 F Supp 1072 (after delivery date passed, parties projected new delivery dates and acted to keep contract in force, and buyer did not invoke penalty clause or declare breach).

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E. Retraction of Waiver

§6.19 1. Ability to Retract Waiver

The waiving party can retract a waiver of an executory portion of a contract if the other party receives reasonable notification that strict performance will be required of any term waived, unless the retraction would be unjust in view of a material change of the other party's position in reliance on the waiver. Com C §2209(5). See *Double-E Sportswear Corp. v Girard Trust Bank* (3d Cir 1973) 488 F2d 292, 296. This provision applies to all waivers, whether resulting from an ineffective attempt at modification or otherwise. *Wisconsin Knife Works v National Metal Crafters* (7th Cir 1986) 781 F2d 1280, 1287; *Westinghouse Credit Corp. v Shelton* (10th Cir 1981) 645 F2d 869, 872.

PRACTICE TIP: Because a waiver (but not a modification) can be retracted, the party benefiting from the waiver should instead attempt to modify the agreement.

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§6.20 2. Reasonable Notification Received

The party retracting the waiver must give the other party reasonable notice that strict compliance with the terms of the contract will be required. *Cassidy Podell Lynch, Inc. v Snydergeneral Corp*. (3d Cir 1991) 944 F2d 1131, 1147. A retraction is valid only if the other party actually *receives* the notification; the party attempting to retract a waiver bears the risk of communication failure. Com C §2209(5). The retraction therefore should be sent by registered or certified mail, return receipt requested, or by other means that create a record of delivery.

A person receives a notification when (Com C §1202(e)):

- The notification comes to that person's attention;
- The notification is delivered at the place of business through which the contract was made; or
- The notification is delivered at another place designated by that person.

Although the place of business through which the contract was made is a proper place of receipt (Com C §1202(e)(2)), this may be changed by agreement (Com C §1302(b)). Because retractions may be too important to be trusted to the ordinary communication routines of a large organization, parties should specify in the sales contract the person or office to which notifications should be delivered. See Com C §1202(e) (receipt of notification by organization).

The Commercial Code does not define "reasonable notification." An analogy may be drawn from Com C §1205, however, which examines the nature, purpose, and circumstances of the action, including course of dealing and trade custom, to ascertain the reasonable time for taking action. A notification that does not give the notified party time to prepare for a performance that he or she had expected to have waived, or that does not specify clearly what the notified party is to do, is unreasonable. See *Cassidy Podell Lynch, Inc. v Snydergeneral Corp., supra*. For a clause indicating retraction of waiver, see form 6.22-1.

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§6.21 3. Retraction Forbidden Because Unjust

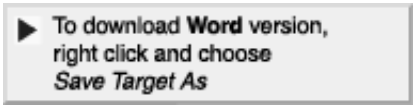
A waiving party cannot retract a waiver and insist on strict performance if the other party has performed, or otherwise materially changed his or her position, in reliance on the waiver. A waiver of the time for performance cannot be retracted if at the time of attempted retraction it is too late for the other party to perform. *Cassidy Podell Lynch, Inc. v Snydergeneral Corp*. (3d Cir 1991) 944 F2d 1131, 1147 (waiving party cannot order compliance with respect to past performance). What amounts to a material change in reliance on the waiver, however, is not specified in the Commercial Code.

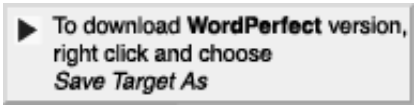
PRACTICE TIP: A "waiver" that causes the other party to change his or her position so as to preclude retraction could constitute a modification of the contract if the formalities of modification are met. See §§6.1-6.8.

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Source: Business Law/California UCC Sales and Leases/6 Modification, Rescission, and Waiver/§6.22 4. Form: Retraction of Waiver Allowing Substitution of Goods

§6.22 4. Form: Retraction of Waiver Allowing Substitution of Goods





6.22-1 Retraction of waiver allowing substitution of goods

By _ _[*a conversation on* _ _[*date*]_ _*/a letter from* _ _[*name of person sending letter*]_ _ *to* _ _[*name of person receiving letter*]_ _*, dated* _ _[*date*]_ _]_ _**, we agreed to permit you to substitute** _ _[*describe substituted goods*]_ _ **for** _ _[*describe original goods*]_ _ **called for by our contract. This is to advise you that after the date of this notice we will not accept** _ _[*describe substituted goods*]_ _ **but will require you to ship** _ _[*describe original goods*]_ _ **in strict conformity to our contract.**

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7

Statute of Frauds and Parol Evidence Rule

Marcia B. Wilbur

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I. STATUTE OF FRAUDS

A. Introduction

§7.1 1. Overview; Purpose

The statute of frauds governing contracts for the sale of goods (Com C §2201) provides in part that, subject to certain exceptions, a contract for the sale of goods for $500 or more is not enforceable by way of action or defense unless there is some writing sufficient to indicate that a contract for sale has been made between the parties and signed by the party against whom enforcement is sought or by his or her authorized agent or broker. A writing is not insufficient because it omits or incorrectly states an agreed-on term; however, the contract is not enforceable under §2201(1) beyond the quantity of goods shown in the writing. Com C §2201(1). Thus, the only essential term is quantity.

The statute is designed to prevent fraud and perjury by requiring certain contracts to be in writing. See §§7.5-7.8. A contract within the scope of the statute will be unenforceable against a party who has not signed a writing that contains certain minimum references to the contract. When the statute applies, the nonsigning party can object to any attempt by the other party to cure the absence of a writing by testimony about the terms of the parties' alleged oral contract.

The statute of frauds has several exceptions. See §§7.17-7.27. If an exception applies, the oral contract will be enforceable (at least in part) despite the fact that the statute requires it to be written.

The Civil Code also has a statute of frauds (CC §1624) that may apply to a sale of goods in very restricted circumstances. See §7.31.

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§7.2 2. Parol Evidence Rule Distinguished

The statute of frauds, which prevents enforcement of certain contracts when they are not evidenced by a sufficient writing, should be distinguished from the parol evidence rule, which applies to written contracts. The parol evidence rule bars oral or written extrinsic evidence contradicting the terms of the written contract. *Beazell v Schrader* (1963) 59 C2d 577, 30 CR 534. Oral terms that are consistent with the contract may be admissible despite the parol evidence rule. However, oral evidence cannot supply an essential element of the writing required by the statute of frauds. 1 Witkin, Summary of California Law, *Contracts* §349 (10th ed 2005).

The parol evidence rule does not exclude evidence relevant to whether an enforceable contract was *formed* and, in any event, would not apply unless the parties intended their written contract to be a "final expression of their agreement" with respect to the terms included in the contract. Com C §2202.

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§7.3 3. Criticism of Statute

The statute of frauds has generated a great deal of litigation, controversy, and commentary. It has been criticized as being riddled with exceptions, undermined by the doctrine of estoppel, and inconsistent with the Uniform Commercial Code's policy of allowing the quantity term in a sales contract to be left open by the parties. See generally East, *Symposium on Revised Article 1 and Proposed Revised Article 2 of the Uniform Commercial Code: The Statute of Frauds and the Parol Evidence Rule Under the NCCUSL 2000 Annual Meeting*, 54 SMU L Rev 867 (Spring 2001). Several California courts have expressed disfavor with the statute. See, *e.g., White Lighting Co. v Wolfson* (1968) 68 C2d 336, 66 CR 697; *Sunset-Sternau Food Co. v Bonzi* (1964) 60 C2d 834, 36 CR 741; *Shell v Darneille* (1984) 162 CA3d 957, 209 CR 68 (noting that it is policy of California courts to construe statute of frauds restrictively).

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Source: Business Law/California UCC Sales and Leases/7 Statute of Frauds and Parol Evidence Rule/§7.4 4. International Sales

§7.4 4. International Sales

In the arena of international trade, the United Nations Convention on Contracts for the International Sale of Goods (CISG; sometimes referred to as the Vienna Sales Convention; see 15 USC App) has no statute of frauds. Article 11 of CISG provides:

> A contract of sale need not be concluded in or evidenced by writing and is not subject to any other requirement as to form. It may be proved by any means, including witnesses.

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B. Transactions Within Statute

1. Contract for Sale of Goods

§7.5 a. Contract for Sale

Division 2's statute of frauds (Com C §2201) applies only if there is a "contract for sale," *i.e.,* either a present sale or a contract to sell in the future. Com C §§2106(1), 2201(1). A "sale" is defined as the passing of title from the seller to the buyer for a price. Com C §2106(1).

California courts have excluded other dealings in personal property from the sale category. For example, some contracts to supply goods to be manufactured specially for the buyer may be classified as contracts for work and materials. Such contracts are not governed by the statute of frauds. See *Aced v Hobbs-Sesack Plumbing Co*. (1961) 55 C2d 573, 580, 12 CR 257.

Dealership arrangements come under Com C §2201 only if the dealer becomes a buyer of the goods. To become a buyer, the dealer must acquire title to identified goods. Com C §§2103(1)(a), 2106(1), 2401(1). Sales agents or dealers selling goods on consignment often do not buy them but are only required to account for the proceeds from selling them, for which they receive commissions or other compensation for their services.

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§7.6 b. Goods

The statute of frauds in Division 2 (Com C §2201) applies only to a sale of *goods.* For definition of goods, see Com C §2105. A contract may come within the statute, however, even though it includes more than goods. *De Filippo v Ford Motor Co*. (3d Cir 1975) 516 F2d 1313, for example, concerned the sale of a car dealership. The oral contract could not properly be divided into "goods" and "non-goods," with the statute of frauds applying only to the former. Because the goods sold were valued at over three times that of other assets sold, the court held that the contract was essentially one for the sale of goods and therefore was unenforceable in its entirety.

A contract that is not essentially for the sale of goods (*e.g.,* one in which the service element of the transaction is the predominant feature) might come within the Civil Code's statute of frauds rather than Division 2's statute of frauds. See CC §1624. To determine whether a contract is the sale of goods or services, California courts look to the essence of the agreement; the question is whether the provision of goods or services predominates. *IMC Chems., Inc. v Niro, Inc.* (D Kan 1998) 30 F Supp 2d 1328 (applying California law). For instance, a maintenance contract for a copying machine might not be governed by Division 2, because the furnishing of replacement parts is only an incidental aspect of what is essentially a service arrangement. If the term of the contract was longer than a year, however, the Civil Code's statute of frauds would require it to be in writing. See CC §1624(a)(1). See §§7.28-7.31 for discussion of other statutes of frauds that may apply to a transaction.

The statute of frauds in Com C §2201(1) does not apply to a "qualified financial contract" as defined in CC §1624(b)(2) if there is sufficient evidence that a contract has been made or the parties agree to be bound by the terms of the qualified financial contract when they reach agreement (by telephone, exchange of electronic messages, or otherwise) on those terms. See Com C §2201(4).

For further discussion of whether a transaction is a sale of "goods," see §§1.4-1.8.

The sale of securities is governed by UCC Division 8, rather than Division 2. See Com C §2105(1). See also 9 Witkin, Summary of California Law, *Corporations* §135 (10th ed 2005).

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§7.7 c. Price of $500 or More

The statute of frauds in Division 2 (Com C §2201) applies only to contracts to sell goods for the price of $500 or more. Com C §2201(1).

If all or part of the price is payable in services or property instead of money, Com C §2201 applies if the total value of the consideration given is at least $500. The price may be determined objectively from written or external facts. *California Lettuce Growers, Inc. v Union Sugar Co.* (1955) 45 C2d 474, 289 P2d 785 (price may be fixed by parties, determined from prior course of performance, or established by court). If the contract does not state the price, the applicability of the statute of frauds depends on whether a "reasonable" price determined under Com C §2305 amounts to $500. If there is no promise or understanding that goods worth at least $500 will be sold under the open quantity term, the statute of frauds presumably does not apply. See *Flint v Giguiere* (1920) 50 CA 314, 195 P 85 (defendant agreed to pay $1 for each head of cattle he purchased but did not bind himself to purchase a specific number; agreement not subject to statute of frauds).

For discussion of open price terms under Com C §2305, see §§4.3-4.20.

The price of goods may depend on the quantity of goods to be sold under an open quantity term, *e.g.,* in requirements or output contracts (see §§4.21-4.47). On the necessity of a quantity term in the writing, see §7.12.

Under the Commercial Code's partial performance exception (see Com C §2201(3)(c); §§7.22-7.23), the statute of frauds can apply to bar enforcement of the remaining portion of the contract after some goods have already been received or paid for. If goods worth at least $500 have already been sold, the minimum quantity has been established and the executed portion of the contract may be enforced. However, the unperformed part of the contract should be barred by the statute of frauds.

In auction sales, each lot of goods is a separate sale for purposes of the $500 minimum. See Com C §2328(1).

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§7.8 2. Sale or Return Transaction

In a sale or return transaction, the buyer purchases the goods for purposes of resale but has an option to return goods that the buyer does not resell. Com C §§2326(1)(b), 2327(2). See §§10.28, 12.53-12.55. This return privilege must be treated as a separate contract for purposes of the statute of frauds. Com C §2326(4). A writing that is sufficient for enforcement of the sale part of the transaction does not entitle the buyer to enforce the right to return the goods unless the writing also shows on its face that the seller has agreed to that right. The enforceability of the return privilege may also be established by a separate writing or by fulfillment of one of the exceptions to the writing requirement (see §§7.17-7.27). This separate compliance with the statute of frauds is required because the right to return conforming goods is "definitely at odds with any ordinary contract for sale of goods." Official Comment 3 to UCC §2-326.

A return privilege is treated as a term contradicting the sale aspect of the contract, and therefore admissibility of such an oral provision is barred under the parol evidence rule (Com C §2202). Com C §2326(4). See §§7.38-7.39.

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§7.9 3. Contract Modifications

Commercial Code §2201(1) applies to oral modifications of contracts that originally fell within its ambit. If a contract that originally did not fall under Com C §2201 is modified and the contract as modified comes within the statute, then its requirements must be satisfied. Com C §2209(3).

If the terms of a contract require that modification be made by a signed writing, the contract cannot be otherwise modified. Except for contracts between merchants, such a requirement on a form supplied by a merchant must be separately signed by the other party. Com C §2209(2); Official Comment 3 to UCC §2-209. However, in certain circumstances, the ineffective modification can operate as a waiver. See Com C §2209(4)-(5).

See §§6.2-6.8 for further discussion of contract modification.

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C. Requirement of Writing

§7.10 1. Form of Writing

A contract within the statute of frauds must be evidenced by a "writing." Com C §2201(1). Writing "includes printing, typewriting or any other intentional reduction to tangible form." Com C §1201(b)(43). The writing need only afford a basis for believing that offered oral evidence represents a real transaction. For example, the writing may be in lead pencil on a scratch pad. See Official Comment 1 to UCC §2-201. It may also be in electronic form. The Electronic Signatures in Global and National Commerce Act (ESIGN) (15 USC §§7001-7031), which became effective October 1, 2000, provides that any signature, contract, or other record cannot be denied legal effect, validity, or enforceability solely because it is in electronic form (15 USC §7001(a)(1)), and any contract cannot be denied legal effect, validity, or enforceability solely because an electronic signature or electronic record was used in its formation (15 USC §7001(a)(2)). Before ESIGN, California adopted a version of the Uniform Electronic Transactions Act (UETA) (see CC §§1633.1-1633.17), which applies to transactions between parties who have each agreed to conduct a transaction electronically. UETA provides for the enforceability of electronic contracts, as well as for records retention and the evidentiary use of electronic records.

A writing may consist of exchanged telegrams or other combinations of documents. *Goodman v Community Sav. & Loan Ass'n* (1966) 246 CA2d 13, 54 CR 456. It may be an irrevocable letter of credit. *Procyon Corp. v Components Direct, Inc.* (1988) 203 CA3d 409, 249 CR 813; *Siam Numhong Prods. Co. v Eastimpex* (ND Cal 1994) 866 F Supp 445 (applying California law). The sufficiency of the writing may be found in one or more writings or a letter. *Kerner v Hughes Tool Co.* (1976) 56 CA3d 924, 128 CR 839.

The writing may incorporate contract terms by referring to another unsigned document that contains them. *Dunham, Carrigan & Hayden Co. v Thermoid Rubber Co*. (1927) 84 CA 669, 258 P 663. Explicit incorporation by reference is not necessary; it is enough if the signed writing refers to the unsigned writing by implication, or that the party to be charged physically attaches one document to the other or encloses them in the same envelope. Even if there is no internal cross-reference or physical connection, the writings may be read together if they clearly relate to the same transaction. *Addiego v Hill* (1968) 268 CA2d 280, 73 CR 901; 1 Witkin, Summary of California Law, *Contracts* §351 (10th ed 2005).

The loss or destruction of a writing does not deprive it of its effect. Restatement (Second) of Contracts §137 (1981). The contents of a lost or destroyed writing may be shown by an unsigned copy or by oral evidence. Restatement §137, comment a.

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2. Contents of Writing

§7.11 a. Minimum Terms

The only specific terms that Com C §2201(1) requires in the writing are that it must:

- Indicate that a contract of sale has been made between the parties (§§7.5-7.6);
- Be signed by the party against whom enforcement is sought or by that party's agent (see §§7.14-7.16); and
- Specify a statement of the quantity of goods (see §7.12).

The writing need not contain all the material terms of the contract, and those terms that are included need not be precisely stated. See *Seaman's Direct Buying Serv. v Standard Oil Co.* (1984) 36 C3d 752, 762, 206 CR 354, overruled in part on other grounds in *Freeman & Mills, Inc. v Belcher Oil Co.* (1995) 11 C4th 85, 88, 44 CR2d 420, and further disapproved on other grounds in *Della Penna v Toyota Motor Sales, U.S.A., Inc.* (1995) 11 C4th 376, 393, 45 CR2d 436 (in enforcing requirements contract, court stated: "What is essential depends on the agreement and its context and also on the subsequent conduct of the parties" (quoting Restatement (Second) of Contracts §131, Comment g (1981))). All that is required is that the writing afford a basis for believing that the offered oral evidence rests on a real transaction. Official Comment 1 to UCC §2-201.

The parties should be identified (Com C §2201(1)), but the memorandum need not show which party is the buyer and which is the seller. Official Comment 1 to UCC §2-201.

The quality of the goods, price, and times and places of payment and delivery may be omitted. See Official Comment 1 to UCC §2-201. The required indication of a "quantity of goods" (see §7.12) may necessitate a description of the goods. For instance, it may be insufficient to state simply "300 pounds" without also referring to flour or fertilizer.

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§7.12 b. Quantity Term

A sales contract within Division 2's statute of frauds is not enforceable beyond the quantity of goods shown in the writing. Com C §2201(1).

Because the Commercial Code permits contracts to sell quantities measured by a seller's output or a buyer's requirements (see Com C §2306(1); §§4.21-4.30), a written contract or memorandum containing such a term states a "quantity of goods" under Com C §2201(1). See *Seaman's Direct Buying Serv. v Standard Oil Co*. (1984) 36 C3d 752, 206 CR 354, overruled in part on other grounds in *Freeman & Mills, Inc. v Belcher Oil Co.* (1995) 11 C4th 85, 88, 44 CR2d 420, and further disapproved on other grounds in *Della Penna v Toyota Motor Sales, U.S.A., Inc.* (1995) 11 C4th 376, 393, 45 CR2d 436 (contract for dealer's "requirements"; no express quantity term necessary to satisfy applicable statute of frauds).

Similarly, a written reference to other nonnumerical measurements (*e.g.,* a carload or all the goods at a specified place; see *Carstens Packing Co. v Miller* (1935) 10 CA2d 48, 51 P2d 161) probably satisfies the statute of frauds.

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§7.13 c. Incorrect Statement of Terms

Commercial Code §2201(1) expressly provides that a writing is not insufficient because it omits or incorrectly states an agreed-on term. Because Com C §2201(1) limits enforceability to the quantity of goods shown in the writing (see §7.12), the contract is apparently enforceable for either the written or the orally agreed quantity, whichever is lower. If the writing specifies 500 pounds, the plaintiff cannot recover on an oral agreement to sell 5000 pounds, but Com C §2201 does not preclude the defendant from introducing evidence that the actual deal was for only 50 pounds. See Official Comment 1 to UCC §2-201.

The parol evidence rule, however, may exclude evidence of variations between the writing and oral terms that would be permitted under Com C §2201. If the writing is intended as a final expression of the parties' agreement, it cannot be contradicted by evidence of an earlier or contemporaneous oral agreement. Com C §2202. See §§7.32-7.40.

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3. Signature

§7.14 a. Manner

The writing must be "signed by the party against whom enforcement is sought." Com C §2201(1). A broad interpretation of "signed" is favored under the Commercial Code; a formal signature is not required. The signature may be "any symbol executed or adopted with present intention to adopt or accept a writing." Com C §1201(b)(37). See *Procyon Corp. v Components Direct, Inc*. (1988) 203 CA3d 409, 249 CR 813 (buyer "signed" letter of credit by directing bank to issue letter and supplying relevant contractual terms; buyer essentially adopted bank's signature on document). The Electronic Signatures in Global and National Commerce Act (ESIGN) (15 USC §§7001-7031), which became effective October 1, 2000, defines an "electronic signature" broadly as "an electronic sound, symbol or process, attached to or logically associated with a contract or other record and executed or adopted by a person with the intent to sign the record." 15 USC §7006(5).

An electronic signature can take many forms, and can be created by many different technologies. Examples of electronic signatures that should qualify under ESIGN include:

- Typing the sender's name at the end of an e-mail message sent by him or her;
- Including a digitized image of a handwritten signature attached to an electronic document;
- A mouse click (*e.g.,* on an "I accept" or "I agree" button); and
- A "digital signature" (for example, a signature created through public key cryptography).

Unlike the federal ESIGN, the state-level Uniform Electronic Transactions Act (UETA) (see CC §§1633.1-1633.17) is premised on consent by the parties; the statute does not apply unless the parties have "agreed to conduct transactions by electronic means." CC §1633.5(b). The consent requirement applies to both business and consumer transactions. Whether the parties have consented to conduct a transaction by electronic means is determined from the context and circumstances surrounding the transaction, and consent may be either express or implied. CC §1633.5(b). Under UETA, the definition of "electronic signature" is limited to signatures "attached to or logically associated with an electronic record" only and therefore excludes signatures associated with paper records. CC §1633.2. This difference may prevent the integration of paper and electronic records and transactions, a goal the UETA sought to accomplish through its integrated definition.

The "signature" may be written, printed or stamped, or consist of initials or a thumbprint, and may appear on any part of the document, including the billhead or letterhead. Official Comment 37 to UCC §1-201. See *Donovan v RRL Corp.* (2001) 26 C4th 261, 109 CR2d 807 (automobile dealer's printed name in newspaper advertisement evidenced intention to authenticate advertisement as offer and therefore constituted signature sufficient to satisfy statute of frauds in Com C §2201(1)); *Barber & Ross Co. v Lifetime Doors, Inc*. (4th Cir 1987) 810 F2d 1276 (seller's trademark sufficient to authenticate documents under signature requirement); *First Valley Leasing, Inc. v Goushy* (D NJ 1992) 795 F Supp 693 (invoice containing company letterhead was sufficient).

The writing must be signed or authenticated only by the party against whom the contract is being enforced. See Official Comment 6 to UCC §2-201.

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§7.15 b. Agent's Signature; Equal Dignities Rule

A writing may be sufficient against a party if it is authenticated by that party's authorized agent or broker. Com C §2201(1). Under California's "equal dignities" rule, however, "an authority to enter into a contract required by law to be in writing can only be given by an instrument in writing." CC §2309. The equal dignities rule requires that the agent have written authority to bind the principal to any agreement that comes within the statute of frauds. But see *Clifton Cattle Co. v Thompson* (1974) 43 CA3d 11, 117 CR 500 (buyer received and accepted cattle purchased by agent; equal dignities rule not invoked, because goods accepted require no written contract under Com C §2201(3)(c)). However, a third party cannot raise an objection to the invalidity of a contract under the equal dignities rule if the principal did not object. *Bumb v Bennet* (1958) 51 C2d 294, 333 P2d 23; *Mitchell v Locurto* (1947) 79 CA2d 507, 179 P2d 848.

The equal dignities rule is subject to numerous exceptions and limitations (see 1 Witkin, Summary of California Law, *Contracts* §§388-391 (10th ed 2005)):

- If a principal negotiates the contract, he or she can orally authorize an agent to perform the mechanical act of signing his or her name to it. *Kadota Fig Ass'n of Producers v Case-Swayne Co*. (1946) 73 CA2d 815, 167 P2d 523 (authority given over telephone).
- If the principal is a corporation, the equal dignities rule does not require that the executive officer of the corporation have written authority to enter into a written contract on the corporation's behalf. See *Jeppi v Brockman Holding Co.* (1949) 34 C2d 11, 206 P2d 847. Frequently, the corporation's bylaws or a resolution by the board of directors grants this authority.
- A principal who gives an agent oral authority to contract, when written authority is required by CC §2309, escapes liability on the contract itself but may be compelled to reimburse the agent for damages resulting from the agent's *personal* liability under the contract. See *Sunset-Sternau Food Co. v Bonzi* (1964) 60 C2d 834, 36 CR 741.
- Civil Code §2309 apparently does not require written authority for an oral waiver of a contractual term. On oral waivers, see Com C §2209(4). See also §§5.12-5.18.
- The written authority may be given before or after the agent acts. Lack of original written authority may be cured by subsequent written ratification. CC §2310; *Moore v Hoar* (1938) 27 CA2d 269, 81 P2d 226.
- When the agent's signing of a written agreement is a purely mechanical act that does not involve the exercise of discretion, the principal's authorization is not required to be in writing and the signature is treated as that of the principal, whether or not the principal was present at the agreement's execution. *Ellis v Mihelis* (1963) 60 C2d 206, 214, 32 CR 415; *Murphy v Munson* (1949) 95 CA2d 306, 312, 212 P2d 603 (oral authorization of signature sufficient).
- If the agent receives a written instrument of authority under CC §2309 and, with only oral authority, alters the instrument and acts under it as altered, the principal's subsequent oral adoption of its signature on the altered instrument amounts to giving the agent written authority to act on the altered terms. *Lawrence Block Co. v England* (1962) 211 CA2d 318, 324, 27 CR 362.
- In an auction sale, the auctioneer can execute a memorandum of sale on behalf of both the seller and the bidder. CC §2363.

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§7.16 D. Effect of Compliance or Noncompliance With Statute of Frauds

Proof of compliance with Division 2's statute of frauds does not establish the existence or enforceability of the contract. The writing is not the contract but merely evidence of its terms. Proof of compliance eliminates a defense against the contract's enforcement, but the creation of the contract itself and its terms still must be independently established. See Official Comment 3 to UCC §2-201 (Official Comment 4 to UCC §2-201 (2003)).

The statute of frauds relates to the remedy available to a party asserting the existence of a contract. Failure to produce a writing complying with Com C §2201 merely renders the oral contract unenforceable, not void. Official Comment 4 to UCC §2-201. The oral contract is effective for all purposes until one party attempts to enforce it by court action. For example, a buyer who takes possession of goods under such a contract is not a trespasser. Official Comment 4 to UCC §2-201.

The statute of frauds may be invoked only by a party to the contract, not by a third party. See Official Comment 4 to UCC §2-201 (Official Comment 5 to UCC §2-201 (2003)). However, a third party in privity to a contract can take advantage of the statute of frauds. *O'Banion v Paradiso* (1964) 61 C2d 559, 39 CR 370.

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Source: Business Law/California UCC Sales and Leases/7 Statute of Frauds and Parol Evidence Rule/ E. Exceptions to Statute/ 1. Merchant's Failure to Object to Written Confirmation/§7.17 a. Requirements Applicable to Confirmation

E. Exceptions to Statute

1. Merchant's Failure to Object to Written Confirmation

§7.17 a. Requirements Applicable to Confirmation

Division 2's statute of frauds is satisfied under certain conditions when one party fails to respond to the other party's written confirmation of their agreement. The following are the conditions that must be met (see Com C §2201(2); see also *Perdue Farms, Inc. v Motts, Inc.* (ND Miss 1978) 459 F Supp 7, 14, for comprehensive discussion of these requirements):

- **The contract must be "between merchants."** For definitions, see Com C §2104(1), (3). See also §1.24.
- **The writing must be in confirmation of the contract and be "sufficient against the sender."** This means that the confirmation must be in writing, it must indicate that a contract for sale has been made between the parties, and it must contain a quantity term. Com C §2201(1).
- **The confirmation must be delivered.** A confirmation that has been lost in the mails cannot bind its addressee. To be received, the confirmation must come to the recipient's attention or be delivered to the recipient's business address. Com C §1202(e)(2). The confirmation is not received by an organization, however, until it either comes to the attention of the individual conducting the transaction or would have come to the individual's attention if the organization had followed reasonable routines for internal communications. Com C §1202(f).

EXAMPLE: In *Dairyman's Coop. Creamery Ass'n v Leipold* (1973) 34 CA3d 184, 109 CR 753, the court held that the oral agreement between the parties did not fall within the merchant's exception, because there was no substantial evidence to prove that a shipping order and an invoice, relied on by the supplier as confirmatory writings, were delivered to the purchaser personally or properly mailed to him. Compare *Perdue Farms, Inc. v Motts, Inc.* (ND Miss 1978) 459 F Supp 7 (buyer could rely on presumption of receipt through mailing of order to prove that seller received confirmation).

- **The recipient must have reason to know the contents of the confirmation but need not have actual knowledge.** The recipient cannot escape the effect of a confirmation by deliberately refraining from reading it after it is received. See Com C §1202(a), (d).
- **Receipt of the confirmation and reason to know its contents must occur "within a reasonable time."** Com C §2201(2). The time is measured, presumably, from the date of the oral agreement.

EXAMPLE: A written confirmation received ten calendar days after an oral agreement was made to buy wheat was received within a reasonable time. *Conagra, Inc. v Nierenberg* (Mont 2000) 7 P3d 369 (court reviewed other cases and stated that there was no bright line rule as to what constituted reasonable time to send written confirmation as between merchant-farmer and merchant-buyer of grain). In contrast a delay of 120 days in sending a written confirmation of an agreement to purchase a farmer's wheat crop was unreasonable as a matter of law. *Lish v Compton* (Utah 1976) 547 P2d 223.

PRACTICE TIP: Between merchants, confirmation is most often made by invoice or statement of account. A purchase order is also occasionally used as a confirmation. Because Com C §2201(1) requires that the writing be "sufficient to indicate that a contract for sale has been made between the parties," a purchase order may not be an adequate confirmation. Generally, a purchase order functions as an *offer* in response to a special quotation or an advertisement in a catalog. The best practice is for the attorney to use a separate confirmation form.

A confirmatory writing is not insufficient merely because it (1) states terms that are in addition to, or different from, the terms of the oral agreement (*Cargill, Inc. v Stafford* (10th Cir 1977) 553 F2d 1222; *St. Charles Cable TV, Inc. v Eagle Comtronics, Inc*. (SD NY 1988) 687 F Supp 820, aff'd without published opinion (2d Cir 1989) 895 F2d 1410) or (2) omits or incorrectly states an agreed term (Com C §2201(1)).

A combination of writings may serve as a confirmation for purpose of the statute of frauds. *Hilford Chem. Corp. v Ricoh Elecs*. (2d Cir 1989) 875 F2d 32.

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§7.18 b. Notice of Objection

Failure to object in writing within 10 days after receipt of a written confirmation deprives the recipient of the defense of the statute of frauds. Com C §2201(2).

To be valid, the notice of objection must be in writing. See *A & G Constr. Co. v Reid Bros. Logging Co*. (Alaska 1976) 547 P2d 1207, 1216 (objection over telephone to increased price term not sufficient). A written disagreement or denial of the terms of the confirmation may not qualify as written notice of objection so as to prevent the confirmation from satisfying the statute. *Perdue Farms, Inc. v Motts, Inc.* (ND Miss 1978) 459 F Supp 7.

When more than 10 days' time has elapsed after receipt of the confirmation, the recipient is no longer entitled to give written notice of objection, and the statute of frauds defense becomes unavailable. See Official Comment 3 to UCC §2-201 (Official Comment 4 to UCC §2-201 (2003)); *Cargill, Inc. v Stafford* (10th Cir 1977) 553 F2d 1222 (14 days' notice not timely).

The receiving merchant is not bound by the terms of the confirmatory writing merely because the merchant failed to give timely notice of objection and is not barred from proving that the terms of the oral agreement were different than those set forth in the confirmatory writing. *Perdue Farms, Inc. v Motts, Inc*. (ND Miss 1978) 459 F Supp 7. Commercial Code §2201(2) merely adds an exception to the statute of frauds; §2201(2) does not control when the question is the terms on which the parties agreed. *Tri-State Petroleum Corp. v Saber Energy, Inc*. (5th Cir 1988) 845 F2d 575. For discussion of whether the confirmation modifies the terms of the agreement under Com C §2207(1)-(2) ("battle-of-the-forms" section), see chap 5.

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§7.19 2. Specially Manufactured Goods

A contract that does not satisfy Division 2's statute of frauds, but is valid in other respects, is enforceable if (Com C §2201(3)(a)):

- The goods are to be specially manufactured for the buyer and are not suitable for sale to others in the ordinary course of the seller's business; and
- The seller, before notice of repudiation is received and under circumstances reasonably indicating that the goods are for the buyer, has made either a substantial beginning of their manufacture or (if a third party is to manufacture them) commitments for their procurement.

One apparent purpose of Com C §2201(3)(a) is to protect a seller that makes or procures specially designed goods, relying on an oral contract, from being left with goods that cannot be sold to others. In terms of the statute's policy, commencement of manufacture or procurement by the seller of goods that only one buyer can use indicates an oral contract as reliably as if the seller had signed a writing sufficient under Com C §2201(1).

A crucial inquiry for purposes of this exception is whether the seller may dispose of the goods in the ordinary course of its business to someone other than the original buyer. *Impossible Elecs. Techniques v Wakenhut Protective Sys.* (5th Cir 1982) 669 F2d 1026 (oral contract for security camera system designed to adjust to lighting conditions at defendant's residence). See also *Smith-Scharff Paper Co. v P.N. Hirsch & Co. Stores* (Mo Ct App 1988) 754 SW2d 928 (oral contract to buy paper bags imprinted with buyer's logo); *Flowers Baking Co. v R-P Packaging, Inc*. (Va 1985) 329 SE2d 462 (cellophane wrapping material manufactured to size required by buyer's container, and imprinted with buyer's name and unique artwork, constituted "specially manufactured" goods).

If the goods in question could be sold after making slight alterations, they may not be considered to be "specially manufactured." If essential changes are required to make the goods marketable, however, then the statutory exception applies. *Impossible Elecs. Techniques v Wakenhut Protective Sys., supra*.

If an oral sales contract covers both specially manufactured goods and standard goods, does the statute of frauds exception for the former also extend to the latter? The court in *Distribu-Dor, Inc. v Karadanis* (1970) 11 CA3d 463, 468, 90 CR 231, held that it does, on the ground that "there is no justification in holding one portion of the contract enforceable and one not." One can reasonably question the court's reasoning. The seller's conduct was probative only for specially manufactured goods and not standard goods; standard goods can readily be sold to others.

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3. Goods Paid for or Received

§7.20 a. All Goods Received and Accepted

The buyer's receipt and acceptance of goods "constitutes an unambiguous overt admission by both parties that a contract actually exists" (Official Comment 2 to UCC §2-201 (Official Comment 3 to UCC §2-201 (2003)) and makes an oral contract for the sale of those goods enforceable by either party (Com C §2201(3)(c); see *Price v McConnell* (1960) 184 CA2d 660, 7 CR 695).

Receipt and acceptance operate retroactively, validating the oral contract from the time it was made. *Schaefer v United Bank & Trust Co*. (1930) 104 CA 635, 645, 286 P 723. Receipt and acceptance by the buyer's agent are sufficient. *Dairyman's Coop. Creamery Ass'n v Leipold* (1973) 34 CA3d 184, 109 CR 753 (broker's oral agreement to purchase milk powder fell outside statute of frauds because powder was delivered to third party at broker's instructions and accepted by third party; court rejected contention that exception applies only to receipt and acceptance by buyer or buyer's authorized agent); *Ben-Hur Mfg. Co. v Empire Factors* (1960) 181 CA2d 123, 5 CR 181 (freezers shipped to third party designated by defendant).

To receive goods is to take physical possession of them. Com C §2103(1)(c). Delivery or tender of delivery does not constitute receipt; the buyer must take possession. Acceptance is defined in Com C §2606 (discussed in §§10.19-10.31). On acceptance of a commercial unit by accepting part of the unit, see §7.23.

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§7.21 b. Entire Price Paid and Accepted

The buyer's payment and the seller's acceptance of the price make the contract enforceable by either party. Com C §2201(3)(c). Payment and acceptance are as valid as receipt and acceptance of the goods to prove the existence of the contract. See Official Comment 2 to UCC §2-201 (Official Comment 3 to UCC §2-201 (2003)). Acceptance of a promissory note is considered acceptance of payment for purposes of the statute of frauds. See *Uni-Prod., Inc. v Bearse (In re Uni-Prod., Inc.)* (Bankr ED Mich 1993) 153 BR 764.

Acceptance by the seller means acceptance of the *price* of the goods, not other charges. *Mardikian v Parador Mining Co*. (1961) 192 CA2d 747, 13 CR 793 (defendant contended that tractor was loaned to it, not sold; defendant's payment of transportation expenses to have tractor shipped to it did not remove contract from application of statute of frauds). A check that is received but returned by the seller does not constitute acceptance for this purpose. *Dessert Seed Co. v Garbus* (1944) 66 CA2d 838, 846, 153 P2d 184.

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§7.22 c. Limited Effect of Partial Performance

"Partial performance" can validate an oral contract within the statute of frauds only for goods that have been accepted or for which payment has been made and accepted. Receipt and acceptance either of goods or of payment constitute an unambiguous overt admission by both parties that a contract actually exists. If the court can make a just apportionment, the agreed price of any goods actually delivered can be recovered without a writing. Alternatively, if the price has been paid, the seller can be made to deliver an apportionable part of the goods (assuming that the contract can be proved). See Com C §2201(3)(c); Official Comment 2 to UCC §2-201 (Official Comment 3 to UCC §2-201 (2003)).

Compare *Allied Grape Growers v Bronco Wine Co*. (1988) 203 CA3d 432, 439, 249 CR 872 (partial performance of oral contract entitled seller to payment only for grapes received and accepted by buyer), with *Lockwood v Smigel* (1971) 18 CA3d 800, 96 CR 289 (even though seller received as downpayment only small portion of price of automobile, oral contract was enforceable because sale involved only one item; apportionment not necessary).

NOTE: The rule that partial performance makes the contract enforceable for only that part actually performed by the parties is analogous to the rule that a writing makes the contract enforceable for only the quantity shown in the writing.

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§7.23 d. Partial Acceptance of Commercial Unit

Commercial Code §2201(3)(c) expressly refers to Com C §2606 for the meaning of "acceptance" of goods. Under Com C §2606(2), a buyer accepts an entire "commercial unit" of goods by acceptance of any part of the unit. A commercial unit means goods that are customarily sold together as "a single whole" and whose sale or use separately, instead of as a unit, would materially impair their character or value. Such a unit may be a single article (*e.g.,* a suite of furniture or an assortment of sizes), a quantity (*e.g.,* a bale, gross, or carload), or any other unit treated in use or in the relevant market as a single whole. Com C §2105(6).

If a bedroom suite is a commercial unit consisting of a bed, dresser, chest, and nightstand, a buyer that receives and accepts only the bed accepts the entire suite under Com C §§2201(3)(c) and 2606(2). Therefore, receipt and acceptance of the bed make an oral contract enforceable for sale of the entire suite. The party relying on receipt and acceptance of the bed to enforce the sale of the bedroom suite, however, would be required to prove that the suite was a commercial unit under Com C §2105(6).

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§7.24 e. Allocation of Goods to Partial Payment

When an oral sales contract is partially performed, the court may be required to apportion the obligations under it between those that the performance makes enforceable and those that it leaves unenforceable. The buyer may be required to pay the part of the price justly apportionable to the goods the buyer has received and accepted; similarly, the seller may be held liable for delivery of goods apportionable to the payment on the price the seller has accepted. Evidence of any terms of the oral agreement that are relevant to a just apportionment are admissible. See Official Comment 2 to UCC §2-201 (Official Comment 3 to UCC §2-201 (2003)).

Except when the price is wholly or partially payable in something other than money (see Com C §2304), there is likely to be little difficulty in allocating a part of the price to goods received and accepted. When the subject of the contract is a single indivisible unit, the court may treat the entire contract as enforceable. See *Lockwood v Smigel* (1971) 18 CA3d 800, 96 CR 289 ($100 downpayment for $11,400 automobile made entire contract enforceable under Com C §2201(3)(c) because there could be no dispute over quantity of goods sold).

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§7.25 f. Installment and Dealership Contracts

Partial performance satisfies Division 2's statute of frauds only with respect to the goods that are paid for or actually received. Com C §2201(3)(c). See §§7.20-7.21. The unperformed part of a long-term sales contract is ordinarily unenforceable unless supported by either (1) a writing signed by the party against whom enforcement is sought or that party's authorized agent or broker (Com C §2201(1)) or (2) a merchant's failure to respond to a written confirmation of the contract (Com C §2201(2); see §§7.17-7.18).

Division 2's statute of frauds therefore covers all partially performed "installment contracts" (Com C §2612(1)), including requirements, output, and exclusive dealing contracts, and makes those contracts unenforceable to the extent that they have not been performed. The attorney should advise business clients to pay close attention to written communications relating to such contracts.

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§7.26 4. Admissions in Court

If the party against whom enforcement is sought admits in that party's "pleading, testimony or otherwise in court" that a contract for sale was made, an oral contract limited to the quantity of goods admitted may be enforced despite the absence of a writing. Com C §2201(3)(b).

The theory of this exception is that the statute of frauds was designed to prevent enforcement of contracts that were not in fact made. If a party admits that an oral contract was entered into, there is no reason not to enforce it. It is not necessary that there be an express declaration in which the party admits the making of the oral contract. It is sufficient if the party's words or admitted conduct reasonably lead to that conclusion. *Quaney v Tobyne* (Kan 1984) 689 P2d 844.

The "judicial admission" exception in Com C §2201(3)(b) was not originally adopted in California when the remainder of the Uniform Commercial Code was adopted. The legislature was concerned that the provision was unclear and its limits uncertain. For example, although an admission in an answer or cross-complaint would clearly remove an oral agreement from the purview of the statute of frauds, what effect would be given to a demurrer to a complaint alleging an oral contract? Would an answer to an interrogatory be considered an "admission" for purposes of this exception? Would the exception apply to a statement made in a deposition? What is meant by "otherwise in court"? Does that include testimony made in other lawsuits? Who is a "party" for purposes of the exception? Is a former employee who was then acting as an agent for the defendant a "party" who can admit the existence of a contract? See *Isaac v A & B Loan Co*. (1988) 201 CA3d 307, 312 n3, 247 CR 104. See also *DF Activities Corp. v Brown* (7th Cir 1988) 851 F2d 920 (holding that once defendant in sworn affidavit has denied existence of contract, "safety valve" of UCC §2-201(3)(b) is closed; affidavit was sufficient to sustain motion to dismiss complaint because chance that defendant at deposition might withdraw denial was too remote to justify prolonging effort to enforce oral contract).

Ultimately, California did adopt the judicial admission exception, in an amendment to Com C §2201 effective January 1, 1990. No California case authority has interpreted the scope of this exception. In a case predating the amendment, however, the court held that the exception did not apply when the alleged "admission" was a declaration made in another action. See *Isaac v A & B Loan Co., supra*.

Note that a contract established by an admission in court is probably enforceable only to the extent that it is admitted. See, *e.g., Driver v Ford (In re Driver)* (Bankr MD Fla 1987) 78 BR 616 (plaintiff asserted that defendant had agreed to purchase all his watermelon requirements from plaintiff; defendant admitted that contract existed, but that he had agreed to make purchases only on truck-by-truck basis, according to his ability to resell; court enforced contract only to extent of watermelons already purchased).

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§7.27 5. Estoppel and Waiver

In *Allied Grape Growers v Bronco Wine Co*. (1988) 203 CA3d 432, 249 CR 872, the court held, in a case of first impression, that the doctrine of promissory estoppel may provide another exception to Division 2's statute of frauds. In *Allied,* a wine company had an oral agreement with a grape growers' cooperative for delivery of a certain type of grape crop. The wine company accepted and paid for one load of grapes but rejected deliveries of the rest. There was evidence that the growers had originally contracted to sell the grapes to a third party but had received permission to sell them to the wine company instead. Given bad weather conditions, the perishable nature of the crop, and the defendant's last-minute scheduling changes, the growers had no opportunity to sell the grapes to someone else. The growers sued for breach of the oral agreement, and the wine company asserted the statute of frauds as a defense.

The court in *Allied* held that the growers had so changed their position in reliance on the oral agreement that they would suffer unconscionable injury if the agreement's enforcement was barred by the statute of frauds. The court based its decision in part on Com C §1103 (now Com C §1103(b)), which provides that general principles of law (such as estoppel) may be used to supplement Commercial Code provisions.

In California, a party is estopped from relying on the statute of frauds if (203 CA3d at 444):

- The party seeking enforcement of the oral contract would be unconscionably injured because it has detrimentally changed its position in reliance on the contract (see, *e.g., Irving Tier Co. v Griffin* (1966) 244 CA2d 852, 53 CR 469); or
- The party resisting enforcement would be unjustly enriched from the benefits that it has already received from the contract (see, *e.g., Monarco v Lo Greco* (1950) 35 C2d 621, 220 P2d 737).

In cases decided before the enactment of the Commercial Code, it has been held that, when a buyer orally agrees to buy existing goods to be delivered at a later date and then repudiates the contract after a sharp drop in the market price of the goods, the buyer may be estopped by the seller's loss of opportunity to sell to others at the higher market price. *Moore v Day* (1954) 123 CA2d 134, 266 P2d 51; *Goldstein v McNeil* (1954) 122 CA2d 608, 265 P2d 113.

Not every detriment is a ground for estoppel, however. See *Caplan v Roberts* (9th Cir 1974) 506 F2d 1039 (applying California law; lost profit, which buyer expected to make on resale of equipment that seller failed to deliver, did not qualify as unconscionable injury; seller could assert statute of frauds as defense). See generally Anno, *Promissory Estoppel as Basis for Avoidance of UCC Statute of Frauds (UCC §2-201)*, 29 ALR4th 1006.

The statute of frauds may be waived by a party's failure to assert it as a defense or by failure to object at trial to evidence of the alleged oral agreement. See *Pao Ch'en Lee v Gregoriou* (1958) 50 C2d 502, 326 P2d 135, disapproved on other grounds in 4 C3d at 22 (defendants waived statute of frauds by permitting proof of oral agreement to be made, without objection, by five witnesses at trial and by failing to make any motion to strike testimony). See also *Clark Equip. Co. v Wheat* (1979) 92 CA3d 503, 154 CR 874 (defense of statute of frauds cannot be raised for first time on appeal).

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Source: Business Law/California UCC Sales and Leases/7 Statute of Frauds and Parol Evidence Rule/ F. Other Statutes of Frauds/ 1. Commercial Code/§7.28 a. Sale of Personal Property Not Goods [Deleted]

F. Other Statutes of Frauds

1. Commercial Code

§7.28 a. Sale of Personal Property Not Goods [Deleted]

This section has been deleted because Com C §1206 was repealed by SB 1481 (2006), effective January 1, 2007.

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§7.29 b. Grant of Security Interest in Goods

The statute of frauds governing transactions in security interests under Division 9 is Com C §9203(b)(3)(A). With the revision of Division 9, effective July 1, 2001, the legislature expanded the concept of a writing. Under the former version of Com C §9203, a security interest was required to be evidenced by "a written agreement signed by the debtor." Under the revised version of Com C §9203, a security interest need only be preserved in a record authenticated by the debtor. (For definition of "authenticate," see Com C §9102(a)(7)). Thus, it may be in a writing *or* stored in an electronic or other medium that is "retrievable in perceivable form." See Com C §9102(a)(69). Further, if the secured party has "control" over a deposit account, an electronic chattel paper, an investment property, a letter-of-credit right, or electronic documents, the security agreement may be oral. Com C §9203(b)(3)(D). See generally Secured Transactions in California Commercial Law Practice, chaps 2-3 (2d ed Cal CEB 2001).

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Source: Business Law/California UCC Sales and Leases/7 Statute of Frauds and Parol Evidence Rule/§7.30 c. Sale of Investment Securities

§7.30 c. Sale of Investment Securities

A contract or modification of a contract for the sale of a security is enforceable whether or not there is a writing signed by the party against whom enforcement is sought, even if the contract or modification is not capable of performance within one year of its making. Com C §8113.

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§7.31 2. Civil Code

The principal statute of frauds outside the Commercial Code is CC §1624.

A sales contract may be subject to that statute even though it is not within Division 2's statute of frauds. For example, an agreement to buy $25 worth of office supplies each month for 15 months is below the $500 minimum of Com C §2201, but, because it is an agreement that by its terms is not to be performed within one year, it cannot be enforced without a writing. CC §1624(a)(1). Similarly, a seller may deliver $450 worth of merchandise to a corporate buyer in reliance on the promise of the corporation's president to guarantee payment. The seller can enforce the contract with the corporation both because the price is under $500 and because the goods have been received and accepted. The personal undertaking of the president, however, is subject to CC §1624(a)(2) and cannot be enforced unless it is in writing.

The purpose and application of the Civil Code's statute of frauds was recently explained by the California Supreme Court in *Sterling v Taylor* (2007) 40 C4th 757, 55 CR3d 116. To summarize:

- The statute of frauds does not require a written contract; a note or memorandum "subscribed by the party to be charged" is adequate. 40 C4th at 765.
- A memorandum satisfies the statute of frauds if it identifies the subject of the parties' agreement, shows that they made a contract, and states the essential contract terms with reasonable certainty. Only the essential terms must be stated; details or particulars need not be. What is essential depends on the agreement and its context and also on the subsequent conduct of the parties. 40 C4th at 766.
- Because the memorandum itself must include the essential contractual terms, extrinsic evidence cannot supply those required terms. It can, however, be used to explain essential terms that were understood by the parties but would otherwise be unintelligible to others. 40 C4th at 767.
- Therefore, if a memorandum includes the essential terms of the parties' agreement, but the meaning of those terms is unclear, the memorandum is sufficient under the statute of frauds if extrinsic evidence clarifies the terms with reasonable certainty and the evidence as a whole demonstrates that the parties intended to be bound. Conflicts in the extrinsic evidence are for the trier of fact to resolve, but whether the evidence meets the standard of reasonable certainty is a question of law for the court. 40 C4th at 771.
- Extrinsic evidence cannot be employed to prove an agreement at odds with the terms of the memorandum. That is, the evidence cannot contradict the terms of the writing. 40 C4th at 771.

In the court's words (40 C4th at 770):

> To clarify the law on this point, we disapprove the statements in California cases barring consideration of extrinsic evidence to determine the sufficiency of a memorandum under the statute of frauds. The purposes of the statute are not served by such a rigid rule.

LEGISLATIVE NOTE: Civil Code §1624.5, enacted in 2006, adds another statute of frauds based on former UCC §1-206. It provides:

> (a) Except in the cases described in subdivision (b), a contract for the sale of personal property is not enforceable by way of action or defense beyond five thousand dollars ($5000) in amount or value of remedy unless there is some record, as defined in [CC §1633.2(m)], but solely to the extent permitted by applicable law, that indicates that a contract for sale has been made between the parties at a defined or stated price, reasonably identifies the subject matter, and is signed, including by way of electronic signature, as defined in [CC §1633.2(h)], but solely to the extent permitted by applicable law, by the party against whom enforcement is sought or by his or her authorized agent.
>
> (b) Subdivision (a) does not apply to contracts governed by the Commercial Code, including contracts for the sale of goods [Com C §2201], contracts for the sale of securities [Com C §8113], and security agreements [Com C §§9201, 9203].
>
> (c) Subdivision (a) does not apply to a qualified financial contract as that term is defined in [CC §1624(b)(2)] if either of the following exists:
>
> (1) There is, as provided in [CC §1624(b)(3)], sufficient evidence to indicate that a contract has

been made.

(2) The parties, by means of a prior or subsequent written contract, have agreed to be bound by the terms of the qualified financial contract from the time they reach agreement (by telephone, by exchange of electronic messages, or otherwise) on those terms.

A retail installment contract for the sale of consumer goods must be in writing. CC §1803.1. The Civil Code specifies the size of type that must be used for text and headings and requires special notices to the consumer about the computation of finance charges and the granting of any security interest. The Code also specifies what terms the contract must contain. See generally CC §§1803.1-1803.11.

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II. PAROL EVIDENCE RULE

§7.32 A. Introduction

The parol evidence rule that applies to contracts for the sale of goods is found in Com C §2202. It prohibits the admission of evidence that contradicts or is inconsistent with the terms of a writing when the parties intended those terms to be the final expression of their agreement.

The text of Com C §2202 follows:

> Terms with respect to which the confirmatory memoranda of the parties agree or which are otherwise set forth in a writing intended by the parties as a final expression of their agreement with respect to such terms as are included therein may not be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement but may be explained or supplemented
>
> (a) By course of dealing, course of performance, or usage of trade (Section 1303); and
>
> (b) By evidence of consistent additional terms unless the court finds the writing to have been intended also as a complete and exclusive statement of the terms of the agreement.

The parol evidence rule comes into play when the parties to a written agreement are involved in litigation and the agreement's meaning or effect becomes an issue. The agreement is introduced into evidence, and one or both parties contend that there were other terms to the agreement that are not reflected in the writing or that the interpretation being given to the written terms is incorrect. The parties will introduce evidence at trial to support their respective positions. When the agreement involves the sale of goods, the admissibility of the evidence is governed by the parol evidence rule of Com C §2202.

Parol evidence is frequently thought to refer to "oral" evidence only. The parol evidence rule, however, embraces all evidence, written or oral, that attempts to show that the parties agreed to certain other terms before or contemporaneous with the agreement that is the subject of the litigation. The limitation to oral evidence applies in the context of agreements allegedly made contemporaneously with the writing.

Although it governs the issue of admissibility, the parol evidence rule is generally viewed as a substantive rule rather than a rule of evidence. *Alling v Universal Mfg. Corp.* (1992) 5 CA4th 1412, 7 CR2d 718; Jefferson's California Evidence Benchbook §34.5 (4th ed CJA-CEB 2009). When a party is successful in asserting the rule and, as a result, evidence of other agreements or negotiations is excluded, the substance of the parties' agreement is limited to the terms contained in the writing.

Throughout the following discussion, when evidence is said to be "admissible," the only restriction on admissibility being considered is the parol evidence rule. The author assumes that the evidence would otherwise satisfy all applicable criteria for admission, such as relevance, competence, proper foundation, and so forth.

See generally Ross & Tranen, *The Modern Parol Evidence Rule and Its Implications for New Textualist Statutory Interpretation*, 87 Geo L J 195 (Oct. 1998); Prince, *Contract Interpretation in California: Plain Meaning, Parol Evidence and Use of the "Just Result" Principle*, 31 Loy LA L Rev 557 (Jan. 1998); Kniffen, *A New Trend in Contract Interpretation: The Search for Reality as Opposed to Virtual Reality*, 74 Oregon L Rev 643 (1995).

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B. Applicability

§7.33 1. Overview

Agreements are made in various ways. They can be completely oral, completely written, or partially oral and partially written. Enforceability issues under the statute of frauds can arise when the agreement is totally or partially oral (see §§7.1-7.31), but parol evidence rule issues do not arise unless the agreement, or part of it, has been reduced to a writing.

When relying on early California cases that discuss the parol evidence rule, the attorney should remember that the Commercial Code's rule is a liberalization of the pre-Code rule and that the non-Code rule (see CCP §1856) was changed extensively by amendment in 1978. See 14 Cal L Rev'n Comm'n Reports 143 (1978).

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2. Limited to Evidence Affecting Terms in Final Writing

§7.34 a. Terms

The Commercial Code defines the agreement as being "the bargain of the parties in fact as found in their language or by implication from other circumstances" (Com C §1201(b)(3)) and a term as "that portion of an agreement that relates to a particular matter" (Com C §1201(b)(40)). The terms can be created by the parties themselves or supplied by the Code's "open term" provisions. See chap 4.

The agreement to the terms may be express or implied. The express terms may be oral or written. The implied terms are created by the conduct between the parties in their performance of the contract (see §§4.94-4.97), in their dealings with each other over the course of time (see §§4.98-4.99), and by the common practices of their trade (see §§4.100-4.103). The parol evidence rule gives preference to the written, express terms that the parties agreed to after any oral or written agreements or negotiations.

Commercial Code §2202 is not the only Code provision that gives preference to the written terms of the parties' agreement. See Com C §1303. Under that section:

- Written, express terms supersede and control all other terms that cannot reasonably be reconciled;
- Oral terms supersede and control all inconsistent implied terms;
- Course of performance supersedes and controls all inconsistent terms found through course of prior dealings and usage of trade; and
- Course of prior dealings supersedes and controls inconsistent terms found through usage of trade.

Thus, the descending order of hierarchy is (1) written terms, (2) oral terms, (3) course of performance, (4) course of dealing, and (5) usage of trade.

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§7.35 b. Writing

The writing to which the parol evidence rule applies does not have to be a formal written contract. It may consist of a single document or several documents (*Stern & Co. v State Loan & Fin. Corp*. (D Del 1965) 238 F Supp 901) and may include confirmatory memorandums (*David J. Joseph Co. v S & M Scrap Metal Co*. (Ga Ct App 1982) 295 SE2d 860).

When oral or written evidence is being introduced to show that there was a prior agreement regarding written terms, the subsequent agreement reflected in the final writing is given primacy, and the evidence may be inadmissible. When there are two contradictory but contemporaneous writings, the judge may admit both writings, and the jury will decide which writing embodies the actual agreement. *General Equip. Mfr. v Bible Press, Inc*. (Mich Ct App 1968) 160 NW2d 370.

Written confirmations can create an interplay between the parol evidence rule and Com C §2207, which allows for terms to be added to a contract by its acceptance. Terms found to be relevant through the application of Com C §2207 are protected by the parol evidence rule. See *Boyd v Oscar Fisher Co*. (1989) 210 CA3d 368, 258 CR 473 (attorney fee provision in manufacturer's invoice added to dealership agreement; no argument made that dealership agreement was final expression of parties' agreement).

The parol evidence rule applies to a successor or assignee of the contracting party but not to strangers to the contract. *Meadows v Lee* (1985) 175 CA3d 475, 221 CR 22; Jefferson's California Evidence Benchbook §34.37 (4th ed CJA-CEB 2009).

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§7.36 c. Final Expression

The fact that one of the parties produces a writing does not automatically invoke the parol evidence rule. The rule only protects a writing that both parties intended to be a final expression of their agreement. Com C §2202.

Some of the terms of an agreement may be final while others are still being negotiated or left for future agreement. The parol evidence rule will apply only to those terms that are final. See *Allapattah Servs. v Exxon Corp.* (SD Fla 1999) 61 F Supp 2d 1300, 1303 (parol evidence rule does not impose supposition that, because agreement may be final writing as to some of terms of agreement, it is final as to all of its terms). The fact that a term has been reduced to writing is partial, but not conclusive, evidence that it was intended to be final. See *Masterson v Sine* (1968) 68 C2d 222, 65 CR 545.

When the parties do not agree that the writing was intended to be the final expression of their agreement, the court must make a preliminary determination of their intent to integrate the writing. *Bert G. Gianelli Distrib. Co. v Beck & Co*. (1985) 172 CA3d 1020, 1037, 219 CR 203, disapproved on other grounds in *Dore v Arnold Worldwide, Inc.* (2006) 39 C4th 384, 46 CR3d 668; *Betaco v Cessna Aircraft Co.* (7th Cir 1996) 103 F3d 1281. Evidence of all the circumstances, including language and conduct, is admissible to show final intention. *Marin Foods, Inc. v Hempy (In re William Rakestraw Co.*) (9th Cir 1971) 450 F2d 6. In determining the extent of integration, a "critical element" to consider is the terms of the alleged oral understanding. Oral terms that conflict with the writing do *not* suggest that the agreement is unintegrated. Indeed, a conflict between oral and written terms is irrelevant to the question of integration. The court's primary concern is whether the oral terms would not "naturally" have been excluded from the writing. Stated another way, could the parties have intended the agreement to be fully integrated *without* the alleged oral terms or would such terms naturally be included in a fully integrated agreement? See *Esbensen v Userware Int'l, Inc.* (1992) 11 CA4th 631, 637, 14 CR2d 93.

For the writing to be considered the final expression of the parties' agreement, the writing need not (1) contain express language to that effect, (2) take any particular form, or (3) be signed by either party. *Tow v Miners Mem. Hosp. Ass'n* (4th Cir 1962) 305 F2d 73.

The parol evidence rule does not apply if a writing is a reflection of negotiations. Although preliminary written proposals exchanged by the parties are not ordinarily intended as final expressions of the terms, they may later be assented to as such orally, in writing, or by other conduct. See Restatement (Second) of Contracts §209 (1981).

The character of the writing itself is often sufficient to persuade the court that the writing was the final expression of the parties' agreement. If a writing's thoroughness and specificity suggest that it embodies the parties' final agreement on its terms, the agreement may be taken as integrated with respect to those terms. Restatement §209.

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§7.37 3. Exceptions to Parol Evidence Rule

Numerous exceptions to the parol evidence rule will permit some types of evidence to be admitted:

- **Modifications and rescissions.** The parol evidence rule does not apply to modifications or rescissions of the agreement. Jefferson's California Evidence Benchbook §34.30 (4th ed CJA-CEB 2009). These occur after the agreement is made, and the rule is limited to negotiations or agreements occurring before or contemporaneously with the writing. The subsequent modification or rescission may be oral or written, but if the agreement, as modified, would be subject to the statute of frauds, the modification must satisfy the statute of frauds. Com C §2209(3).
- **No valid written agreement.** The parol evidence rule does not apply to evidence introduced to show that no valid written agreement existed (*e.g.,* evidence showing that the offer was not accepted, that the parties never got beyond negotiations, or that the writing was a forgery, joke, or sham). Jefferson's Evidence Benchbook §34.28. See also *Sho-Pro of Ind., Inc. v Brown* (Ind Ct App 1992) 585 NE2d 1357.
- **Condition.** Evidence should be admissible to show that the parties intended that the written agreement would take effect only if a stated condition occurred. That condition should be one that must occur before any duty of performance arises on either side. Corbin on Contracts §589 (rev ed 1993).
- **Failure of consideration.** The parol evidence rule does not bar evidence showing failure of consideration. Even if there is a recital of consideration in the writing, evidence will be admitted to show that the recital is untrue. Corbin on Contracts §591.
- **Mistake, fraud, duress, or undue influence.** A written agreement obtained or executed through mistake, fraud, duress, or undue influence is not protected by the parol evidence rule. See, *e.g., Pacific State Bank v Greene* (2003) 110 CA4th 375, 1 CR3d 739, as modified (Aug. 7, 2003) 2003 Cal App Lexis 1204 (parol evidence rule does not bar party from offering evidence that its signature on agreement was procured by misrepresentation concerning content of document to be signed); *Bell v Exxon Co*. (9th Cir 1978) 575 F2d 714 (parol evidence admitted to show that buyer was fraudulently induced to enter into contract). An agreement that violates public policy is also not protected by the parol evidence rule. The rule does not bar evidence of illegality or unauthorized alteration because such common law defenses undermine the parties' intended finality. Corbin on Contracts §580.
- **Collateral contemporaneous oral agreement.** The parol evidence rule does not bar evidence of a contemporaneous oral agreement that is collateral to, and consistent with, a written agreement when the written agreement is either incomplete or silent on the subject and the circumstances justify an inference that it was not intended to constitute a final inclusive statement of the transaction. *Ellis v Klaff* (1950) 96 CA2d 471, 476, 216 P2d 15; *In re Pacific Sunwest Printing* (Bankr SD Cal 1980) 6 BR 408. In determining whether the oral agreement is collateral to the written agreement, the court will consider whether the oral agreement is not one that the parties would "certainly have included." *Birsner v Bolles* (1971) 20 CA3d 635, 638, 97 CR 846.

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C. Inadmissibility of Evidence of Contradictory Terms

§7.38 1. Overview

The Commercial Code states that terms that are set forth in a writing intended by the parties as a final expression of the parties' agreement "may not be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement…." Com C §2202. Thus, evidence of an alleged prior or contemporaneous oral agreement that is at odds with the terms of the parties' final agreement will not be admitted.

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§7.39 2. Sale or Return Contracts

In an ordinary agreement for the sale of goods, the buyer is under an obligation to accept and pay for conforming goods. See §10.1. Under a "sale or return" contract, the buyer may return goods that conform to the agreement. See Com C §§2326(1)(b), 2327(2). On sale or return contracts, see §§10.28, 12.53-12.55.

The Commercial Code recognizes that an "or return" provision is so definitely at odds with an ordinary contract for the sale of goods that, when written agreements are involved, the "or return" provision must be contained in a written memorandum. The "or return" aspect of the sales agreement is treated as a separate contract under the statute of frauds, and the term is treated as contradicting the sale for purposes of the parol evidence rule. Official Comment 3 to UCC §2-326. Therefore, parol evidence that the sale was on an "or return" basis may not be introduced to contradict a written contract for the sale of goods.

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§7.40 3. Admissibility When Contract Is Silent

Under Com C §2202, a writing cannot be supplemented by parol evidence that would contradict it. The question may arise, however, whether a contradiction may exist about an issue on which the agreement is silent. The answer to this question seems to be "no." A contradiction should arise only when the evidence would negate an express term within the writing. In *Hunt Foods & Indus. v Doliner* (App Div 1966) 270 NYS2d 937, parol evidence was admitted to show that an apparently unconditional option was nonetheless conditional. The writing did not expressly state that the option was unconditional. The court found that the parol evidence did not contradict the writing and admitted the evidence. On the other hand, the court in *Snyder v Herbert Greenbaum & Assocs.* (Md Ct Spec App 1977) 380 A2d 618 rejected "the narrow view of inconsistency" in *Hunt* and held that parol evidence of a contractual right to unilateral rescission was inconsistent with a written agreement for the sale and installation of carpeting. The court in *Snyder* defined "inconsistency" as used in UCC §2-202 as the absence of reasonable harmony in terms of the language and respective obligations of the parties. The UCC appears to carry over the definition of consistency employed by Restatement (Second) Contracts §216(2)(b). As noted in Official Comment 3 to §2-202, "If the additional terms are such that, if agreed upon, they would certainly have been included in the document in the view of the court, then evidence of their alleged making must be kept from the trier of fact."

If a writing is silent about a term that the law would otherwise presume, parol evidence that contradicts the presumption will be allowed. See, *e.g., Masterson v Sine* (1968) 68 C2d 222, 65 CR 545 (option agreement is presumed to be assignable unless it contains a restriction on assignment; however, evidence of such a restriction is not barred by parol evidence rule).

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D. Admissibility of Evidence to Explain Meaning of Terms

§7.41 1. Overview

Extrinsic evidence is always admissible to resolve ambiguities on the face of the agreement. Com C §2201(1). See *Seaman's Direct Buying Serv. v Standard Oil Co*. (1984) 36 C3d 752, 206 CR 354, overruled in part on other grounds in *Freeman & Mills, Inc. v Belcher Oil Co.* (1995) 11 C4th 85, 88, 44 CR2d 420, and further disapproved on other grounds in *Della Penna v Toyota Motor Sales, U.S.A., Inc.* (1995) 11 C4th 376, 393, 45 CR2d 436.

The writing, however, does not have to be ambiguous for the extrinsic evidence to be admitted. Extrinsic evidence is admissible to explain the meaning of a facially unambiguous written instrument if the written instrument is reasonably susceptible of the proffered interpretation. See, *e.g., Morey v Vannucci* (1998) 64 CA4th 904, 75 CR2d 573 (extrinsic evidence allowed to explain meaning of contract term "affiliated entities"; because extrinsic evidence was in conflict, court properly submitted question of interpretation to jury). An Official Comment to the Uniform Commercial Code's parol evidence rule specifically rejects ambiguity as a precondition to admissibility. See Official Comment 1(c) to UCC §2-202. The language of the agreement should be interpreted in its commercial context, with the goal of finding the parties' intent. See Official Comment 1(b) to UCC §2-202.

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§7.42 2. Admissibility of Course of Performance, Course of Dealing, and Usage of Trade to Explain Express Terms

Although a writing may contain an apparently clear and unambiguous term, seemingly contradictory parol evidence may sometimes be admitted to show that the parties gave the term a different meaning. The meaning of the agreement is determined by the language used by the parties and by their actions, read and interpreted in the light of commercial practices and other surrounding circumstances. Com C §1201(b)(3); Official Comment 1 to UCC §1-303.

The meanings intended by the parties and the commercial practices and other surrounding circumstances can be revealed through the parties' performance of the agreement, their prior course of dealing, and the usages of their trade. By definition, these terms are the reasonable expectations of the parties and are relevant in finding their intent.

Commercial Code §2202(a) permits usage of trade to be placed in evidence as an instrument of interpretation. Official Comment 2 to UCC §2-202 states that evidence of usage of trade is admissible

> in order that the true understanding of the parties as to the agreement may be reached. Such writings are to be read on the assumption that the course of prior dealings between the parties and the usages of trade were taken for granted when the document was phrased. Unless carefully negated they have become an element of the meaning of the words used. Similarly, the course of actual performance by the parties is considered the best indication of what they intended the writing to mean.

See also *Heggblade-Marguleas-Tenneco, Inc. v Sunshine Biscuit, Inc*. (1976) 59 CA3d 948, 954, 131 CR 183.

A course of prior dealings establishes a common basis of understanding for interpreting the parties' terms and conduct. Both it and usage of trade give particular meaning to or qualify the terms of the agreement. Com C §§1201(b)(3), 1303(b), (d). See *Petroleo Brasileiro, S.A., Petrobras v Nalco Chem. Co.* (D NJ 1992) 784 F Supp 160, aff'd without published opinion (3d Cir 1992) 977 F2d 569 (preagreement phone conversation in which defendant refused to guarantee performance was admissible because plaintiff knew from prior dealings that it was defendant's policy not to make such guarantees).

In the same manner, course of performance is relevant to determine the meaning of the agreement. Com C §1303(d). It serves not only to establish a waiver or modification of a term (Com C §1303(f)) but also to establish any meaning reasonably consistent with the agreement's express terms (Com C §1303(d)).

The effect is to make course of prior dealings, course of performance, and usage of trade always admissible unless they totally negate the writing's express terms. This result is illustrated in *Nanakuli Paving & Rock Co. v Shell Oil Co*. (9th Cir 1981) 664 F2d 772 (applying Hawaii law), in which the court held that a usage of trade in the asphalt paving trade, by which asphalt suppliers protected paving contractors against price increases, did not totally negate the contract term that the stated price was the suppliers' posted price at the time of delivery. Consequently, the usage of trade was admissible even though the contract terms were clear. In *Heggblade-Marguleas-Tenneco, Inc. v Sunshine Biscuit, Inc., supra,* the court admitted evidence that, in the potato-processing trade, the quantity of sacks of potatoes specified in the contract was merely an estimate of the buyer's requirements. See also *Michael Schiavone & Sons, Inc. v Securalloy Co*. (D Conn 1970) 312 F Supp 801, in which the court ruled that the defendant-seller could attempt to prove that the quantity term was modified by an oral understanding, in line with a usage of trade, that the seller would supply only as many tons as it could, with an upper limit.

For a court to use such implied terms to better understand the express terms does not mean that the court is allowing the evidence to contradict the written instrument. The use of such evidence "simply places the court in the position of the parties when they made the contract, and enables it to appreciate the force of the words they used in reducing it to writing." *Nanakuli Paving & Rock Co. v Shell Oil Co*. (9th Cir 1981) 664 F2d 772, 798 (applying Hawaii law).

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§7.43 3. Admissibility to Explain Terms Defined by Commercial Code

If a written agreement contains a term that is defined by the Commercial Code, parol evidence may be introduced to show that the parties intended a different meaning. An example of such a term is "bill of lading," which is defined in Com C §1201(b)(6) and includes airbills. In *Board of Trade v Swiss Credit Bank* (9th Cir 1979) 597 F2d 146 (applying California law), the defendant successfully resisted a summary judgment by arguing that evidence of custom and usage should be admitted to show that "full set clean on board bills of lading" meant only ocean shipment.

The California Supreme Court has specifically rejected the theory that some words have immutable meaning that must be applied regardless of the parties' intent. See *PG&E v G. W. Thomas Drayage & Rigging Co*. (1968) 69 C2d 33, 38, 69 CR 561.

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E. Admissibility of Evidence to Supplement Terms of Writing

§7.44 1. Overview

Even though the terms of a writing are final, the writing may not be "complete and exclusive" (Com C §2202(b)) because it does not contain all the terms of the agreement. If the writing is not complete and exclusive, other express or implied terms can be admitted to complete the agreement.

Two theories may be used to exclude evidence that is being proffered to supplement the writing:

- The evidence contradicts or is inconsistent with the writing (see §7.38); or
- The contract is a complete and exclusive statement of the terms of the agreement (a totally integrated contract) (see §§7.47-7.50).

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2. Admissibility of Consistent Terms

§7.45 a. Consistency

Parol evidence cannot be admitted to prove terms that are inconsistent with the writing. Com C §2202. The Commercial Code expressly requires that the implied terms of the agreement (for course of performance, course of dealing, and usage of trade) should be construed as consistent with each other whenever reasonable. Com C §1303(e).

Parol evidence is consistent as long as it does not totally negate the written term. *Nanakuli Paving & Rock Co. v Shell Oil Co*. (9th Cir 1981) 664 F2d 772, 796 (applying Hawaii law). The question of consistency is one of fact. 664 F2d at 793.

But see Official Comment 3 to UCC §2-202.

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§7.46 b. Examples

In the following cases, the courts held that the terms were consistent with the agreement:

- Parol evidence that the seller promised a delivery date no later than the end of the second week of a specified month and would try to make delivery by the first week of that month does not negate a statement in the writing that the seller would try to ship by approximately the first of the month. *MacGregor v McReki, Inc*. (Colo Ct App 1971) 494 P2d 1297.
- Evidence of market value of the product at the time of the sale was admissible on the issue of damages. The evidence was not barred by the parol evidence rule as contradicting the purchase price stated in the contract. *Ford Motor Co. v Tidwell* (Tex Civ App 1978) 563 SW2d 831.
- Parol evidence of precontract oral representations and warranties made by salespersons was simply an explanation of the equipment and software purchased and could be introduced for the purpose of explaining or supplementing the contract's terms. *Triad Sys. Corp. v Alsip* (10th Cir 1989) 880 F2d 247 (applying California law).

In the following cases, the courts held that the terms were inconsistent with the agreement:

- When the contract required the seller to make extensive preparations, parol evidence of an additional oral term that would give the buyer an unqualified, unilateral right to cancel the contract was not reasonably harmonious with the obligation imposed on the seller and therefore was inadmissible. *Snyder v Herbert Greenbaum & Assocs*. (Md Ct Spec App 1977) 380 A2d 618.
- In a seller's action to force the buyer to take delivery of and pay for cable assemblies, the agreement unambiguously required the assemblies to be tested *only* to ensure that the wires within each assembly were unbroken when they were shipped. The agreement did not require that each cable assembly be tested to ensure that it would withstand the rigors of future commercial use. The court refused to admit the buyer's evidence that the latter test was also intended. *ITT Corp. v LTX Corp*. (1st Cir 1991) 926 F2d 1258.

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3. Inadmissibility When Agreement Is Complete and Exclusive

§7.47 a. Generally

If a writing is a fully integrated agreement, one that is complete and exclusive, it cannot be supplemented by evidence of additional terms even though they may be consistent with the writing. Com C §2202(b). A written contract is *not* assumed to be fully integrated; the court must determine whether the parties intended their agreement to be a final statement of its terms. See *Balfour, Guthrie & Co. v Gourmet Farms* (1980) 108 CA3d 181, 188, 166 CR 422.

Whether the agreement is fully integrated is a question of law, not fact. *Mobil Oil Corp. v Handley* (1978) 76 CA3d 956, 961, 143 CR 321; *Brawthen v H & R Block* (1975) 52 CA3d 139, 145, 124 CR 845. See also *Esbensen v Userware Int'l, Inc.* (1992) 11 CA4th 631, 637, 14 CR2d 93. The court must make a separate finding on whether the agreement is complete and exclusive, taking into consideration the circumstances under which the agreement was entered into by the parties. The court will consider the language in the writing, the length of the agreement, the detail of its provisions, and whether it was signed by both parties. The focus is on the intention of the parties, not what a reasonable person might have done under the circumstances. *Sunniland Fruit, Inc. v Verni* (1991) 233 CA3d 892, 284 CR 824; *Interform Co. v Mitchell* (9th Cir 1978) 575 F2d 1270. An explicit declaration in the agreement that there are no other agreements between the parties is evidence of intent, but it is not conclusive. Restatement (Second) of Contracts §209, Comment b (1981); 2 Witkin, California Evidence, *Documentary Evidence* §65 (4th ed 2000).

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§7.48 b. Inapplicability to Course of Performance, Course of Dealing, and Usage of Trade

If the court finds that the contract is complete and exclusive, parol evidence of additional express terms, but not implied ones, will be excluded. Unless the parties agree otherwise, implied terms are a part of the contract and supplement its terms. The implied terms may be those arising from the parties' course of performance, course of dealing, and usage of trade, or those implied by law (*e.g.,* the Commercial Code's open term provisions or implied warranties). They can be explicitly negated by language in the written agreement, but they are admissible if the written agreement says nothing about implied terms. *Heggblade-Marguleas-Tenneco, Inc. v Sunshine Biscuit, Inc*. (1976) 59 CA3d 948, 131 CR 183.

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§7.49 c. Merger Clauses

A merger clause (also called an integration clause) is a declaration that the document is complete and exclusive, that it contains all the terms of the contract, and that there are no other terms or representations. To bar the introduction of evidence of additional terms, the agreement must be complete and exclusive. Although not conclusive, a merger clause can be strong evidence that the parties intended the writing to be a complete and exclusive embodiment of all the terms contained in the writing. See *Sierra Diesel Injection Serv., Inc. v Burroughs Corp*. (9th Cir 1989) 890 F2d 108 (applying Nevada law); *Enrico Farms, Inc. v H. J. Heinz Co*. (9th Cir 1980) 629 F2d 1304 (applying California law).

A merger clause may be effective in preventing the introduction of terms to supplement the writing, but the clause will not exclude evidence admitted to explain or interpret the writing. 2 Witkin, California Evidence, *Documentary Evidence* §§70-71, 74 (4th ed 2000). Nor will it prevent the introduction of evidence of a prior or contemporaneous oral collateral agreement that is consistent with the terms of the integrated writing unless the court finds the writing to have been intended as a complete and exclusive statement of the terms of the agreement. *Simmons v California Inst. of Technol.* (1949) 34 C2d 264, 209 P2d 581; 2 Witkin, Evidence, *Documentary Evidence* §86.

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§7.50 d. Special Problems With Warranty Disclaimers

Special problems may arise because of the interaction between the parol evidence rule and Com C §2316(1), which governs the exclusion or limitation of express warranties.

Under Com C §2316(1):

> Words or conduct relevant to the creation of an express warranty and words or conduct tending to negate or limit warranty shall be construed wherever reasonable as consistent with each other; but *subject to the provisions of this division on parol or extrinsic evidence…* negation or limitation is inoperative to the extent that such construction is unreasonable. [Emphasis added.]

The issue arises when the buyer claims that the seller made an express warranty, but the written contract contains a clause seeking to exclude "all warranties, express and implied." In addition, the contract may contain a merger clause. In this circumstance, the buyer's attorney must overcome two separate problems to maintain an action based on a breach of the express warranty:

- First, the attorney must show that the parties did not intend the contract to be complete and exclusive even though there is a merger clause; and
- Second, the attorney must show that the parol evidence of the express warranty is consistent with the writing in spite of the written disclaimer of express warranties.

Commercial Code §2316(1) states that the language of warranty and the language of disclaimer must be construed as consistent with each other when that is reasonable. If such a construction is unreasonable, then the language of disclaimer is inoperative. This reflects the Commercial Code's policy of protecting the buyer from unexpected and unbargained-for language of disclaimer. Official Comment 1 to UCC §2-316.

The operation of Com C §2316(1), however, is subject to the parol evidence rule. If the parties' contract was found to be fully integrated, parol evidence of an express warranty made by the seller before the contract was executed would not be admitted unless the warranty could reasonably be reconciled with the contract's disclaimer provision. Assuming that the warranty and disclaimer are inconsistent and cannot be reconciled, the parol evidence rule would bar evidence of the warranty, and the buyer would never receive the benefit of Com C §2316(1).

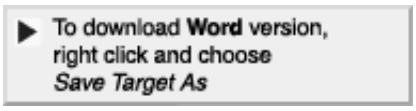
When there is no finding that the agreement was fully integrated, the test for the admissibility of an express warranty is consistency. In this instance, the buyer can obtain the benefit of Com C §2316(1), because, if the warranty and disclaimer cannot be reconciled, the disclaimer will be "inoperative." If the warranty and disclaimer *can* be harmonized, they are not likely to be "inconsistent" for purposes of the parol evidence rule.

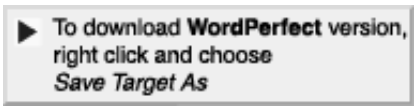
PRACTICE TIP: If the attorney represents the seller, unwanted express warranties may be prevented by use of a merger clause in the written agreement, along with language limiting the authority of persons qualified to create express warranties. See form 7.54-6 for sample language. On warranties generally, see chap 3.

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F. Litigation

§7.51 1. Checklist





The attorney who wishes to introduce evidence should consider doing the following:

- Show that the evidence is being introduced to explain or supplement the writing. See §§7.42-7.46.
- Determine whether the writing contains a merger clause, if additional terms will supplement the writing. See §§7.47, 7.49.
- Review a writing that contains a merger clause to discover whether necessary terms were omitted, indicating that the writing could not be complete. See §7.47. The level of detail in various parts of the contract may be used to argue that the contract was only partially integrated. If so, Official Comment 3 to UCC §2-202 suggests that a court may admit some additional oral terms and exclude others:

> "If the additional terms are such that, if agreed upon, they would certainly have been included in the document in the view of the court, then evidence of their alleged making must be kept from the trier of fact."

Thus, if a written contract deals exhaustively with the time, place, and manner of the buyer's payment, the court may exclude evidence of an additional payment term on the ground that, if the term had been agreed on, it would have been included in the document. Yet the same document may contain so little about the time or manner of delivery that an additional agreed delivery term might have been omitted from the document and would be admissible in evidence. See also Official Comment 1(a) to UCC §2-202 (Official Comment 3 to UCC §2-202 (2003)), which emphasizes that a writing may be final on some matters but not include all the matters agreed on.

- Determine whether the original writing has been modified expressly or through course of performance. See §§6.2-6.5, 7.48.
- Find out whether the parties have been performing the agreement in such a way and over a sufficient period of time to establish a course of performance. See §§4.95-4.97, 7.48.
- Investigate whether there have been dealings between the parties in the past to establish a prior course of dealing. See §§4.98-4.99, 7.48.
- Ascertain whether the parties had actual or constructive knowledge of a trade practice or usage of trade. The attorney should locate an expert within the trade who can testify about its common practices. See §§4.100-4.103, 7.48.
- Find out about prior negotiations or other agreements by checking, *e.g.,* confirmation slips, memorandums, telephone messages, or potential testimony of the parties or employees.
- Examine the facts to determine whether there is a cause of action other than the one based on the contract that would permit the introduction of the evidence.

The attorney who wishes to bar the introduction of evidence should consider doing the following:

- Introduce evidence to show that the parties intended the writing to be a final integration of the terms of their agreement. The attorney should ascertain whether the agreement has a merger clause. See §§7.47-7.49.
- Show that the proffered term negates the terms of the writing. See §7.38.
- Determine whether the parties were dealing at arm's length. To the extent that they were not, the attorney may be able to argue that the agreement was not carefully negotiated and therefore does not reflect the parties' intent or that a merger clause contained within the agreement is unconscionable. See §§18.69-18.71.

If a writing is fully integrated, evidence may not be admitted that contradicts terms contained in the writing. If the agreement is fully integrated, evidence of consistent implied terms (course of performance, course of dealing, and

usage of trade) may still be admitted but not evidence of other additional terms, even if the latter are consistent with the writing and do not contradict it.

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§7.52 2. Burden of Proof

From the wording of Com C §2202(b), it appears that the opponent of evidence of consistent additional terms, rather than the proponent of such evidence, has the burden of showing that the writing was intended to state the complete agreement of the parties. See Note, *Contract Draftsmanship Under Article Two of the Uniform Commercial Code*, 112 U Pa L Rev 564, 566 (1964).

Under Evid C §§400-401, the evidence of consistent additional terms is "proffered evidence," the admissibility of which depends on a "preliminary fact" (*i.e.,* that the writing was intended as the parties' complete agreement). Evidence Code §405(a) requires the court to allocate the burden of proof of disputed preliminary facts according to the applicable rule of law, which in this case is Com C §2202(b). Therefore, the court will place the burden of showing intended completeness of the agreement on the opponent of the consistent additional terms.

Although Evid C §403(a)(1) states that the proponent of proffered evidence has the burden of establishing a preliminary fact on which the admissibility of the evidence depends, this section does not apply for two reasons:

- Under Com C §2202(b), the admissibility of evidence of consistent additional terms (proffered evidence) depends not on the existence of a fact, but on the absence of a finding that would exclude the evidence, *i.e.,* that the writing is a complete and exclusive statement of the agreement.
- The preliminary facts to which Evid C §403(a)(1) applies may become jury questions (see Evid C §403(c)). This would be inconsistent with Com C §2202(b), which requires the court to make the preliminary finding. Preliminary facts under Evid C §405(a) are decided wholly by the court. See Evid C §405(b).

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§7.53 3. Failure to Object at Trial

Failure to object at trial to the admission of evidence that violates the parol evidence rule does not waive the right to assert the rule on appeal. The parol evidence rule is a rule of substantive law and, as such, is not subject to the usual rules of objection and waiver found in the Evidence Code. Improperly admitted evidence may be considered by the trier of fact but, if the issue is raised on appeal, it will not be considered by the appellate court in deciding whether substantial evidence supports the judgment. *Tahoe Nat'l Bank v Phillips* (1971) 4 C3d 11, 23, 92 CR 704, modifying the approach of *Pao Ch'en Lee v Gregoriou* (1958) 50 C2d 502, 326 P2d 135, disapproved on other grounds in 4 C3d at 22. But see *Santa Clara Props. Co. v R.L.C., Inc*. (1963) 217 CA2d 840, 849, 32 CR 333.

As a rule of substantive law, federal courts hearing diversity cases generally apply the parol evidence rule of the state in which the court sits. *Western Cas. & Sur. Co. v Harris Petroleum Co*. (SD Cal 1963) 220 F Supp 952.

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Source: Business Law/California UCC Sales and Leases/7 Statute of Frauds and Parol Evidence Rule/§7.54 G. Form: Merger Clauses

§7.54 G. Form: Merger Clauses

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7.54-1 Alternative: Merger clause

The parties agree that the terms set forth in this writing are intended to be the final expression of their agreement on the terms included in the agreement.

7.54-2 Alternative: Entire agreement

The parties intend this writing to be the final expression of the terms of their agreement and further intend that this writing be the complete and exclusive statement of all the terms of their agreement.

7.54-3 Alternative: Statement of effect

The parties intend this writing to be the final expression of the terms of their agreement and further intend that this writing be the complete and exclusive statement of all the terms of their agreement. This writing supersedes all prior agreements and all oral agreements made contemporaneously with the execution of this agreement. Any prior agreements or oral contemporaneous agreements may not be used to contradict, supplement, or explain this writing.

7.54-4 Alternative: Exclusion of implied terms

The parties intend this writing to be the final expression of the terms of their agreement and further intend that this writing be the complete and exclusive statement of all the terms of their agreement. This writing supersedes all prior agreements and all oral agreements made contemporaneously with the execution of this agreement. Any prior agreements or oral contemporaneous agreements may not be used to contradict, supplement, or explain this writing.

The parties expressly agree and understand that this writing may not be contradicted, supplemented, or explained by evidence of course of performance, course of dealing, or usage of trade.

7.54-5 Alternative: Oral modification prohibited

The parties intend this writing to be the final expression of the terms of their agreement and further intend that this writing be the complete and exclusive statement of all the terms of their agreement. This writing supersedes all prior agreements and all oral agreements made contemporaneously with the execution of this agreement. Any prior agreements or oral contemporaneous agreements may not be used to contradict, supplement, or explain this writing.

The parties agree that any modification of this writing must be made in writing and signed by both parties.

[*Add if appropriate*]

The course of performance described below is not to be regarded as modifying the terms of this writing. Any performance of this agreement that is inconsistent with the terms of this writing will be ignored in determining the meaning of this writing. Specifically, the following may not be regarded as in any way affecting or determining the meaning of the original agreement: _ _[*Describe performance*]**_ _.**

7.54-6 Alternative: Warranties merged

The parties intend this writing to be the final expression of the terms of their agreement and further intend that this writing be the complete and exclusive statement of all the terms of their agreement. This writing

supersedes all prior or contemporaneous oral or written agreements or representations.

All express or implied warranties, including the warranty of merchantability, not set forth in a writing signed by an authorized representative of _ _[*name of company*]_ _ are excluded. No agent, employee, or representative of _ _[*name of company*]_ _ other than _ _[*name of company*]_ _'s officers _ _[*and/or*]_ _ _ _[*names of other authorized persons*]_ _ has authority to bind _ _[*name of company*]_ _ to any affirmation, representation, promise, or warranty concerning the _ _[*describe goods*]_ _.

Comment: Form 7.54-1 provides for the minimum protection of the parol evidence rule. It expresses the parties' intent that the writing be their final expression of the terms in the writing, thereby barring evidence that would contradict the written terms. This protection is not absolute, however, because the court can still consider other evidence to determine the extent of the integration of the agreement.

Using the language of Com C §2202, form 7.54-2 gives evidence that the parties intended their agreement to be final, complete, and exclusive. This clause will not bar evidence of course of performance, course of dealing, or usage of trade.

Like form 7.54-2, form 7.54-3 uses the language of the Commercial Code and provides equivalent protection. Form 7.54-3 also puts the parties on notice of the possible effect of the use of such language and therefore clarifies their intent regarding finality.

Form 7.54-4 not only provides the protection of forms 7.54-2 and 7.54-3 but also attempts to bar the introduction of implied terms. The implied terms will normally be admitted to explain the meaning of the writing. The attorney should be fully aware of the existence of any implied terms and the rights and obligations they would create. A thorough discussion with the client of any prior relationship that the client has had with the other party is needed. In addition, it is advisable for the attorney to discuss trade practices and customs with the client and others within the trade. If there are some desirable implied terms, the attorney should not use the general statement of exclusion in form 7.54-4. The attorney may want to include or exclude implied terms selectively.

Form 7.54-5 provides the protection of forms 7.54-2 and 7.54-3 and attempts to protect against oral modifications and modifications that occur because of course of performance. The no-modification clause should be separately signed if this clause has been drafted for a merchant seller and the intended buyer is a consumer. Com C §2209(2). But see Com C §2209(4): An ineffective modification may nonetheless operate as a waiver.

The attorney should bear in mind that the Commercial Code emphasizes the intent of the parties rather than the integration practices of reasonable persons acting normally and naturally. *Interform Co. v Mitchell* (9th Cir 1978) 575 F2d 1270, 1277 (applying Idaho law). California law has shifted from assuming that a writing was intended as a complete integration to assuming that it was not intended as such unless the court expressly finds otherwise. A merger clause more appropriately reflects the parties' intent when the contract has been carefully negotiated between parties of relatively equal bargaining power. The exclusion of warranties must be conspicuous. On warranties generally, see chap 3.

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8

Title and Identification

Hon. Whitney Rimel

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§8.1 I. SCOPE OF CHAPTER; APPLICABILITY OF RULES

This chapter addresses the passage of title to goods from a seller to a buyer under the California Commercial Code. See §§8.2-8.25. It also discusses the identification of particular goods under the Commercial Code as those to which a sales contract refers, which is a prerequisite to the passage of title. See §§8.28-8.31.

In foreign trade, neither the International Chamber of Commerce's Incoterms 2000 (see discussion in chap 9) nor the United Nations Convention on Contracts for the International Sale of Goods (CISG) (sometimes referred to as the Vienna Sales Convention) deal with title or other property rights of the seller and buyer; title issues are resolved by the parties' agreement or by the applicable local law. On Incoterms, see the website at http://www.iccwbo.org/incoterms/id3042/index.html. On the Vienna Sales Convention, see generally Leete, *Contract Formation Under the United Nations Convention on Contracts for the International Sale of Goods and the Uniform Commercial Code: Pitfalls for the Unwary*, 6 Temp Int'l & Comp L J 193 (Fall 1992).

Before enactment of California's Commercial Code, most of the rights and duties of the parties to a sales contract could be determined by analyzing who had title to the goods in question. The enactment of the UCC, however, greatly altered prior law by virtually eliminating title as a factor in such determinations. Almost all sales matters are now covered by special narrow rules, and title is rarely employed in the solution of cases governed by the Commercial Code. See Com C §2401; Official Comment to UCC §2-101; Official Comment 1 to UCC §2-401. Indeed, by its own terms, Com C §2401, which sets forth the Commercial Code's rules for passage of title, applies only when:

- Title becomes important for resolving issues not governed by Division 2, *e.g.,* tax liability, insolvency, or insurability (see Official Comment 1 to UCC §2-401); or
- Another Commercial Code provision refers to title (see, *e.g.,* Com C §§2106 (Definition of "Sale"), 2312 (Warranty of Title), 2326 (Sale on Approval), 2327 (Special Incidents of Sales), 2403 (Power To Transfer), 2501 (Insurable Interest in Goods), and 2722 (Who Can Sue Third Parties for Injury to Goods); see also §8.20).

For cases applying the Commercial Code's rules for passage of title, see, *e.g., California State Electronics Ass'n v Zeos Int'l Ltd.* (1996) 41 CA4th 1270, 49 CR2d 127 (shipment contracts); *Rudiger Charolais Ranches v Van De Graaf Ranches* (9th Cir 1993) 994 F2d 670 (passage of voidable title); *Pacific Express, Inc. v Teknekron Infoswitch Corp. (In re Pacific Express, Inc.)* (9th Cir 1986) 780 F2d 1482, 1489; *Diesel Performance, Inc. v G. Paoletti Co.* (*In re G. Paoletti, Inc.)* (Bankr ND Cal 1997) 205 BR 251 (both cases determining whether disputed property was part of bankruptcy estate).

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II. TITLE

§8.2 A. Overview of Rules for Passage of Title

Commercial Code §2401 governs passage of title as follows:

- Title to goods cannot pass under a contract for sale before their identification to the contract. Com C §2401(1). On identification, see §§8.28-8.31.
- On identification of the goods to the contract, unless otherwise explicitly agreed, the buyer acquires a "special property" in the goods. Com C §2401(1). On buyer's "special property," see §8.31.
- Any reservation of title by the seller in goods shipped or delivered to the buyer is limited in effect to a reservation of a security interest. Com C §2401(1). On seller's security interest, see §§8.21-8.24.
- Subject to the provisions of Com C §2401(1) set forth immediately above, title passes as the parties explicitly agree (Com C §2401(1)).
- Unless otherwise explicitly agreed, passage of title is controlled by Com C §2401(2) (see §§8.3-8.13) when there is to be physical delivery of the goods and by Com C §2401(3) (see §§8.14-8.16) when delivery is to be made without moving the goods.
- The buyer's rejection of the goods, whether or not justified, or the buyer's justified revocation of acceptance revests title in the seller. Com C §2401(4). On rejection of goods or revocation of acceptance, see §§8.18-8.19.

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§8.3 B. Delivery Requiring Movement of Goods

When delivery requires movement of the goods, unless the parties agree otherwise, title will pass to the buyer at the time and place at which the seller completes performance with respect to the physical delivery of the goods. Com C §2401(2). The specific act required for completion of performance depends in turn on whether the contract is a shipment contract (see §§8.4-8.9) or a destination contract (see §§8.10-8.13).

If, under the contract, the seller is to send the goods to the buyer but is not required to deliver them at the destination (*i.e.,* a "shipment contract"), title passes to the buyer at the time and place of shipment. Com C §2401(2)(a). On the meaning of "shipment" for title-passing purposes, see §8.4.

If, however, the seller is to deliver the goods to the buyer at the destination (*i.e.,* a "destination contract"), title passes on tender at the destination. Com C §2401(2)(b).

These rules apply despite any reservation of a security interest and even though a document of title is to be delivered at a different time or place. Com C §2401(2).

California's Commercial Code makes it possible to choose between shipment and destination contracts, and thereby to select the applicable title-passing provision, by using mercantile shipment terms. Some terms (*e.g.,* "F.O.B. place of shipment" (see §8.6) and "C.I.F." (see §8.9)) create shipment contracts, and others (*e.g.,* "F.O.B. destination" (see §8.11)) create destination contracts.

Note that the rules of Com C §2401(2) for contracts requiring movement of goods may apply even though the goods are not to be shipped. On arrival of the buyer's truck to pick up the goods at the seller's plant, for example, the seller may be obligated to pack or load the goods or to bring them to the loading dock. By completing performance with respect to this physical delivery of the goods, the seller makes the final commitment with respect to specific goods (see Official Comment 4 to UCC §2-401) that causes title to pass under Com C §2401(2).

On passage of title when delivery does not require movement of the goods, see §§8.14-8.16.

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1. Shipment Contracts

§8.4 a. Title Passage on Shipment

A shipment contract requires or authorizes the seller to send the goods but does not require the seller to deliver them at a particular destination. See Com C §2401(2)(a). Under the Commercial Code, the shipment contract is regarded as the normal arrangement and the destination contract (requiring the seller to deliver at the destination) as the variant type. Official Comment 5 to UCC §2-503 Under a shipment contract, title passes at the time and place of shipment. Com C §2401(2)(a). "Shipment," for title-passing purposes, means completion of the physical handling of the goods required of the seller under a shipment contract. Com C §2401(2)(a). See §8.5.

In *California State Electronics Ass'n v Zeos Int'l Ltd.* (1996) 41 CA4th 1270, 49 CR2d 127, the defendant was a computer manufacturer located in Minnesota which solicited orders for its computers through advertising, took those orders over a toll-free line, and shipped the computers by overnight carrier. The plaintiff was a trade association of businesses that serviced warranties on consumer electronic products. The purpose of its lawsuit was to compel the defendant and other computer manufacturers located outside California to comply with the requirement of the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) that manufacturers provide local repair facilities to service those warranties. The court found that the defendant's arrangement with its customers constituted a contract calling for shipment by the seller. Under Com C §2401(2), title thereby passed in Minnesota on shipment by the defendant. Because title passed in Minnesota, the sale was in Minnesota, and the Act did not apply.

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§8.5 b. Seller's Duties Under Shipment Contract

Commercial Code §2504 prescribes the seller's duties under a shipment contract. See Com C §2503(2); Official Comment 1 to UCC §2-504. The duties are to:

- Put the goods into the carrier's possession;
- Make a reasonable contract for their transportation;
- Obtain and promptly deliver or tender to the buyer any necessary document; and
- Promptly notify the buyer of the shipment.

See also §§9.5-9.9.

The duties set forth in Com C §2504 may be more specifically prescribed (1) by an agreement between the seller and the buyer, *e.g.,* expressed by the use of mercantile shipment terms, or (2) by the Commercial Code's open terms provisions, *e.g.,* Com C §§2307 (delivery in single or multiple lots), 2309(1) (time for delivery), and 2311(2) (seller's choice of shipping arrangements). If agreed shipping terms become commercially impracticable, an available and commercially reasonable substitute must be tendered and accepted. Com C §2614(1).

Only the first of the seller's duties prescribed by Com C §2504 (*i.e.,* putting the goods into the carrier's possession) pertains to the seller's required performance with respect to physical delivery of the goods. Because title passes on completion of this performance (Com C §2401; see *Welding Eng'rs, Inc. v Aetna-Standard Eng'g Co.* (WD Pa 1958) 169 F Supp 146, 148), title may pass even though other duties under Com C §2504 remain to be performed (*e.g.,* delivery of documents).

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§8.6 c. F.O.B. Place of Shipment

Unless otherwise agreed, "F.O.B." (free on board) is a delivery term, *i.e.,* it imposes duties of delivery and is not relevant merely with respect to price. When used with the place of shipment (*e.g.,* "F.O.B. WIG warehouse, San Francisco, California"), it requires the seller to ship the goods from that place in the manner provided in Com C §2504 and to bear the expense and risk of putting the goods into the carrier's possession. Com C §2319(1)(a). See §§9.17-9.18. Title passes when physical delivery to the carrier is completed. Com C §2401(2)(a). See §8.4.

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§8.7 d. F.O.B. Carrier

The term "F.O.B. (free on board) carrier," referred to in California's Commercial Code as "F.O.B. vessel, car or other vehicle" (see Com C §2319(1)(c)), designates both a means of transportation and a place. It requires the seller to bear the expense and risk of loading the goods on board. Com C §2319(1)(c). See §§9.20-9.22. Unless the term specifies the exact vehicle and place (*e.g.,* "F.O.B. *Steve F.,* Pier 12, San Francisco, California"), the buyer must seasonably specify them in subsequent delivery instructions. Com C §2319(3). The seller may either perform the duty of loading or pay to have it done by a stevedore, some other independent contractor, or the carrier. Title passes when the loading is completed. Com C §2401(2)(a). See §8.4.

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§8.8 e. F.A.S. Vessel

The term "F.A.S. (free alongside) vessel" is similar to "F.O.B. vessel" (see §8.7) except that the seller is not required to load the goods but only to deliver them alongside the vessel in the usual manner in that port or on a dock designated and provided by the buyer. Com C §2319(2)(a). See §9.25. Because the arrival of the goods alongside the vessel or at the dock completes the seller's performance with respect to the physical delivery of the goods, title passes to the buyer at that point. Com C §2401(2)(a). See §8.4.

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§8.9 f. C.I.F. and C. & F.

The term "C.I.F." means that the price includes in a lump sum the cost of the goods and the insurance and freight to the named destination. Com C §2320(1). The term "C.A.F." is identical to "C.I.F." Official Comment 17 to UCC §2-320. The term "C. & F." (or "C.F.") is the same as "C.I.F." except that it does not require the seller to insure the goods. Com C §2320(1)-(3). See §§9.26-9.38. All these terms create shipment contracts, not destination contracts, and title therefore passes on "shipment" (Official Comments 1, 16 to UCC §2-320), *i.e.,* title passes when the seller completes performance with respect to physical delivery of the goods to the carrier (Com C §2401(2)(a); see §8.4).

Unfortunately, California's Commercial Code is unclear about the point at which the seller completes performance with respect to physical delivery. Commercial Code §2320(2)(b) requires the seller under the term "C.I.F." or its equivalent to load the goods. But when the contract contemplates overseas shipping, the seller under the term "C.I.F." need only obtain a negotiable bill of lading stating that the goods have been received for shipment. See Com C §2323(1). Official Comment 1 to UCC §2-320 states that, for purposes of risk and title, delivery to the carrier is delivery to the buyer. If loading is required, title passes when loading is completed. If not, title passes when the goods are put into the carrier's possession. Com C §2401(2)(a). See §8.4.

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2. Destination Contracts

§8.10 a. Title Passage on Tender

A destination contract is one that requires the seller to deliver the goods to the buyer at their destination. See §9.3. Title passes when delivery is tendered at the destination. Com C §2401(2)(b). Tender of delivery requires that the seller (1) put and hold conforming goods at the buyer's disposition at a reasonable hour and for a reasonable time, (2) give the buyer reasonable notification, and (3) tender appropriate documents. Com C §2503(1), (3)-(5). Thus the seller's performance of all these duties is required for passage of title under a destination contract. This differs from the rule for shipment contracts, *i.e.,* that title passes when the seller puts the goods into the carrier's possession even though other duties remain to be performed (see §§8.4-8.5).

Note that, because title passes when delivery is tendered, the buyer's refusal to accept the goods will not avoid the passage of title. The refusal will, however, result in title revesting in the seller. Com C §2401(4). See §8.18. The revesting occurs automatically at the moment of the buyer's rejection. See *Pacific Express, Inc. v Teknekron Infoswitch Corp. (In re Pacific Express, Inc.)* (9th Cir 1986) 780 F2d 1482, 1489.

On the effect of a nonconforming tender on passage of title, see §8.19.

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§8.11 b. F.O.B. Destination

An "F.O.B. (free on board) destination" term requires the seller, at its own expense and risk, to transport the goods to the destination and tender delivery there in the manner required for destination contracts generally. Com C §2319(1)(b). See Com C §2503. See also §§8.10, 9.19. If the term designates a vessel, car, or other vehicle at the destination (*e.g.,* "F.O.B. *Jane M.,* New York City"), tender of delivery is not complete until the goods are loaded on board the receiving vessel. Com C §2319(1)(c). Title under F.O.B. destination contracts passes on tender at the destination. Com C §2401(2)(b).

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§8.12 c. Ex Ship

"Ex ship," meaning "from the carrying vessel" (Com C §2322(1)), may be regarded as the reverse of "F.A.S. vessel" (see §8.8), *i.e.,* the buyer receives the goods alongside the incoming vessel. Unless otherwise agreed, an ex ship term requires delivery from a ship that has reached a place at the named port of destination where goods of that kind are usually discharged. Com C §2322(1). See also §9.39. Delivery need not be from a particular vessel unless specifically required by the agreement. Com C §2322(1); Official Comment 2 to UCC §2-322. Even when delivery from a particular vessel is required by the agreement, an available and commercially reasonable substitute must be tendered and accepted if use of the named vessel becomes commercially impracticable. Com C §2614(1). Unless otherwise agreed, the seller must discharge all liens arising out of the carriage and furnish the buyer with a direction that obligates the carrier to deliver the goods. Com C §2322(2)(a).

An ex ship contract is presumably governed by the title-passage rule specifically applicable to destination contracts, *i.e.,* title passes on tender at destination (Com C §2401(2)(b)). Tender requires putting the goods at the buyer's disposition, notifying the buyer, and tendering appropriate documents. Com C §2503(1), (3)-(5). This apparently is accomplished under an ex ship contract when the seller discharges the carriage liens and furnishes the buyer with a direction obligating the carrier to deliver the goods. See Com C §2322(2)(a).

Under Com C §2322(2)(b), however, passage of risk of loss is delayed until the goods are unloaded. This provision modifies the general destination contract rule that risk of loss passes on tender sufficient to enable the buyer to take delivery (Com C §2509(1)(b)). It is arguable that §2322(2)(b) also delays passage of title. Under Com C §2401(2), title passes when the seller completes performance with respect to the physical delivery of the goods. Under this rule, tender for title-passing purposes under an ex ship contract may require the unloading necessary to pass risk of loss under §2322(2)(b).

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§8.13 d. No Arrival, No Sale

Under a "no arrival, no sale" term, unless otherwise agreed, the seller must properly ship conforming goods and must tender them to the buyer on arrival, but the seller assumes no obligation that the goods will arrive unless the seller has caused the nonarrival. Com C §2324(a). Title does not pass until the seller properly tenders delivery of the goods. Com C §2401(2)(b). If, through no fault of the seller, part of the goods are lost, or the goods have materially deteriorated or arrive late, the buyer may refuse to accept or pay for the goods but may not seek to hold the seller liable for breach. See Com C §§2324(b), 2613. See also §§9.41-9.43. After the seller's tender has passed title to the buyer, the buyer's refusal to accept the goods revests title in the seller. Com C §2401(4).

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C. Delivery Without Movement of Goods

§8.14 1. General Rules

The rules governing passage of title when delivery is to be made without moving the goods are set forth in Com C §2401(3). Unless the parties agree otherwise, when the seller is to deliver tangible documents of title, title passes at the time and place of delivery of the documents. Com C §2401(3)(a). (If electronic documents of title are involved, title passes when the seller delivers the document. Com C §2401(3)(a).) If, however, the goods are already identified at the time of making the contract and no documents are to be delivered, title passes at the time and place of contracting. Com C §2401(3)(b).

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§8.15 2. Delivery With Documents of Title

When, in the case of delivery without movement of the goods, the seller is to deliver tangible documents of title, title passes at the time and place of delivery of the documents. Com C §2401(3)(a). (If electronic documents of title are involved, title passes when the seller delivers the document. Com C §2401(3)(a).) A "document of title" may be a bill of lading, a warehouse receipt, or any other document that, in the regular course of business or financing, is treated as adequate evidence of the right to receive, hold, and dispose of the document and the goods it covers. Com C §1201(b)(16). Further, the document must purport to be issued by a bailee and to cover goods in the bailee's possession. Thus, the rule for passing title by delivery of documents of title applies only to goods in the hands of bailees, and, because the rule applies only when delivery is to be made without moving the goods (Com C §2401(3)), the bailee is more likely to be a warehouse than a carrier. On documents of title in general, see chap 15.

Note that, under Com C §2401(3)(a), title passes at the time and place at which the seller "delivers" the documents. Com C §2401(3)(a). With respect to documents of title, "delivery" is defined as "voluntary transfer of possession." Com C §1201(b)(15). The use in Com C §2401(3)(a) of the word "delivers," rather than "tenders," indicates that title to the goods does not pass until the buyer takes possession or control of the documents. Mere tender of the documents appears to be insufficient to pass title. This requirement that the buyer receive the documents is consistent with the corresponding rules on risk of loss. See Com C §2509(2)(a), (c). The requirement seems inconsistent, however, with the statement in Official Comment 4 to UCC §2-401 that the test for determining the time that title passes is based on the time when the seller is finally committed with regard to specific goods. Tender of the documents seems to be sufficient to establish the seller's final commitment.

NOTE: Because it is not clear that documentary tender alone is sufficient to pass title, it may be prudent for a buyer who wants to ensure that title not pass until the receipt of the documents do so by express agreement with the seller. Acquisition of title on mere tender may be especially undesirable when the documents are to be delivered "through customary banking channels," as expressly authorized by Com C §§2308(c) and 2503(5)(b). Tender in this manner may require only a notice to the buyer from the bank that the documents are on hand. See Official Comment 3 to UCC §2-308.

Documents of title may be either negotiable or nonnegotiable. See Com C §7104. Although the rules for tender of delivery and passage of risk of loss of goods in the possession of bailees turn on the negotiability of the documents (see Com C §§2503(4), 2509(2)), title passes on delivery of either negotiable or nonnegotiable documents (Com C §2401(3)(a)).

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§8.16 3. Delivery Without Documents of Title

When, in the case of delivery without movement of the goods, the goods are already identified at the time of contracting and no documents are to be delivered, title passes at the time and place of contracting. Com C §2401(3)(b). If the goods are identified after the contract is made, title presumably passes on identification.

Commercial Code §2401(3)(b) applies to goods in the possession of a bailee when the seller is to tender delivery by procuring the bailee's acknowledgment of the buyer's right to the goods (see Com C §2503(4)(a)) or by giving the buyer delivery instructions addressed to the bailee (see Com C §2503(4)(b)). The making of the contract may pass title considerably before the applicable act of tender of delivery.

Passage of title to goods not held by a bailee, but still in the seller's possession, may also be governed by Com C §2401(3)(b) if the goods are to be delivered without being moved. The making of the contract passes title as soon as the goods are identified. Thus, title to crops may pass as soon as they are planted (see Com C §2501(1)(c)) and title to a machine specially manufactured for the buyer may pass when it is in identifiable form but still incomplete. See Com C §2501(1)(b); Official Comment 4 to UCC §2-501.

NOTE: Because Com C §2401(3) applies only to delivery without movement of the goods, however, it probably does not apply if the seller has any duties of physical delivery, *e.g.,* to help load the goods on the buyer's truck at the seller's place of business. The principal applications of Com C §2401(3)(b) to goods not held by bailees will generally be to bulky, stationary items that the buyer is to load and haul away without the seller's assistance, crops that the buyer alone is to harvest, and timber that the buyer alone is to log.

With respect to goods in the seller's possession, the passage of title, governed by Com C §2401(3)(b), occurs before the passage of risk of loss, which ordinarily remains with a merchant seller until the buyer receives the goods and with a nonmerchant seller until tender of delivery (see Com C §2509(3)).

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§8.17 D. Auction Sale

The Commercial Code does not provide a passage-of-title rule specifically for auctions. An auction sale is "complete" when the auctioneer announces completion by the fall of the hammer or other customary means. Com C §2328(2). See §§2.53-2.54. The Commercial Code defines "sale" as "the passing of title from the seller to the buyer for a price." Com C §2106(1). Thus, the fall of the hammer arguably passes title to the successful bidder. See *Gentillalli v County of San Diego* (1966) 240 CA2d 456, 49 CR 705. Section 2328(2) may be intended, however, not as a title-passing provision but only to fix the time of completion of a contract of sale between the bidder and the seller. In that event, passage of title is governed by Com C §2401. See *Robertson v Trustee (In re Western States Wire Corp.)* (9th Cir 1974) 490 F2d 1065.

Under Com C §2401, if the successful bidder is to take delivery without assistance from the seller, so that delivery is to be made without moving the goods, title passes when documents of title are delivered (Com C §2401(3)(a)) or, if no documents are to be delivered, when formation of the contract is announced by the fall of the hammer (Com C §2401(3)(b)). If the successful bidder is entitled to have the seller (or auctioneer or other agent of the seller) deliver the goods, title does not pass until the seller has completed his or her duties with respect to physical delivery of the goods. Com C §2401(2). See *Robertson v Trustee (In re Western States Wire Corp.), supra*. See generally Anno, *Auction Sales Under UCC §2-328*, 44 ALR4th 110 (1986).

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E. Rejection of Goods or Revocation of Acceptance

§8.18 1. Revesting Title in Seller

When the buyer rejects the goods or otherwise refuses to receive or retain them, whether or not the action is justified, title to the goods revests in the seller. Com C §2401(4). See *Pacific Express, Inc. v Teknekron Infoswitch Corp. (In re Pacific Express, Inc.)* (9th Cir 1986) 780 F2d 1482, 1489 (title in telephone equipment had automatically reverted to seller before filing of bankruptcy proceeding where debtor either rejected equipment during delivery or refused to retain it afterwards and demanded that seller retrieve it). Likewise, the buyer's revocation of acceptance revests title in the seller, but only if the revocation is justified. In either event, the revesting occurs by operation of law and is not a "sale," *i.e.,* revesting is not subject to sales taxes or to any other law burdening the passage of title.

By providing for revesting, Com C §2401(4) enables the seller to resell the goods, an option that is particularly important when the seller does not have an unqualified right to sue the buyer for the price. The seller may recover the price if the buyer has accepted the goods and has not justifiably revoked the acceptance. Otherwise, the seller may recover the price only if (a) the goods were lost or damaged after the risk of their loss had passed to the buyer or (b) the seller has been or will be after reasonable effort unable to resell them for a reasonable price. Com C §2709(1). See Official Comment 5 to UCC §2-709 (Official Comment 3 to UCC §2-709 (2003)). By revesting title in the seller whenever the buyer justifiably or nonjustifiably refuses acceptance or justifiably revokes acceptance, Com C §2401(4) removes any question of the seller's full control over goods that the seller may wish to resell.

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§8.19 2. Effect of Nonconformity on Passage of Title

The provisions of the Commercial Code addressing passage of title in the absence of explicit agreement contain no express exceptions that apply when the goods or their tender of delivery are nonconforming. The rules on risk of loss sharply divide conforming deliveries (see Com C §2509) and nonconforming ones (see Com C §2510), making it clear that the seller cannot unilaterally shift the risk of loss to the buyer unless the seller's action conforms with all the conditions under the contract. Official Comment 1 to UCC §2-510. But there are no corresponding provisions with respect to passage of title that prevent the seller from unilaterally burdening the buyer with title to nonconforming goods.

Notwithstanding the seller's ability to vest in the buyer title to nonconforming goods, the buyer's justifiable or nonjustifiable rejection of the goods or justifiable revocation of acceptance revests title in the seller. Com C §2401(4). Revocation of acceptance is justified only by nonconformity of the goods. Com C §2608.

Thus, it appears that a nonconforming delivery does pass title to the buyer, and that the buyer's rejection or justifiable revocation of acceptance then revests title in the seller. Identification to the contract, the only characteristic of the goods expressly required under Com C §2401 for passage of title, can occur even though the goods are nonconforming and subject to rejection by the buyer. Com C §2501(1).

PRACTICE TIP: Avenues may be open to the attorney seeking to resist or prevent passage of title to nonconforming goods. If title is significant for a nonsales purpose (*e.g.,* the imposition of a personal property tax), the attorney may argue that title passage should turn not on Com C §2401, which by its own terms is treated as having limited applicability, but, on the Commercial Code's allocation of risk of loss, a matter of economic importance. When a tender or delivery of goods so fails to conform to the contract as to give the buyer a right of rejection, risk of loss remains with the seller until cure or acceptance. Com C §2510(1).

If the buyer foresees the need for avoiding title to nonconforming goods in a particular transaction (*e.g.,* title is to pass just before the property tax assessment date), it may be possible to arrange an early inspection of the goods to determine whether they conform. See Com C §2513. On right of inspection generally, see §§10.13-10.18.

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§8.20 F. Other Code Sections Dealing With Passage of Title

Other than Com C §2401, which sets forth the Commercial Code's basic rules for passage of title, two Code sections address the matter. Commercial Code §2327(1)(a) provides that, unless otherwise agreed, title to goods sold on approval does not pass to the buyer until acceptance, and Com C §2403 sets forth rules regarding transfer of title to certain classes of purchasers by transferors having title or voidable title. For further discussion of Com C §2403, see chap 12. In addition, the following five Commercial Code provisions contain references to "title":

(1) A "sale" consists of "the passing of title from the seller to the buyer for a price." Com C §2106(1).

(2) Absent certain indications to the contrary, the seller warrants that "[t]he title conveyed shall be good, and its transfer rightful." Com C §2312(1)(a).

(3) The provisions by which goods delivered to a dealer for resale are deemed to be on "sale or return" with respect to the dealer's creditors apply even though an agreement purports "to reserve title to the person making delivery until payment or resale." Com C §2326(3).

(4) The seller retains an insurable interest in goods "so long as title to or any security interest in the goods" remains in the seller. Com C §2501(2).

(5) Third parties dealing with goods may be sued for resulting actionable injury by either party to the contract for sale "who has title to or a security interest or a special property or an insurable interest in the goods." Com C §2722(a).

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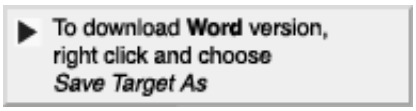
G. Seller's Security Interest and Title

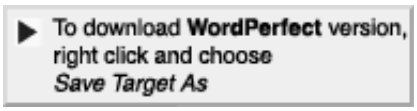
§8.21 1. Effect of Reservation of Title

One function of title in sales law that survived California's adoption of the Commercial Code is in determining whether a seller has retained a security interest or an insurable interest in goods. Any retention or reservation by the seller of title in goods shipped or delivered to the buyer is limited in effect to a reservation of a security interest. Com C §2401(1). The seller retains an insurable interest in goods as long as title to, or any security interest in, the goods is retained. Com C §2501(2). On insurable interests, see §8.30.

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§8.22 2. Form: Reservation of Title





8.22-1 Reservation of title

The seller retains title to the goods until the buyer performs all _ _[*his/her/its*]_ _ obligations under this contract.

Comment: The reason for expressly reserving title, in addition to retaining a security interest (see §8.21), is to protect the seller in the event a controversy governed by law other than California's Commercial Code arises, *e.g.,* a controversy occasioned by the buyer's bankruptcy. With very limited exceptions (*e.g.,* sale of an account or chattel paper by a debtor while a buyer's security interest is unperfected; see Com C §9318), title is of no importance in determining the rights and obligations of the parties to a secured transaction under Commercial Code Division 9. See Com C §9202.

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§8.23 3. Perfection of Security Interest Not Necessary

A security interest arising through the seller's reservation of title is governed by Commercial Code Division 9. Com C §9109(a)(5). Until the buyer obtains possession of the goods, that interest is enforceable even in the absence of a security agreement, and filing is not necessary to perfect the interest. Com C §9110(1)-(2); Official Comment to UCC §9-110. Until the buyer obtains possession, the seller's interest has priority over conflicting security interests created by the buyer. Com C §9110(4). Note, however, that the seller-secured party's rights on the buyer's default are governed by Division 2, rather than Division 9. Com C §9110(3).

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§8.24 4. Purchase Money Security Interest

A security interest reserved by the seller to secure all or part of the price is a "purchase money security interest." See Com C §9103(a)(2), (b). Having a purchase money security interest in goods other than inventory or livestock gives the seller priority over conflicting security interests in the same goods. Com C §9324(a). On purchase money security interests in inventory, see chap 12.

PRACTICE TIP: Because of the priority accorded to the seller, the seller's attorney may find it useful in the sales contract to specifically describe the seller's reserved interest as a purchase money security interest. With respect to certain goods bought for personal or household use, such a security interest avoids the requirement of filing a financing statement to perfect the interest. Com C §9309(1). Nonetheless, it is always a prudent practice to file a financing statement.

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§8.25 H. Control of Title for Nonsales Purposes

The parties to a sales contract may wish to regulate the time and place of passage of title for nonsales purposes, *e.g.,* tax effects. They may seek to avoid having the sale deemed to have been made, for sales tax purposes, in a particular jurisdiction. They may wish to control the time of accrual of the price for income tax purposes. The buyer may want to delay, or the seller to accelerate, title passage to avoid a property tax on the goods. For such purposes, the parties often wish to pass title at either the earliest or the latest possible moment.

To accomplish these results, the attorney should first determine when title will pass in the transaction under the applicable Commercial Code rules, particularly Com C §2401. The attorney should note, however, that even if the time of title passage under these rules is satisfactory, the courts may apply other rules in light of the particular nonsales purpose. See Official Comment 1 to UCC §2-401. This possibility should also be explored. The attorney should determine all possible effects of causing title to pass at any particular point. Vesting title in the buyer, for example, may be undesirable for the seller because it will cause the goods to be available to the buyer's attaching creditors.

DRAFTING CONSIDERATIONS: If a particular time and place of title passage are desired, and it is not clear that title will pass at that point in the absence of agreement, the sales contract should provide when title is to pass. The parties' ability to control passage of title under the Commercial Code, however, is limited by Com C §2401(1), which provides that title cannot pass before identification of the goods to the contract. Therefore, if title passage is to be accelerated, acceleration of identification may also be necessary.

Commercial Code §2401(1) also provides that any reservation by the seller of title in goods shipped or delivered to the buyer is limited in effect to a reservation of a security interest. If passage of title is to be delayed beyond the time it would normally occur, it may be necessary to consider this restriction. The parties can leave full title in the seller between shipment and tender of delivery by utilizing a destination contract (see §§8.10-8.13) rather than a shipment contract (see §§8.4-8.9), or they can delay title passage by delaying identification.

In considering such measures, of course, the parties must take into account the business consequences. Identification creates a "special property" in the buyer and certain rights in the seller. A destination contract normally requires the seller to pay freight and bear risk of loss until the goods are tendered at destination. The exact extent to which these incidents of a destination contract may be contractually shifted from the seller to the buyer without changing the transaction into a shipment contract is unclear. The buyer probably will be able to reimburse the seller for freight and insurance without effecting such a change.

An agreement on title passage that is effective under Com C §2401 will not necessarily be effective for all nonsales purposes. See, *e.g., Northrop Corp. v State Bd. of Equalization* (1980) 110 CA3d 132, 167 CR 707 (court held that taxable sale occurred despite fact that seller retained title to tooling as security for purchase price). See also *W.E. Hall Co. v Franchise Tax Bd.* (1968) 260 CA2d 179, 183, 66 CR 911 ("[i]n interpreting [a] transaction the taxing authority is not necessarily bound by the language the taxpayer chose to describe it or by the bookkeeping entries chosen to record it"); *U.S. v Thomas* (9th Cir 1964) 329 F2d 119, 130 ("economic realities determine tax consequences").

The effectiveness of an agreement about title passing for nonsales purposes is thus likely to depend on the extent to which other important rights of the parties coincide with "title." When the parties control passage of title by changing other rights and remedies on which title depends under the Commercial Code (*e.g.,* by postponing identification or changing a shipment contract into a destination contract), title may be defended more easily as reflecting economic reality. If, for example, in the absence of agreement the Commercial Code separates title from risk of loss in the particular kind of transaction, an agreement changing passage of title to coincide with risk of loss may well be respected. But if the agreement otherwise creates or leaves a gap between title and risk of loss, the attorney should consider a contractual modification of risk to make it coincide with title. Consideration should also be given to harmonizing title with other rights or remedies that the courts consider important in determining title for the nonsales purpose in question.

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III. COMPARISON OF TITLE AND RISK OF LOSS

§8.26 A. Table: Passage of Title and Passage of Risk of Loss

This table covers passage of title and risk of loss in the absence of breach. The table in §8.27 shows the effect of breach.

Kind of Delivery or Sale	Point at Which Title Passes	Point at Which Risk of Loss Passes
Delivery by movement of goods		
1. Shipment contract	Shipment (delivery to carrier). Com C §2401(2)(a). See §8.4.	Delivery to carrier. Com C §2509(1)(a). See §§16.42-16.43.
2. Destination contract	Tender at destination. Com C §2401(2)(b). See §8.10.	Tender at destination while in possession of carrier. Com C §2509(1)(b). See §§16.42-16.43.
3. Other contracts requiring physical delivery by seller		
a. Merchant seller	Completion of seller's duties of physical delivery. Com C §2401(2). See §8.3.	Buyer's taking physical possession of goods. Com C §§2509(3), 2103(1)(c). See §16.45.
b. Nonmerchant seller	Completion of seller's duties of physical delivery. Com C §2401(2). See §8.3.	Tender of delivery. Com C §2509(3). See §16.45.
Delivery without movement of goods		
1. Goods held by bailee		
a. Delivery by negotiable document of title	Delivery of document. Com C §2401(3)(a). See §§8.15-8.16.	Delivery of document. Com C §2509(2)(a). See §16.44.
b. Delivery by nonnegotiable document of title	Delivery of document. Com C §2401(3)(a). See §§8.15-8.16.	Bailee's honor of document or buyer's inaction for reasonable time after receiving it. Com C §§2509(2)(b)-(c), 2503(4)(b). See §16.44.
c. Delivery by procuring bailee's acknowledgment without document of	Identification of goods or making of sales contract (whichever is later). Com C	Bailee's acknowledgment. Com C §2509(2)(b). See §16.44.

title	§2401(3)(b). See §8.16.	
d. Delivery by giving buyer written direction to bailee	Identification of goods or making of sales contract (whichever is later). Com C §2401(3)(b). See §8.16.	Bailee's honor of document or buyer's inaction for reasonable time after receiving it. Com C §§2509(2)(b)-(c), 2503(4)(b). See §16.44.
2. Goods held by seller		
a. Merchant seller	Identification of goods or making of sales contract (whichever is later). Com C §2401(3)(b). See §8.16.	Buyer's taking physical possession of goods. Com C §§2509(3), 2103(1)(c). See §16.45.
b. Nonmerchant seller	Identification of goods or making of sales contract (whichever is later). Com C §2401(3)(b). See §8.16.	Tender of delivery. Com C §2509(3). See §16.45.
Sale on approval	Acceptance. Com C §2327(1)(a). See §8.20.	Acceptance. Com C §2327(1)(a).

The rules shown above apply unless varied by agreement of the parties. On varying passage of title by agreement, see §8.25. On varying risk of loss, see §16.46.

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§8.27 B. Table: Effect of Breach on Title and Risk of Loss

This table covers the effect of breach on passage of title and risk of loss. The table in §8.26 shows the passage of title and risk of loss in the absence of breach.

Kind of Breach or Response	Effect on Title	Effect on Risk of Loss
Buyer's breach		
1. Anticipatory breach	Seller probably cannot pass title by further performance. Com C §2610. See §§16.27-16.32.	Risk of uninsured loss passes temporarily to buyer. Com C §2510(3). See §16.50.
2. Wrongful refusal to receive goods from merchant seller delivering without carrier or bailee (see Com C §2509(3))	Title revests in seller. Com C §2401(4). See §8.18.	Risk of uninsured loss passes temporarily to buyer. Com C §2510(3). See §16.50.
3. Wrongful rejection in other situations	Title revests in seller. Com C §2401(4). See §8.18.	Risk remains with buyer. See §16.50.
4. Breach after acceptance or wrongful attempt to revoke acceptance	Title remains in buyer.	Risk remains with buyer. See §16.50.
Seller's breach entitling buyer to reject goods		
1. Breach before buyer accepts or rejects	Title apparently passes as if seller had not breached. See §8.19.	Risk remains with seller. Com C §2510(1). See §16.48.
2. Buyer's response to breach		
a. Buyer's rightful rejection	Title revests in seller. Com C §2401(4). See §8.18.	Risk remains with seller. Com C §2510(1). See §16.48.
b. Buyer's acceptance of goods	Title remains in buyer. See §8.19.	Risk passes to buyer. Com C §2510(1). See §16.48.
c. Buyer's rightful revocation of acceptance	Title revests in seller. Com C §2401(4). See §8.18.	Risk returns to seller; uninsured risk returns retroactively. Com C §2510(2). See §16.49.
Seller's breach insufficient to entitle buyer to reject	Breach probably does not affect title. See §8.19. On passage of title without breach, see table in §8.26.	Breach does not affect risk. Com C §2510(1). See §16.48. On passage of risk without breach, see table in §8.26.

The rules shown above apply unless varied by agreement of the parties. On varying passage of title by agreement, see §8.25. On varying risk of loss, see §16.46.

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IV. IDENTIFICATION

§8.28 A. Overview

Title to goods cannot pass under a contract for sale before their identification to the contract. Com C §2401. Although identification is not specifically defined by the Commercial Code, it apparently means the designation of particular existing goods as the goods to which the contract refers. Although identification does not necessarily pass title, title cannot pass until the goods have been identified. Com C §§2105(2), 2401(1).

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§8.29 B. Rules Governing Identification

Commercial Code §2501 governs identification. Under that section, the buyer obtains an insurable interest (see §8.30) and a "special property" in goods by identification of existing goods as those to which the contract refers, even when the goods are nonconforming and the buyer has an option to return or reject them. Com C §2501(1).

The general policy is to resolve all doubts in favor of identification. Official Comment 2 to UCC §2-501. There is no requirement that identified goods be in a deliverable state or that all the seller's duties with respect to the processing of the goods be completed for identification to occur. Official Comment 4 to UCC §2-501.

The time and manner of identification may be set by "explicit agreement" of the parties. Com C §2501(1). See also *Diesel Performance, Inc. v G. Paoletti Co. (In re G. Paoletti, Inc.)* (Bankr ND Cal 1997) 205 BR 251 (finding that there was no such explicit agreement between buyer and seller). Such an agreement (*e.g.,* contained in a term giving the buyer power to select the goods) need not necessarily be found in the contract terms used in the particular transaction. When a usage of the trade has previously been reduced to a standard set of rules incorporated into the parties' contract, a relevant portion of those rules will be considered "explicit" for the purposes of Com C §2501. Official Comment 3 to UCC §2-501.

In the absence of explicit agreement, identification occurs:

- If the contract is for the sale of already existing and identified goods, when the contract is made (Com C §2501(1)(a));
- If the contract is for the sale of future goods other than unborn young or future crops, when the goods are shipped, marked, or otherwise designated by the seller as goods to which the contract refers (Com C §2501(1)(b)); or
- If the contract is for the sale of unborn young or future crops, when the young are conceived or the crops are planted or otherwise become growing crops (Com C §2501(1)(c)).

When identification is by the seller alone, the seller may substitute other goods for those identified until default, insolvency, or notification to the buyer that the identification is final. Com C §2501(2).

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§8.30 C. Insurable Interests of Buyer and Seller

Commercial Code §2501 addresses the issue of insurable interests of both the buyer and the seller. The buyer obtains an insurable interest in goods when they are identified to the contract, even when the goods are nonconforming and the buyer has an option to return or reject them. Com C §2501(1). The seller retains an insurable interest in goods as long as the seller retains title or has any security interest in the goods. Com C §2501(2). Thus, when goods are identified but title has not passed or when the seller retains a security interest after title passes, the buyer and the seller may both have an insurable interest in the same goods at the same time.

The concept of an insurable interest must be distinguished from the concept of risk of loss. Under the Commercial Code, an insurable interest in goods arises on their identification, which may precede the passage of risk of loss from seller to buyer. Insurable interest and risk of loss are, however, closely related commercially.

For an insurance policy to be enforceable, the owner of the policy must have an insurable interest. Ins C §280. An "insurable interest" is an interest such "that a contemplated peril might directly damnify the insured." Ins C §281.

The insurable interests of the buyer and seller are well recognized in California. See *Dunne v Phoenix Ins. Co.* (1931) 113 CA 256, 298 P 49 (buyer); *Kleiber Motor Truck Co. v International Indem. Co.* (1930) 106 CA 709, 289 P 865 (seller). Any insurable interest recognized under any other statute (see Ins C §§281-286) or rule of law is expressly left unimpaired by Com C §2501(3). The circumstances under which such insurable interests may exist appear to be more extensive than those expressly provided for in Com C §2501. For example, when the contract provides for title to pass to the buyer on identification, which is to occur before shipment or delivery, and the seller does not retain a security interest in the goods, then, once identification occurs, the seller will no longer have any insurable interest under Com C §2501(2). If, under Com C §2509, the seller retains the risk of loss until shipment or delivery, the seller will also retain an insurable interest under Ins C §281. See *Tri-State Mut. Grain Dealers Fire Ins. Co. v Morris* (9th Cir 1959) 268 F2d 956 (party who bore risk of loss thereby had insurable interest).

Presumably, the contract of sale cannot redefine insurable interest to validate or invalidate insurance carried by either the buyer or the seller on the goods. Nonetheless, the contract can provide a basis for establishing an insurable interest in either party by allocating the risk of loss (see Com C §§2303, 2509(4)) or providing for other liabilities or rights on which an insurable interest can be based.

A practical method of insuring a seller for the unpaid balance of the price in the event the goods are destroyed or lost after delivery to the buyer is to obtain a policy that names both the buyer and the seller as insureds, with benefits payable according to their respective interests. The sales contract can require either party to obtain such a policy. If only the seller's interest is insured, problems may arise in establishing the seller's loss on destruction of the goods. Because the risk of loss under the sales contract is usually on the buyer after delivery, the insurer may require the seller to prove that the unpaid balance is uncollectible from the buyer. Even if the insurer pays the seller, the insurer will probably assert subrogation to the seller's claim against the buyer, unless the insurer has expressly waived subrogation in the policy or the policy names the buyer as an insured.

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§8.31 D. Buyer's "Special Property"

On identification of goods, the buyer obtains a "special property" in the goods. Com C §2501(1). Although it is not defined in the Commercial Code, "special property" refers to the rights that the buyer acquires on identification. See Official Comment 3 to UCC §2-401.

The special property is not a security interest, although a buyer may acquire a security interest by complying with the requirements of the Commercial Code's provisions on secured transactions, *i.e.,* Division 9. Com C §1201(b)(35).

A buyer who has a special property in goods and has paid at least part of their price may, on tender of the unpaid portion, recover the goods from the seller if (a) the goods are for personal, family, or household purposes, and the seller repudiates or fails to deliver the goods, or (b) in all cases, the seller becomes insolvent within ten days after receipt of the first installment. Com C §2502(1).

Special considerations apply in bankruptcy cases, however. It has been held that Com C §2502 gives a buyer nothing more than an unsecured claim against the bankruptcy estate. *Diesel Performance, Inc. v G. Paoletti Co.* (*In re G. Paoletti, Inc.)* (Bankr ND Cal 1997) 205 BR 251, 262. In *Paoletti,* the court stated that a buyer's special property interest in goods identified to the contract is a property interest in name only. The only right this "property interest" gives a buyer is the right to possession of the goods under certain circumstances. If the buyer does not exercise this right and the goods are sold, the buyer has no right to any portion of the sale proceeds. The court also pointed out that 11 USC §546(c) preserves the state law rights of a seller of goods to an insolvent debtor with certain limitations. The court reasoned that the drafters of the Bankruptcy Code must have been aware of UCC §2-502 and, had they wanted to preserve a buyer's rights under that section, they would have enacted a comparable provision to that effect.

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9

Seller's Performance

Henry S. David
Erich P. Wise

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§9.1 I. APPLICABLE LAW

The law generally applicable to the seller's performance in California is Division 2 of the California Commercial Code. In particular transactions, however, the law of other jurisdictions or special provisions outside the Commercial Code may apply, *e.g.,* the Rees-Levering Motor Vehicle Sales and Finance Act (CC §§2981-2984.4) (motor vehicle sales and financing), CC §§1799.90-1799.206 (consumer credit contracts), and the Unruh Act (CC §§1801-1812.20) (retail installment sales). On warranties, see chap 3.

If the transaction involves the interstate shipment of goods by common carrier, the attorney should consult the federal bill of lading law. See 49 USC §§80101-80116.

International sales are governed by the United Nations Convention on Contracts for the International Sale of Goods (CISG; sometimes referred to as the Vienna Sale Convention; see 15 USC App). CISG applies to contracts of sales of goods between parties whose respective places of business are in contracting states that have adopted it. If both parties are from CISG nations, the CISG applies in the form adopted by the nation whose law applies to the contract. See *Filanto, S.p.A. v Chilewich Int'l Corp.* (SDNY 1992) 789 F Supp 1229, 1237.

One significant difference between the U.S. version of the CISG and the version adopted by nearly all other CISG nations relates to CISG's applicability if only one party to the contract has its place of business in a CISG nation. Nearly all CISG nations have agreed that, if one party to the contract is in a CISG nation whose law applies to the contract, and the other party is in a nation that does not recognize the CISG, the CISG will apply and will be enforced as part of the CISG nation's domestic body of law. The United States has rejected this majority position and has adopted the CISG with the reservation that the CISG will not apply to contracts involving a party in the United States if only one party is in a CISG nation. Therefore, if a party in California makes an international sales contract with a party in a nation that has not adopted the CISG (*e.g.,* the United Kingdom), and California law applies, the CISG will not apply because the U.K. has not adopted the CISG. In that situation, the California version of the UCC would apply and a written contract would be required for amounts of $500 or more. (Note that if the U.K.'s law governed the contract, the CISG would not have applied, because the U.K. has not adopted the CISG, but an oral contract would be enforceable because U.K. law allows oral contracts.) If neither party is in a CISG nation, the CISG will apply only if the parties have so agreed or, in rare instances, if a court applies the CISG unilaterally for lack of a more appropriate law to govern.

DRAFTING CONSIDERATIONS: If CISG is not intended to govern a contract to which it otherwise would apply, it is recommended that the contract should explicitly state this and specify the law that does apply.

NOTE: CISG provides that the parties may exclude or vary the effect of any of its provisions. See CISG, art 6.

The text of CISG as well as current information about countries that have ratified it can be obtained through the library of the United Nations, United Nations Headquarters, New York, NY 10017, (212) 963-7394. For online information about the CISG, see http://www.cisg.law.pace.edu/cisg/text/cisg-toc.html.

The meaning and effect of shipping terms may also be defined by nonstatutory standards such as Incoterms 2000, prepared by the International Chamber of Commerce. See §9.15.

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§9.2 II. OBLIGATIONS OF PARTIES

All sales transactions are governed by one fundamental principle: The seller must transfer and deliver the goods in accordance with the agreed terms and the buyer must accept and pay for them. Com C §2301. This principle is as true for the sale of one pair of shoelaces by a corner drugstore as for the sale of a million tons of sheet steel by an industrial giant.

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III. DUTY TO SHIP

A. Shipment and Destination Contracts

§9.3 1. Definitions and Distinctions

If the goods are to be shipped, the sales contract usually contains a shipment provision. Customarily, the provision specifies that the seller must ship, establishes a date by which the shipment must be made, and stipulates who must pay freight and insurance.

The issues of which party bears the obligation to ship and where delivery must take place determine when title passes (Com C §2401(2); see §§8.2-8.13) and which party bears the risk of loss during shipment (Com C §2509(1); see §§8.26-8.27).

Sales contracts that contain a shipment provision are characterized as either "shipment contracts" or "destination contracts."

Shipment contracts. A contract is a shipment contract if the seller's obligation (whether expressed fully in the sales contract or as determined under Com C §§2503(2) and 2504) is limited to dispatching the goods to the buyer and does not include a duty to guarantee arrival of the shipment. Under such a contract, the seller is obliged only to dispatch the goods on their way. The seller is not obligated to ensure that the goods arrive at the contractually specified destination. See Com C §2504(a); Official Comment 1 to UCC §2-504. The seller's obligation of "tender" (*i.e.,* its duty to offer possession of the goods to the buyer; see §§9.44-9.50) is fulfilled simply by shipping the goods in compliance with Com C §2504. Com C §§2503(2), 2504. See §§9.5-9.9. There is a presumption that the parties intended a shipment contract. Official Comment 5 to UCC §2-503.

The seller, of course, must provide the carrier with shipping instructions. It follows that a contract is not a destination contract simply because the seller places an address label on the package, or directs to carrier to "ship to" a particular destination. Thus, a "ship to" term has no significance in determining whether a contract is a shipment or destination for risk of loss purposes. *Wilson v Brawn* (2005) 132 CA4th 549, 33 CR3d 769.

Destination contracts. To be considered a destination contract, the contract must require the seller to ensure that the goods reach their destination. A seller who is required to deliver at a particular destination must put and hold conforming goods at the buyer's disposition and give a reasonable notice to the buyer so that the buyer can take delivery. Com C §2503(3). Accordingly, the seller must make the goods physically available to the buyer. To do this, the seller must first ensure that the goods arrive at the specified destination.

If the contract does not specify the place of delivery, the seller's place of business is the place for delivery unless, when the contract is made, the parties know that the goods are in another place. In the latter circumstance, the place of delivery is where the goods are at the time of contracting. Com C §2308.

If the contract either requires or authorizes the seller to ship the goods, but does not require the seller to deliver them to a particular destination, the place of delivery is where the facilities of the seller's carrier are located, because the seller must put the goods into the possession of the carrier. Com C §2504(a).

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§9.4 2. Effect of Freight or C.O.D. Term

The seller need not deliver at a particular destination unless the contract provides for this. Com C §2504. If the agreement is silent or ambiguous, the statutory rule on shipment by the seller (*i.e.*, Com C §2504) automatically applies. Official Comment 5 to UCC §2-503.

Comment 5 also provides that:

The seller is not obligated to deliver at a named destination and bear the concurrent risk of loss until arrival, unless the seller has specifically agreed to deliver or *the commercial understanding of the terms used by the parties contemplates a destination contract*. [Emphasis added.]

The italicized language of the Comment may raise the claim that terms such as "freight at seller's expense," "freight allowance," or "freight prepaid" oblige the seller to deliver to a particular destination because the pre-Division 2 commercial understanding of these terms contemplated delivery. However, Division 2 itself specifies the delivery obligations under various mercantile shipment terms, such as F.O.B. and C.I.F. (see §§9.15-9.43).

The Commercial Code does not state whether the seller's agreement to ship C.O.D. creates a shipment contract or a destination contract. The usual method of shipping C.O.D. is to arrange for the carrier to collect from the buyer on delivery both the freight charges (if the buyer is to pay them) and the price due the seller. See §9.12. The Commercial Code expressly refers to C.O.D. contracts in Com C §2513(3)(a), which denies the C.O.D. buyer the right to inspect before payment. See also Com C §2507(2); Official Comment 1 to UCC §2-511.

The term "C.O.D.," however, does not by itself usually designate the place at which delivery is to occur. Because the Commercial Code regards the shipment contract as the presumptive type, a C.O.D. term presumably will not be held to convert a shipment contract into a destination contract unless special circumstances create a commercial understanding that the term requires the seller to deliver at a particular destination and thus bear the risk of loss. See Official Comment 5 to UCC §2-503. For discussion of C.O.D. shipment as a shipment under reservation, see §9.12.

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B. Seller's Obligation Under Shipment Contract

§9.5 1. Introduction

If the parties create a destination contract, the seller must ensure that conforming goods reach their destination. If they are lost or damaged in transit, the seller is liable to the buyer just as though the goods had never been shipped. Under a shipment contract, if the seller dispatches the goods to the buyer, its liability for their nonarrival or arrival in a damaged condition is governed by Com C §2504.

Essentially, if the seller under a shipment contract properly discharges certain duties (see §§9.5-9.9), the risk of loss or damage in transit falls on the buyer. If the seller does not discharge these duties, it retains all or part of the risk. For discussion of risk of loss, see §§16.40-16.50. Because the buyer under such a contract bears the risks of the carriage but has only a limited opportunity to guard against them by insurance or independent arrangements with the carrier, the Commercial Code places significant responsibilities on the seller with respect to shipping arrangements under the contract of shipment. See §§9.5-9.9.

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§9.6 2. Proper Contract of Carriage

The seller's obligation for transportation arrangements depends primarily on the terms of the sales agreement, subject to the seller's right and duty to make substituted performance (Com C §2614(1); see §9.69). See Official Comment 2 to UCC §2-504. Unless the parties agree otherwise, the seller has discretion to determine shipping arrangements (Com C §2311(2); see §4.89) within the limits imposed by Com C §2504(a). See Official Comment 3 to UCC §2-504. Failure to make proper arrangements will have more serious consequences if the seller violates express contractual terms than if it merely violates Com C §2504(a). See §9.68.

The seller must make a reasonable contract of carriage. Com C §2504(a). Reasonableness is determined by "the nature of the goods and other circumstances of the case." Com C §2504(a). This duty encompasses a number of obligations:

- First, the seller must select a reasonable carrier. This duty would forbid, for example, shipment of highly perishable produce from New York to San Francisco by a slow freighter routed around Cape Horn. Employing such a carrier to ship iron ore, however, might be reasonable if the scheduled or reasonably expected arrival date is met.

- Second, the seller must provide any care that the goods need in transit. For example, livestock must be fed and watered; lettuce must be refrigerated; oranges must be kept from freezing. The seller must see that all necessary arrangements are made, unless the buyer is in a position to make the appropriate arrangements and the seller notifies it of the need to do so. Official Comment 3 to UCC §2-504. There is no specific support in the Commercial Code for imposing these duties on the buyer, however, and the courts may not construe Com C §2504(a) in accordance with Comment 3.

- Third, the seller must value the goods properly. Carriers ordinarily operate under schedules that assign fixed values to thousands of classifications of goods by commodity, quantity, weight, or size. These values limit the carrier's responsibility for loss or damage to a fixed sum, unless a special value is declared and extra charges paid. The description of the goods on the bill of lading may determine their classification, quantity, weight, or size, and thus their value for purposes of carrier liability. See 46 USC App §1304(5) (ocean carriers may limit liability to "$500 per package or customary freight unit"); 49 USC §11706(c); 49 USC §14706 (the Carmack Amendment to the Interstate Commerce Act; common carriers may limit liability to value declared by shipper or established by contract).

NOTE ABOUT PREEMPTION: Under the Airline Deregulation Act of 1978 (49 USC §41713), federal common law governs contractual clauses that limit interstate carriers' liability for damage to goods shipped by air. *Wayne v DHL Worldwide Express* (9th Cir 2002) 294 F3d 1179, 1183. See §18.54. State statutes are preempted by the Carmack Amendment if they in any way enlarge the responsibility of the carrier for loss or at all affect the ground of recovery, or the measure of recovery. The Carmack Amendment and the set of federal regulations that complement it cover not only the actual transport of goods, but also govern the claims process. *Rini v United Van Lines, Inc.* (1st Cir 1997) 104 F3d 502, 504, quoting *Charleston & Western Carolina Ry. Co. v Varnville Furniture Co.* (1915) 237 US 597, 603, 59 L Ed 1137, 35 S Ct 715.

- If the seller fails to have the goods described, classified, or declared at their true worth, and loss or damage ensues in transit, the seller will likely bear any loss in excess of the carrier's liability limit. If the seller is obliged to pay extra shipping charges because it values the goods at their true value, however, these charges should be added to the buyer's account because the risk is on the buyer in a shipment contract and the seller should be reimbursed for reasonable expenditures in reducing or eliminating that risk. If the seller's dereliction entitles the buyer to reject the goods (see §9.9), the seller retains the risk of loss in transit. Com C §2510(1). See also §§16.41-16.43. Even if the buyer accepts the goods as damaged, the excess loss is recoverable from the seller as damages for the breach. Com C §2714(1), (3).

- Fourth, once a reasonable carrier is selected and proper arrangements for care of the goods in transit are made, the seller must put the goods in the possession of the carrier. Com C §2504(a). For discussion of this duty as imposed by Com C §2319(1)(a) under an F.O.B. point of shipment term, see §9.18.

- Fifth, the seller must arrange for the goods under a shipment contract to be properly loaded. If the seller does not make such arrangements and transit damage results, the seller must bear the loss. *Goldberg v Southwestern Metals Corp.* (1949) 92 CA2d 819, 208 P2d 75.

Once the seller has made proper shipping arrangements under a shipment contract, the seller will not bear losses caused by transit hazards. See, *e.g., Gates v Carquinez Packing Co.* (1889) 78 C 439, 21 P 1 (weight of goods at point of dispatch determined their price under shipment contract; buyer bore shrinkage loss due to natural evaporation).

Similarly, the seller under a shipment contract need not guarantee that the goods will arrive by the contractually specified date. If the seller places the goods in the hands of a reasonable carrier under a proper contract of carriage by a date that normally would afford time for seasonable arrival of the goods, the seller has made a reasonable transportation agreement and discharged its duty

under Com C §2504(a); it is not responsible for the subsequent tardiness of the carrier.

If the shipper does not meet the terms of the contract with respect to shipping arrangements, however, it can be held liable for its obligations under the contract or for damages for material loss or delay caused by this failure. Com C §2504; *Monte Carlo Shirt, Inc. v Daewoo Int'l (Am.) Corp.* (9th Cir 1983) 707 F2d 1054, 1059; *Harlow & Jones, Inc. v Advance Steel Co.* (ED Mich 1976) 424 F Supp 770, 775.

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§9.7 3. Delivery of Documents

The seller must promptly procure and offer to the buyer any documents that the buyer needs to obtain possession of the goods at their destination. Com C §2504(b). See also *Monte Carlo Shirt, Inc. v Daewoo Int'l (Am.) Corp.* (9th Cir 1983) 707 F2d 1054. For discussion of tender and delivery of documents, see §9.71.

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§9.8 4. Notice of Shipment

Under a shipment contract, the seller must notify the buyer promptly when the shipment has been made. Com C §2504(c). The seller may give notice by sending an invoice or straight nonnegotiable bill of lading or, in a documentary sale (see §§9.71-9.77), by forwarding the documents as required by Com C §2504(b). Official Comment 5 to UCC §2-504. If the agreement requires notice by wire or cable, the seller must comply. According to Official Comment 5 to UCC §2-504, if a buyer's rejection is to be predicated on a seller's failure to wire a notice of dispatch, the contract provision must be one of the specifically negotiated terms rather than a "form" term. Note, however, that this Comment is not substantiated by any textual provision.

NOTE: As a practical matter, the seller should dispatch a notice of shipment simultaneously with release of the goods to the carrier. The seller's failure to notify the buyer promptly may enable a buyer to reject the goods (see §9.9) and shift transit losses and the effect of any price decline back to the seller (Com C §2510(1)). Under a shipment contract, if the seller fails to give prompt notice of shipment and the goods are lost in transit, the seller bears the risk of loss because the seller's failure to notify deprives the buyer of an opportunity to insure the goods. See *Rheinberg-Kellerei GMBH v Vineyard Wine Co.* (NC Ct App 1981) 281 SE2d 425.

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§9.9 5. Effect of Failure to Ship Properly

If the seller does not make a proper contract of carriage as required by Com C §2504(a) (*e.g.,* the seller undervalues the goods, deals with an irresponsible carrier, or does not make proper arrangements for loading or care in transit), or if the seller fails to notify the buyer of shipment as required by Com C §2504(c), the buyer may reject the goods if material delay or loss ensues. Com C §2504. Furthermore, late shipment that causes damage to the buyer may constitute an actionable breach giving rise to a right to recover damages. *Monte Carlo Shirt, Inc. v Daewoo Int'l (Am.) Corp.* (9th Cir 1983) 707 F2d 1054, 1059.

There is no need for a causal connection between the seller's failure to discharge its obligation and the material loss or delay. The word "ensues" does not expressly require causation, but only requires that the seller's dereliction in fact is followed by material delay or damage. Official Comment 6 to UCC §2-504.

Material loss or delay may not be required as a ground for rejection if the seller has violated an express term of the contract. See *Monte Carlo Shirt, Inc. v Daewoo Int'l (Am.) Corp., supra*. See also §9.68.

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C. Shipments Under Reservation

§9.10 1. Seller's Security Interest

Shipment under reservation permits the seller to retain control of the goods in transit without incurring the disadvantages of a destination contract, *i.e.,* without prepaying freight and assuming the risk of loss or damage in transit. If a shipment is not under reservation, the seller runs a risk that the buyer will (a) refuse to accept the goods, or (b) accept the goods but not pay for them. The seller's only recourse then is to reclaim the goods (if the buyer refuses to accept or revokes acceptance), sue the buyer, or both.

As a practical matter, because the goods and the buyer are both in the buyer's jurisdiction, reclaiming the goods is costly to the seller. By shipping under reservation, the seller retains a security interest in the goods; the seller can prevent the buyer from taking possession of the goods before paying for them, and it can make alternative arrangements for disposing of the goods if the buyer refuses to pay the contract price.

The Commercial Code's requirements for shipping under reservation are embodied in Com C §2505. The seller may reserve a security interest by procuring a negotiable bill of lading (see §9.11) or, under certain circumstances, a nonnegotiable bill of lading (see §9.12). Com C §2502. Shipment under reservation does not prevent the seller from transferring both title and risk of loss to the buyer on delivery of the goods to the carrier. The seller's reserved security interest is exempt from the requirements of Commercial Code Division 9 (secured transactions) as long as the buyer does not obtain possession of the goods. Com C §9110.

Shipment under reservation exempts the buyer from having to show that "cover" (*i.e.,* substitute goods) was not available before it can obtain the goods by replevin. The buyer need only tender the price or otherwise satisfy the seller's security interest. Com C §2716(3). The replevin technically is of the documents representing the goods, not of the goods themselves. See Official Comment 5 to UCC §2-716 (Official Comment 4 to UCC §2-716 (2003)); Com C §7602. For discussion of replevin, see §18.46.

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§9.11 2. Order Bills of Lading

Commercial Code §2505(1) contains two provisions for shipping under reservation; which one applies depends on the form of the bill of lading used (*i.e.,* negotiable or nonnegotiable). A bill of lading is issued by a carrier to the shipper (seller) as evidence of the carrier's receipt of the goods for shipment. Com C §1201(b)(6). Bills of lading for interstate shipments are governed by federal law (*e.g.,* 49 USC §§80101-80116); those for shipments within California are governed by Commercial Code Division 7. See Com C §7103(a).

The most important classification of bills of lading under the Commercial Code is between negotiable and nonnegotiable bills. See Official Comment to UCC §7-104; 49 USC §80103. An order bill, consigning goods to the order of a named person, is negotiable under both the Commercial Code and federal law. Under the Commercial Code, bearer bills also are negotiable. See Com C §7104(a). A straight bill, consigning goods "to" a specified person (not "to the order of" that person), is nonnegotiable, but, under the Commercial Code, it must be conspicuously marked "nonnegotiable." Com C §7104(b)-(c). A common carrier issuing a nonnegotiable bill of lading must put "nonnegotiable" or "not negotiable" on the bill. 49 USC §80103.

Every shipment under a negotiable bill of lading automatically reserves a security interest in the goods in favor of the seller. Com C §2505(1)(a). See Official Comment 2 to UCC §2-505. The carrier will not deliver goods shipped under a negotiable bill without surrender of the bill itself; possession of the bill gives control over the goods. See Com C §7403(c).

When shipping to the buyer's location under a negotiable bill, the seller customarily draws a draft on the buyer for the price. (A draft is an instrument, usually negotiable in form, by which the drawer of the draft orders the drawee to pay the payee. "Sight" drafts are payable on demand. "Time" drafts are payable a specified period of time after presentment or date. A check is a draft drawn on a bank and payable on demand. See Com C §3104(f).)

The seller attaches the bill of lading, the invoice, and any other necessary documents (*e.g.,* an inspection certificate) to the draft, which then becomes a "documentary draft" because it is accompanied by documents to be delivered against honor of the draft. Com C §4104(a)(6). The seller delivers the documentary draft to its bank, which forwards the draft for collection to a bank at the buyer's location.

Although a bill of lading issued to the order of the buyer reserves a security interest, the bill of lading customarily is issued either to the order of the seller, which endorses the bill to its bank, or to the order of the bank itself. Either method begins a chain of endorsement through which the collecting bank becomes the holder of the bill of lading and is thus entitled to deal with the goods if the draft is dishonored. Destination bills may be used for quick shipments that would arrive before the documents. See UCC §7-305; Official Comment to UCC §7-305.

Frequently, the seller's bank advances credit or funds to the seller against collection of the draft and thus acquires a security interest in both the draft and the bill of lading. See Com C §§4208-4209, 7501-7503. This security interest may defeat an attempt by the buyer to litigate claims against the seller in the buyer's jurisdiction, *e.g.,* by attaching the bill of lading or the goods as property of the seller. Similarly, if the buyer obtains possession of the goods by accepting (Com C §3409) a draft payable more than 3 days after sight (Com C §§2514, 4503), the bank's security interest will defeat the buyer's attempt to offset its indebtedness on the draft by claims it may have against the seller.

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§9.12 3. Nonnegotiable Bills of Lading and C.O.D.

If the seller ships the goods to the buyer's location under a straight (nonnegotiable) bill of lading that names either the seller or its nominee (*e.g.*, its bank) as consignee, the seller reserves possession of the goods as security. Com C §2505(1)(b). Although technically distinct from a security interest, this reserved right is its practical equivalent. The distinction may have bankruptcy implications, however, because the seller under a straight bill of lading will not have the status of a secured party.

As consignee, either the seller or the bank ordinarily can instruct the carrier to deliver the goods without surrender of the bill. Com C §§7102(a)(9), 7303(1)(c), 7403(a).

Whether consignee or consignor, the seller may be entitled to stop delivery of the goods on the buyer's insolvency or default. Com C §2705. See §§17.14-17.22. If the bank has credited the seller with the price, the bank may also exercise the seller's power to stop delivery. Com C §§2506, 2707. See §17.18. These powers are not unlimited, however. If a seller or bank withholds delivery improperly, its rights in the goods are subject to the buyer's right to tender payment and compel delivery. See Official Comment 3 to UCC §2-505; Official Comment 4 to UCC §2-506.

From the bank's standpoint, the nonnegotiable bill of lading consigned to the seller or its nominee is a less satisfactory financing device than the negotiable bill. If the seller is consignee of a nonnegotiable bill and transfers it to the bank, the bank's rights can be defeated by acts of the seller or its creditors until the carrier receives notice of the transfer. See Com C §7504(b). If the bank is consignee, the seller, as consignor, still may be able to give changes in shipping instructions. Com C §7303.

Even if a nonnegotiable bill of lading names the buyer as consignee, the seller retains some power to change shipping instructions or to stop delivery. The seller's bank also may be able to stop delivery if it has purchased the seller's draft for the price of the goods. Com C §2506. Once the buyer reroutes a shipment in transit to a subsequent buyer, however, the seller's right to stop shipment is extinguished. See *Butts v Glendale Plywood Co.* (9th Cir 1983) 710 F2d 504. Nevertheless, a nonnegotiable bill consigned to the buyer does not reserve a security interest in the seller except in a case of conditional delivery. Com C §2505(1)(b).

Under the exception of Com C §2507(2), a security interest presumably is reserved:

Where payment is due and demanded on the delivery to the buyer of goods or documents of title, its right as against the seller to retain or dispose of them is conditional upon its making the payment due.

NOTE: The discussion of Com C §2507(2) in Official Comment 3 to UCC §2-507 and Official Comment 4 to UCC §2-505 principally concerns the seller's permitting the buyer to obtain possession of the goods on the condition that the buyer pay for them immediately. The language of Com C §2507(2) also seems to cover C.O.D. shipments, in which the buyer does not have the right to inspect the goods until it pays for them. In a C.O.D. shipment, the carrier contracts with the seller not only to transport and deliver the goods but also to collect the price from the buyer on delivery. See Official Comment to UCC §7-305.

A C.O.D. carrier that delivers goods to the buyer in exchange for a worthless personal check instead of demanding cash, certified check, or money order as required by the seller is liable to the seller for the stated value of the goods and cannot raise in defense the issue of the value of the goods or defects in the goods. See *Cermetek, Inc. v Butler Avpak, Inc.* (9th Cir 1978) 573 F2d 1370, 1379. When a C.O.D. carrier accepts a cashier's check that is later determined to have been forged, however, the carrier is liable only if it failed to exercise due care in accepting the check. *Littleton Stamp & Coin Co. v Delta Airlines, Inc.* (1st Cir 1985) 778 F2d 53.

NOTE: A C.O.D. carrier can limit its liability by specifying in the agreement that all checks and money orders are collected at seller's risk, including risk of nonpayment and forgery. *McCall-Thomas Eng'g Co. v Federal Express Corp.* (4th Cir 1996) 81 F3d 28.

A C.O.D. sale presumably is included in the exception provided by Com C §2505(1)(b) for shipments in which payment is due and demanded on the delivery to the buyer. Com C §2507(2). Thus, by implication, a C.O.D. shipment reserves a security interest in the seller. For discussion of C.O.D. as a shipment contract term rather than a destination contract term, see §9.4.

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§9.13 4. Documentary Sales and Buyer's Inspection

In a pure documentary sale, the buyer not only must pay in exchange for documents but also must pay before it has an opportunity to inspect the goods. Shipment under reservation is a more inclusive concept; it means any shipment in which the form of and control over the documents of title reserve a security interest in the seller, whether or not the buyer is entitled to inspect before payment. See Com C §§2505, 2509(1). See also §9.10.

Shipment in a pure documentary sale ordinarily is under reservation. For example, C.I.F. and C. & F. terms usually create documentary sales by requiring the buyer to pay against documents instead of goods. Com C §2320(4). See §9.34. Unless the contract calls for payment on or after arrival (Com C §2321(3)), the sale is "purely" documentary, *i.e.,* the buyer may not inspect the goods before payment (see Official Comment 12 to UCC §2-320).

F.O.B. vessel and F.A.S. terms also require the buyer to pay against documents before inspecting the goods. See Com C §§2319(4), 2513(3)(b); Official Comment 5 to UCC §2-513. See also §§9.21-9.22, 9.25. The buyer ordinarily is unwilling to pay against documents unless it receives a negotiable bill of lading, without which the carrier will not surrender the goods. Recognizing this interest of the buyer, the Commercial Code expressly requires a negotiable bill of lading under some of the mercantile terms that provide for payment against documents. See Com C §§2320(2)(a), (3) (C.I.F. and C. & F.), 2323(1) (C.I.F., C. & F., and F.O.B. vessel in overseas shipment). Documentary sale shipments therefore ordinarily are under negotiable bills of lading and thus are under reservation. See Com C §2505(1)(a). See also §9.11.

The seller does not need express contractual authority to ship under reservation. It may do so under any shipment contract that does not contain terms precluding it, *e.g.,* credit terms (except if the buyer is to receive possession in exchange for its acceptance of a draft payable more than 3 days after sight; see §9.11). Unless the contract contains a term requiring payment before inspection, however, the seller must give the buyer an opportunity, before payment, to inspect the goods after their arrival. See Com C §2310(b). See also §§10.4-10.15.

The forms on which carriers issue order bills of lading commonly deny the consignee or holder the right to inspect before it takes delivery of the goods unless permission to inspect is endorsed on the bill itself or given in writing by the shipper. Thus, a seller that, relying on its right to ship under reservation, ships under a negotiable bill of lading may be in breach if the words "inspection allowed" or similar permission does not appear on the bill of lading or accompanying documents. See Official Comment 2 to UCC §2-310. Similarly, although a C.O.D. shipment is a shipment under reservation (see §9.12), it ordinarily denies the buyer the right to inspect before payment. See Com C §2513(3)(a). Therefore, shipping C.O.D. requires express contractual authorization.

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§9.14 5. Unauthorized Reservation Shipments

If a shipment under reservation violates the contract of sale, it constitutes an improper contract for transportation. Com C §2505(2). An improper contract for transportation is a ground for rejection only if material delay or loss ensues. Com C §2504.

For example, if the contract of sale entitles the buyer to receive the goods on credit, but the reservation shipment requires it to pay cash when it takes delivery, the buyer presumably is materially damaged by being unable to obtain the goods without premature loss of money. See *U.S. ex rel Industrial Instrument Corp. v Paul Hardeman, Inc.* (ND Tex 1962) 202 F Supp 124, 134.

NOTE: If the reservation shipment is improper because it deprives the buyer of the right to inspect the goods before paying the price, the buyer presumably is materially damaged by being required to take a risk to which it has not agreed, *i.e.,* the risk that the goods will prove defective and that it will be left with only a cause of action against the seller.

The impropriety of a shipment under reservation does not impair the rights of either the buyer or the holder of a document duly negotiated by the seller. Com C §§2505(2), 7501(a)(5). A shipment by itself gives the buyer certain rights. Shipment is one means of "identifying" goods to the contract. See Com C §2501(1)(b). See also §§8.29-8.30. Identification entitles the buyer to insure the goods, to recover the goods if the seller becomes insolvent, to replevy them, or to sue third parties for injuries to them. See Com C §§2501(1), 2502, 2716(3), 2722.

None of these rights is impaired by an unauthorized reservation shipment (Com C §2505(2)), nor are the seller's powers as holder of a negotiable document (*e.g.,* an order bill of lading) impaired. They remain the same as though the document's origins were legitimate. Even though creation of the order bill violates the sales contract, the bill has independent validity once created. The buyer has recourse against the seller for having created it in violation of the sales contract, but the title document is fully negotiable by the seller. Com C §2505(2). Any other result, of course, would destroy the value of negotiable documents. See Com C §§7501-7503.

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D. Mercantile Shipment Terms

§9.15 1. Introduction

Commercial contracts frequently establish the seller's shipment obligations by use of shorthand terms, such as F.O.B., F.A.S., C.I.F., and C. & F. These terms are referred to generically as the "mercantile shipment" terms or "trade terms."

Because the Commercial Code adopted the trade terms already in use in business, businesspersons who contemplate transportation almost always use those terms. The Commercial Code gives the mercantile shipment terms statutory sanction, elaborating on them in detail. See Com C §§2319-2324. Therefore, in the absence of an agreement to the contrary, the definitions of mercantile terms in Com C §§2319-2325 should be used for domestic sales contracts.

For foreign trade, the most widely recognized sets of nonstatutory definitions are Incoterms 2000, prepared by the International Chamber of Commerce, with its headquarters in Paris. For online information, see http://www.iccwbo.org. The United Nations Convention on Contracts for the International Sale of Goods (see §9.1) does not provide definitions of shipping terms.

The Incoterms reflect changes in the world of commercial sales and transportation of goods, particularly the use of electronic transfers of information and multimodal carriage of goods. The Introduction to Incoterms 2000 notes that the various trade terms are grouped into four categories, depending on where the goods are to be delivered and the obligations imposed on the seller with respect to the costs and risks of shipment. The categories are:

- The "E-terms" (the goods are made available at the seller's premises, *e.g.,* EXW);
- The "F-terms" (the seller delivers the goods to a carrier appointed by the buyer, *e.g.,* FOB);
- The "C-terms" (the seller contracts for carriage but does not assume the risk of loss or damage or additional costs arising from events occurring after shipment, *e.g.,* CFR); and
- The "D-terms" (the seller bears the costs and risks necessary to bring the goods to the agreed destination, *e.g.,* DAF).

The Com C §§2319-2323 definitions of some of the principal "C," "D," and "F" terms differ from those in Incoterms 2000.

PRACTICE NOTE: The parties using mercantile symbols in an international transaction should indicate which set of definitions apply.

Incoterms 2000 can be obtained through the internet at http://www.iccbooks.com, or from ICC national committees.

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Source: Business Law/California UCC Sales and Leases/9 Seller's Performance/§9.16 2. Table: Allocation of Responsibilities Under Mercantile Shipment Terms

§9.16 2. Table: Allocation of Responsibilities Under Mercantile Shipment Terms

SHIPMENT CONTRACT TERMS	WHO BEARS								
	Risk of Loss in Transit	**Point at Which Risk Shifts**	**Cost of Freight**	**Cost of Loading**	**Duty To Arrange Shipping**	**Cost of Insurance**	**Duty To Procure Insurance**	**Cost of Export Licenses, etc.**	**Cost of Import Duties, etc.**
F.O.B. point of shipment (see §§9.18, 9.24)	Buyer.	Possession of carrier. Com C §2319(1)(a).	Buyer.	Buyer unless carrier requires shipper to load.	Seller. Com C §§2311(2), 2319(1)(a), 2504.	If wanted, buyer.	If wanted, buyer.	Buyer.	Buyer.
*F.O.B. vessel, car, or other vehicle** (see §§9.20-9.21)	Buyer.	On board carrier. Com C §2319(1)(c).	Buyer.	Seller. Com C §2319(1)(c).	Seller. Com C §§2311(2), 2319(1)(a), 2504. Buyer if F.O.B. vessel. Com C §2319(1)(c), (3).	If wanted, buyer. See also §9.24.	If wanted, buyer. See also §9.24.	Buyer.	Buyer.
*F.A.S. vessel** (see §9.25)	Buyer. Com C §2319(2)(a).	Alongside vessel of carrier. Com C §2319(2)(a).	Buyer.	Buyer. Com C §2319(2)(a).	Buyer. Com C §2319(3).	If wanted, buyer.	If wanted, buyer.	Buyer.	Buyer.
C.I.F.	Buyer. Com C §2320(2)(a). See §9.26.	Possession of carrier. Com C §§2320(2)(a), 2323(1). Maybe on board. Com C §2320(2)(b). See §9.27.	Seller. Com C §2320(2)(b). See §9.29.	Seller. Com C §2320(2)(b). See §§9.27, 9.29.	Seller. Com C §§2311(2), 2504.	Seller. Com C §2320(2)(c). See §§9.30-9.32.	Seller. Com C §2320(2)(c). See §§9.30-9.32.	Seller. See §9.36.	Buyer. See §9.36.
C. & F. (see §§9.26, 9.37)	Buyer. Com C §2320(2)(a), (3).	Possession of carrier. Com C §§2320(2)(a), (3), 2323(1). Maybe on board. Com C §2320(2)(b). See also §9.27.	Seller Com C §2320(2)(b), (3). See §9.29.	Seller. Com C §2320(2)(b), (3). See §9.27.	Seller. Com C §§2311(2), 2504.	If wanted, buyer. Com C §2320(3).	If wanted, buyer. Com C §2320(3).	Seller. See also §9.36.	Buyer. See also §9.36.
Ex source (see §9.40)	Buyer.	Ex point.	Buyer.	Buyer.	Buyer.	If wanted, buyer.	If wanted, buyer.	Buyer.	Buyer.
F.O.B. destination	Seller. Com C	Delivery. Com C	Seller. Com C	Seller. Com C	Seller. Com C	If wanted, seller.	If wanted, seller.	Seller.	Seller.

(see §9.19)	§2319(1)(b).	§2319(1)(b).	§2319(1)(b).	§2319(1)(b).	§2319(1)(b).				
*No arrival, no sale** (see §9.41)	Seller. Com C §2324.	Delivery. Com C §2324.	Seller. Com C §2324.	Seller. Com C §2324.	Seller. Com C §2324.	If wanted, seller. Com C §2324.	If wanted, seller. Com C §2324.	Seller.	Seller.
Ex ship (see §9.39)	Seller. Com C §2322(2)(b).	Unloaded at destination. Com C §2322(2)(b).	Seller. Com C §2322(2)(a).	Seller. Com C §2322(2)(a).	Seller.	If wanted, seller.	If wanted, seller.	Seller.	Seller.

"F.O.B. vessel, car, or other vehicle" and "F.A.S. vessel" may refer to a delivery aboard or alongside a conveyance at a transshipment point, or even at destination, as well as at the point of original shipment. See §§9.23, 9.25. However, the information in this table assumes that the delivery is to a conveyance at the point of original shipment.

On the term "to arrive," see Official Comment 4 to UCC §2-324. See also §9.42.

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3. F.O.B.

§9.17 a. Price Term and Delivery Term

The principal "F" term, F.O.B., literally means "free on board." Com C §2319(1). More elaborately, it means that goods are to be delivered on board the carrier, at the seller's expense. *Swerdfeger v United Acceptance Corp.* (1935) 9 CA2d 590, 50 P2d 818. F.O.B. is not merely a price term; it is a delivery term that requires the seller to bring the goods to the F.O.B. point at its own expense and risk. Com C §2319(1). See Official Comment 1 to UCC §2-319.

Commercial Code §2319 describes different types of F.O.B. contracts that can be added to either of the F.O.B. place terms: "F.O.B. the place of shipment" (Com C §2319(1)(a)), "F.O.B. the place of destination" (Com C §2319(1)(b)), and "F.O.B. vessel, car or other vehicle" (Com C §2319(1)(c)). The shipping duties of the parties differ slightly under each of these variants of the F.O.B. term.

Under F.O.B. place of shipment, the seller puts the goods in possession of a carrier, contracts for transportation with the carrier, obtains and tenders proper documents necessary to effect the buyer's possession of the goods, and notifies the buyer of the shipment. Com C §§2319(1)(a), 2504.

The F.O.B. destination term described by Com C §2319(1)(b) requires the seller to transport the goods to the destination point at the seller's risk and expense and to deliver the goods at that destination. If the vessel, car, or vehicle is also designated by the F.O.B. term, the buyer must name the vessel, car, or vehicle and otherwise timely provide any instructions needed to allow the seller to make the delivery. The seller takes on the obligation and risk of loading the goods on board. Com C §2319.

Under Incoterms 2000, the buyer must nominate the vessel, provide the seller with the necessary particulars to effect timely loading, contract at its expense for the carriage of the goods from the named port of shipment, and bear all risks of damage and loss once the goods are placed on board. Incoterms 2000 recognizes only the F.O.B. point of shipment term and only shipments by water. The seller must deliver the goods on board the specified vessel, bearing the risks of loss or damage until the goods pass the ship's rail.

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§9.18 b. F.O.B. Point of Shipment

Perhaps the most frequent form of F.O.B. quotation is one that couples F.O.B. with a geographical location. If the place named is the point from which the goods are to be shipped, a shipment contract (see §9.3) has been created. The seller then must arrange for carriage of the goods in accordance with Com C §2504. See Official Comment 1 to UCC §2-504; §§9.5-9.9. At its own expense, the seller must deliver the goods to the carrier; the seller bears the risk of loss until the carrier obtains possession. Com C §2319(1)(a). Putting the goods into the carrier's possession may or may not require the seller to load the goods on board. For example, a railroad carrier ordinarily requires the shipper to load carload shipments into freight cars but may load less-than-carload lots itself. See *Railroad Retirement Bd. v Duquesne Warehouse Co.* (1946) 326 US 446, 90 L Ed 192, 66 S Ct 238.

The specific requirement that the seller load the goods under an F.O.B. vessel or F.O.B. car term (Com C §2319(1)(c); see §9.21) seems to imply that the seller need not load under an F.O.B. point of shipment term (Com C §2319(1)(a)). Yet, if the carrier properly requires the shipper to load, as in a rail carload shipment, it is difficult to see how the seller can put the goods into the carrier's possession without loading them.

Perhaps because of this uncertainty, Official Comment 2 to UCC §2-319 discourages the use of F.O.B. terms linked only to the name of a locale, *e.g.,* "F.O.B. Los Angeles." Thus, the F.O.B. location should be pinpointed by reference to an exact spot (*e.g.,* "cars or dock") to avoid disputes over who bears the expense of loading and the risk of loss. Because Com C §2319(1)(c) expressly provides that the seller must load the goods at its risk and expense when the F.O.B. point of shipment term is also F.O.B. vessel, car, or other vehicle, use of both terms in an F.O.B. contract eliminates any question about who bears the cost of loading. For further discussion, see §9.21.

As noted above, Incoterms 2000 seeks to resolve the ambiguity created by the Commercial Code by restricting the F.O.B. term to shipments by water transportation, requiring the buyer to nominate the vessel and the seller to deliver the goods to the vessel even if the contract does not include an F.O.B. vessel term, and shifting the risks from the seller to the buyer when the goods pass the ship's rail. The term may still be ambiguous as to which party bears the expense of loading, but the requirement that the seller deliver the goods on board the nominated vessel clearly *implies* that the seller must bear the expense of loading.

Under an F.O.B. point of shipment quotation, the buyer also has certain obligations. It must bear any loss resulting from destruction or deterioration of the goods in transit and must provide the seller with any instructions needed for making delivery. See Com C §2319(3); *C-ART, Ltd. v Hong Kong Islands Line Am., S.A.* (9th Cir 1991) 940 F2d 530, 533. The seller may treat the buyer's failure to furnish instructions as a failure of cooperation and may pursue the remedies specified in Com C §2311(3). See §§4.89-4.92. It may also move the goods in any reasonable manner preparatory to making delivery or shipment, unless the buyer has repudiated the contract. See Com C §2319(3); Official Comment 3 to UCC §2-319. For discussion of repudiation, see §§16.21-16.39.

An "F.O.B. Point of Shipment" provision in a bill of lading does not absolve the carrier of liability. In *C-ART, Ltd. v Hong Kong Islands Line Am., S.A., supra,* the defendant carrier argued that the fact that goods were shipped "F.O.B. Hong Kong," the place of origin, indicated that the insolvent consignee had taken title to the goods; therefore, the consignor could not claim that the goods had been misdelivered by the carrier. The bill of lading at issue had a "surrender upon delivery" clause that instructed the carrier to deliver the goods only when it received the original bill of lading. However, the carrier delivered the goods without the bill of lading. The court concluded (940 F2d at 553):

Although the goods were shipped "F.O.B. Hong Kong," with the consignee bearing the risk of loss… it is undisputed that the consignee never paid C-ART for the goods. In this case, therefore, the bill of lading controls.

Similarly, in *Lite-On Peripherals, Inc. v Burlington Aire Express, Inc.* (9th Cir 2001) 255 F3d 1189, the court found that a consignor under a bill of lading with an "F.O.B. Taiwan" shipment term had standing to sue the carrier, who delivered the goods to the consignee without obtaining the original bill of lading (255 F3d at 1194):

[T]he proposition that [the consignor] was a stranger to the shipping contract cannot be supported. Bills of lading, after all, are designed to prevent sellers of goods from losing money when distant or unfamiliar buyers turn out to be insolvent.… The documentary sale evidenced by a bill of lading enables the distant seller to protect himself from an insolvent or fraudulent foreign buyer by ensuring that the buyer ordinarily cannot take possession of the goods until he has paid for them.… Absent a valid agreement to the contrary the carrier, the issuer of the bill of lading, is responsible for releasing the cargo only to the party who presents the original bill of lading.… If the carrier delivers the goods to one other than the authorized holder of the bill of lading, the carrier is liable for misdelivery.

(Quoting from *Allied Chem. Int'l Corp. v Companhia de Navegacao Lloyd Brasileiro* (2d Cir 1985) 775 F2d 476, 481.)

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§9.19 c. F.O.B. Point of Destination

An agreement linking the letters "F.O.B." with the arrival point is a destination contract (see §9.3). The seller is required to transport the goods at its own expense and risk to the designated destination. Com C §2319(1)(b). See *Collingwood Grain, Inc. v Coast Trading Co. (In re Coast Trading Co.)* (9th Cir 1984) *744* F2d 686. When the goods arrive, the seller must tender delivery at the destination point as provided by Com C §2503(3).

Incoterms 2000 differs substantially from the Commercial Code on this term. Incoterms does not consider any destination contract to be within the scope of an F.O.B. term. Instead, Incoterms uses a "D-term," either D.D.U. or D.D.P. ("Delivered Duty Unpaid" or "Paid"), as the equivalent of an F.O.B. point of destination term. Under the D.D.U. term, the seller bears the risks of loss or damage and expenses of shipment until the goods are placed at the disposal of the buyer at the destination. If the D.D.P. term is used, the seller must also pay all duties, taxes, and other official charges payable on importation of the goods. The buyer under the D.D.P. term is responsible only to render at the seller's request, risk, and expense every assistance in obtaining any import license or other official authorization necessary for the importation of the goods.

Under the Incoterms 2000 D.E.S. term ("Delivered Ex Ship"), delivery occurs when the goods are made available to the buyer on board the ship at the named port of destination. Discharge is at the risk and expense of the buyer. This is the equivalent of the "F.O.B. vessel place of destination" term under the Code. It should not be confused with "Delivery Ex Ship" as provided for in Com C §2322, which requires delivery "from a ship" and places the risk of loss on the seller until the goods are "properly unloaded." See §9.39.

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§9.20 d. F.O.B. Carrier

"F.O.B. vessel, car, or other vehicle," often referred to as "F.O.B. carrier," requires the seller to load the goods on board at its own expense and risk. Com C §2319(1)(c). On whether loading is included in the seller's duty of putting the goods into the carrier's possession under an F.O.B. point of shipment term, see §9.18. If the carrier does its own loading and absorbs the cost in the freight charged the buyer (*e.g.,* in a less-than-carload shipment), the only effect of an F.O.B. carrier term may be that the seller continues to bear the risk of loss or delay until the carrier has completed loading. Presumably, the buyer would not be entitled arbitrarily to allocate part of the freight charge to a loading cost that had not been stated separately by the carrier. For discussion of the duty of loading under an F.O.B. vessel term, see §9.21.

An F.O.B. carrier term includes the city or other designation of location at which the goods are to be delivered. The designated delivery point may be either the place of shipment or the place of destination. Com C §2319(1)(c). For discussion of F.O.B. carrier at a point of transshipment, see §9.22. An F.O.B. carrier term imposes the same obligations on the buyer as those imposed by an F.O.B. point of shipment term. The buyer is required to furnish any needed delivery instructions. If it does not, the seller may treat the failure as noncooperation under Com C §2311(3) (see §§4.89-4.92) or may move the goods in a reasonable manner preparatory to fulfilling its duties of delivery or shipment. See Com C §2319(3); Official Comment 3 to UCC §2-319.

As noted in §9.19, under Incoterms 2000, all F.O.B. contracts are shipment contracts and by definition include a vessel carrier term even if the carrier term is not stated.

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e. F.O.B. Vessel

§9.21 (1) Duties of Seller and Buyer

The F.O.B. vessel quotation is a form of F.O.B. carrier term, but separate comment is warranted because many Commercial Code and common law rules relate especially to it and because all F.O.B. contracts under Incoterms 2000 are F.O.B. vessel contracts. The term is ordinarily expressed as "F.O.B. vessel (named port of shipment)," *i.e.,* the contract specifies the port but not the vessel.

Unlike the F.O.B. land carrier term, under which the seller selects the carrier (see §9.20), the F.O.B. vessel term requires the buyer to name the vessel, its loading berth, and its sailing date. Com C §2319(1)(c), (3). The seller must "at its own expense and risk load the goods on board." Com C §2319(1)(c). Thus, the bill of lading must show the goods as loaded on board, not simply as received for shipment. See Official Comment 4 to UCC §2-319. The seller must pay the stevedoring and other charges incurred in loading the goods aboard.

NOTE: Commercial Code §2319 apparently does not take into account the situation in *Meyer v Sullivan* (1919) 40 CA 723, 730, 181 P 847, 849, in which the cost of loading from the dock into the ship was found to be customarily paid by the shipowner, who absorbed it in the freight charge, so that there apparently was no separate loading charge that the seller could calculate and pay in advance. Under those circumstances, the court declared that the only practical significance of F.O.B. vessel, as distinct from F.A.S. (free alongside) vessel, was that the seller retained "responsibility" (*i.e.,* risk of loss or damage) until the goods were on board ship. The modern practice is for shipping carriers to state their handling charges separately. See *Sun-Maid Raisin Growers Ass'n v U.S.* (ND Cal 1940) 33 F Supp 959.

The seller's duty ordinarily is to load the goods on the vessel named by the buyer. See *Hecht v Alfaro* (9th Cir 1926) 10 F2d 464. If it is commercially impracticable for the seller to do so and a commercially reasonable substitute manner of delivery is available, the seller must use it. Com C §2614(1). See §9.69. The duty to load aboard a vessel is for the benefit of the buyer; if the buyer orders a substitute manner of delivery that is no more burdensome for the seller (*e.g.,* on a dock or to a warehouse), the seller must comply. *Douglas Fir Exploitation & Export Co. v Comyn* (9th Cir 1922) 279 F 203.

If the buyer fails to give instructions necessary for the seller to make delivery, the seller may treat this failure as noncooperation. Com C §2319(3). See §§4.89-4.92.

Under Incoterms 2000 (see §9.15), the risk of loss and cost of further handling pass to the buyer if the seller is ready to load and the vessel named by the buyer fails to arrive or to load within the designated time. The goods must have been identified to the contract, however, in order to shift these risks to the buyer.

Under the Commercial Code, the seller presumably retains the burden of cost and risk in this situation until it has exhausted the possibilities of substitute performance under Com C §2614. The seller's duty to cooperate with the buyer (Com C §2319(3)) may also require it to notify the buyer of obstacles to the designated manner of delivery, giving the buyer an opportunity to furnish alternative instructions and avoid being put in breach. The buyer's breach saddles it with the risk of loss, but only to the extent that a loss is not covered by the seller's insurance. See Com C §2510(3). See also §16.50. The buyer may be excused from its obligation to accept and pay for the goods if, without its fault, neither the vessel that it designated nor any commercially reasonable equivalent is available. See *H. Hackfeld & Co. v Castle* (1921) 186 C 53, 198 P 1041.

Once the goods are loaded, the buyer must handle their movement to the destination, bearing the risk of loss in transit. Incoterms 2000 provides for the seller to pay for export licenses or any other export charges as well as for documents in proof of delivery of the goods on board the carrier.

Incoterms 2000 also provides for shipment F.C.A. or "Free Carrier" (named place). This term can be used with any transportation mode and requires the seller to deliver the goods to the carrier at a designated place or other point such as a transport terminal or other receiving point. This term is, therefore, the Incoterms' equivalent of the Commercial Code's F.O.B. place of shipment, although Incoterms 2000 includes detailed provisions regarding delivery and allocation of the risks and expenses of loading, depending on the mode of transport involved.

Finally, in an F.O.B. vessel transaction the buyer must pay only on a proper tender of documents and cannot demand, nor may the seller deliver, goods in substitution for the documents without the buyer's consent. Com C §2319(4).

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§9.22 (2) Form and Number of Bills of Lading

Under the Commercial Code, in an overseas F.O.B. vessel transaction the seller must obtain a negotiable bill of lading showing that the goods have been loaded on board the vessel. See Com C §2323(1). The requirement in Incoterms 2000 is less specific than the Code's and is not limited to "overseas" shipments. In all F.O.B. shipments under Incoterms 2000, the seller must provide "the usual document in proof of delivery" on board, but the document need not be a negotiable bill of lading. If, however, the document in proof of delivery on board is *not* the bill of lading or other "transport document," Incoterms 2000 requires that, at the buyer's request, the seller must render the buyer "every assistance in obtaining a transport document" (which itself may or may not be a negotiable bill of lading).

An air or water shipment is said to be "overseas" if by usage of trade or agreement it is subject to the commercial, financing, or shipping practices characteristic of international deepwater commerce. Com C §2323(3). This broad definition conceivably could cover inland marine passage (*e.g.,* on the Great Lakes) or intracontinental air shipments. A negotiable bill should be used even in domestic commerce if there is a possibility that the shipment would be defined as overseas.

In international trade, ocean bills of lading are generally issued in sets of "parts," *e.g.,* in duplicate or triplicate originals. Goods may be delivered by the carrier against a single part of the bill. The customary phraseology used is: "One being accomplished, the other to stand void." The Commercial Code prohibits issuance of bills in sets except when it is customary in overseas transportation. Com C §7304(1). The purpose of the overseas custom is to obviate the hazards of communication; one part of the bill may be forwarded by air and another by ship.

If the seller under an overseas F.O.B. vessel contract uses a bill in a set, the effect on the parties' rights depends on whether the bill and other documents against which the buyer must pay the price originate abroad or in the United States. Com C §2323(2)(b). If the documents come from abroad, tender of one part of the set is sufficient. Even an express contractual requirement of a full set does not automatically put in breach a seller that tenders only one part; such a seller may avoid breach in either of two ways:

- If its time for performance has not yet expired, the seller may cure its defective tender under Com C §2508(1) (Com C §2323(2)(a); see §9.75); or
- The seller may offer to indemnify the buyer against any adverse effect of the missing parts and, unless the buyer has a good faith reason to object to the adequacy of the indemnity offered, the buyer must accept it and pay the price of the goods (Com C §2323(2)(b)).

For rules governing losses that the missing parts may cause, see Com C §7304.

If the documents do not originate abroad, the buyer is entitled to demand that the seller tender the full set, unless the contract affirmatively provides otherwise. Com C §2323(2). A seller that refuses this demand cannot escape liability for breach by indemnifying the buyer under Com C §2323(2)(b) but may be entitled to cure its tender before the time for performance has expired. Com C §2508(1). See §9.63. On the necessity for strict correctness in documentary tender, see Com C §2503(5)(a). See also §9.71.

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§9.23 f. F.O.B. Intermediate Point

Although the Commercial Code provides for the terms "F.O.B. place of shipment" and "F.O.B. place of destination" (Com C §2319(1)(a)-(b)), it does not mention "F.O.B. place of transshipment or other intermediate point." Presumably the common law rule, that under an F.O.B. intermediate point term the seller must bear the expense and risk of loss until the goods reach that place, will continue to be followed. See *American Factors, Ltd. v Goss* (1925) 72 CA 742, 238 P 121 (F.O.B. dock). It may be possible to use "F.O.B. vessel, car, or other vehicle" (Com C §2319(1)(c); see §§9.20-9.21) to put the expense and risk of delivery aboard a carrier at a transshipment point on the seller.

An F.O.B. term that simply names the city of origin or destination can often be made more definite by reference to the exact point (*e.g.*, a siding or a loading dock) at which the seller or buyer customarily ships or receives similar goods; a comparable exact point of reference is less likely to be available for an F.O.B. intermediate city term.

DRAFTING CONSIDERATIONS: The Commercial Code discourages use of an intermediate port or city term because it does not specify who bears the cost and risk of transshipment. For example, under the Code, "F.O.B. San Francisco" may mean that the seller's responsibility ceases when the goods arrive "free on board" the inland conveyance at San Francisco, or only when they are "free on board" the ocean vessel in San Francisco harbor. Because Incoterms 2000 recognizes the F.O.B. term only for the port of shipment and only for vessel transport, the seller's responsibility under this example would continue until the goods were on board the ship, if Incoterms applied.

In any event, a well-drafted agreement will specify the precise point at which the seller's responsibility terminates and the buyer's begins. See Official Comment 2 to UCC §2-319. See also §9.17. Thus, if the seller is to load the goods on the next carrier, words such as "F.O.B. vessel San Francisco" should be used. If the seller is to deliver the goods to the next carrier, but not load them, words such as "F.O.B. *ABC* Shipping Company receiving terminal, San Francisco" should be given. If the seller's responsibility is to cease before the goods are unloaded from the original carrier, the words should be something like "F.O.B. cars, *XYZ* Railroad Freight Depot, San Francisco."

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§9.24 g. Matters Not Covered by F.O.B. Term

The parties may want the contract to express delivery obligations not resolved by an F.O.B. term as described in Com C §2319. The F.O.B. term implies nothing about who is to package the goods and, if the parties do not expressly agree, the seller ordinarily is entitled and required to select the packing method. See Com C §2311(2); §3.88. Incoterms 2000 specifies that the seller must provide, at its own expense, the customary packing of the goods, unless it is the custom of the trade to ship the goods unpacked. Incoterms 2000 FOB A9.

Unless the parties agree otherwise, the seller may ship by any reasonable form of carrier. Com C §2504(a). Dispute can be avoided if the contract specifies the method of transportation (*e.g.,* truck, railroad, barge).

In international shipments, all F.O.B. terms except F.O.B. destination imply that the buyer is responsible for obtaining ocean freight space and insuring itself against loss of or damage to the goods during ocean transit. Because trade usages often impose this obligation on the seller, however, a specific agreement in advance about which party assumes these obligations is desirable. The seller, for its own protection, is advised to have the contract of sale require the buyer to obtain marine insurance that includes standard warehouse-to-warehouse coverage.

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§9.25 4. F.A.S. Vessel

The "F.A.S. vessel" term is an ocean shipping term requiring the seller, at its own expense and risk, to deliver the goods "free alongside" the vessel at a named port. Often, the use of an F.A.S. term contemplates that the vessel will be loaded while at anchor, as contrasted with being loaded at a pier. Although the F.A.S. term may be used if the ship is being loaded from a pier, thereby giving it the same meaning as "F.O.B. Dock" (which is preferred by most Americans), in an international transaction the American seller should use the F.A.S. term to avoid any misunderstanding.

If the buyer designates and provides a dock, the seller must deliver the goods to that dock; if the buyer does not so designate, the seller must deliver the goods alongside the vessel in the manner customary at the port. Com C §2319(2)(a). The seller must obtain and give the buyer a receipt for the goods that will entitle the buyer to procure a bill of lading from the carrier. Com C §2319(2)(b). Incoterms 2000 requires that the receipt must be "the usual proof of delivery" of the goods alongside the named vessel. Incoterms 2000 FAS A8.

In short, under both the Commercial Code and Incoterms, the only difference between F.A.S. and F.O.B. vessel terms is that F.A.S. shifts expense and risk to the buyer when the goods are alongside, rather than on board, the vessel. The buyer's other obligations are the same. Com C §2319(3)-(4).

The discussion in §9.24 about the desirability of agreement between the parties on who is to procure ocean freight space and insurance also applies to an F.A.S. agreement.

Like "F.O.B.," "F.A.S." is a delivery, not merely a price, term. Com C §2319(2). See §9.17. Like "F.O.B. vessel," F.A.S. creates a documentary transaction. The buyer must pay against documents and cannot demand goods instead, nor can the seller tender goods instead of documents. Com C §2319(4). The F.A.S. contract, therefore, does not entitle the buyer to inspect the goods before payment of the price. Com C §2513(3).

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5. C.I.F.

§9.26 a. Meaning of Term

The initials "C.I.F." stand for "cost, insurance, freight." Used in a contract, the term means that the quoted price includes the cost of the goods plus the insurance and freight to the named destination. Com C §2320(1). The place designated in the C.I.F. term is the destination; *e.g.,* "C.I.F. Liverpool" means "cost, insurance, and freight to Liverpool." Nonetheless, C.I.F. is a shipment rather than a destination term; in transit, the goods are at the risk of the buyer, who is in turn protected by the insurer. *Wilson v Brawn* (2005) 132 CA4th 549, 33 CR3d 769; Official Comment 1 to UCC §2-320. A C.I.F. contract is always a documentary transaction, requiring payment on tender of documents rather than goods. See §9.34.

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§9.27 b. Expense and Risk of Loss

A C.I.F. contract requires the seller to put the goods into the possession of a carrier at the port for shipment for transportation over a regular line to the destination. See Com C §2320(2)(a). There is some confusion about the point at which the seller's responsibilities end. Although Com C §2323(1) permits the seller in a C.I.F. contract for overseas shipment to obtain and tender either an "on board" or a "received for shipment" bill of lading, Com C §2320(2)(b) declares that C.I.F. sellers in general must, at their own expense and risk, "load the goods."

This requirement appears to force the seller to retain the risk of loss until the goods are aboard ship even when the seller uses a "received for shipment" bill, indicating only delivery at the dock for shipment. Placing the risk of loading on the seller seems contrary to Official Comment 1 to UCC §2-320, which declares: "Delivery to the carrier is delivery to the buyer for purposes of risk and title." Nowhere do the extensive Comments to UCC §2-320 indicate that the seller's risk extends beyond the time of delivery to the carrier, as shown by properly tendered documents.

Incoterms 2000 requires the seller to load the goods at its own expense on board the vessel and to bear all risks until the goods have passed the ship's rail. Incoterms 2000 CIF A4.

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§9.28 c. Obtaining Bill of Lading

Under a C.I.F. agreement, the bill of lading obtained by the seller, whether an "on board" or a "received for shipment" bill, must be negotiable and must cover the entire transportation to the named destination. Com C §2320(2)(a). The "overseas shipment" requirements of Com C §2323(1), (3), which are discussed in §9.21, also apply to a C.I.F. (or C. & F.) quotation.

If the ship is to discharge the goods at a place other than the named destination, the bill of lading must cover any inland transportation required to take the goods to their destination. See Com C §2320(2)(a). Inland transportation before exportation is not covered by an ocean bill; nevertheless, a C.I.F. contract may properly provide for transportation beginning with inland carriage under a "through" or combination bill issued by the initial carrier. Official Comment 13 to UCC §2-320. For rules governing through bills of lading, see Com C §7302; 49 USC §§11706 (liability of rail carriers), 14706 (liability of motor carriers/freight forwarders), 15906 (liability of pipeline carriers).

To permit the buyer to deal in the documents representing the goods while they are in transit, the bill of lading must cover the precise quantity of goods ordered by the buyer. If the bill covers more goods than ordered (*e.g.,* those intended for other buyers), the buyer need not accept its part of the goods without first receiving the bill, or the bill and an undertaking to hold the excess goods for their owner. The seller may not tender nor the buyer demand delivery of the goods in substitution for the documents. Com C §2320(4).

For example, a Hong Kong seller under a contract to sell goods C.I.F. San Francisco does not have the right to buy those goods in San Francisco for tender there. They must be shipped from Hong Kong. The buyer is, however, entitled to claim its rights in any goods identified to the contract. Official Comment 4 to UCC §2-320. The rules concerning the number of bills of lading to be tendered, discussed in §9.22 in connection with the F.O.B. vessel term, apply equally in this situation.

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§9.29 d. Payment or Provision for Freight

The C.I.F. seller must obtain a receipt from the carrier showing that the freight has been paid or provided for. Com C §2320(2)(b). The seller may provide for freight by obtaining the carrier's services on credit, but it may not ship freight collect and deduct the transportation charges from the invoice price, unless permitted to do so by explicit agreement. Official Comment 5 to UCC §2-320. If credit is extended in this way, the carrier should not have a lien on the goods that is binding on the buyer, because such a lien will defeat the purpose of the section, which is to ensure that the buyer has no obligation for freight charges to the contracted destination.

The parties should have a clear understanding of what charges are included in the seller's obligation to deliver the goods to the carrier and to prepay or provide for the freight. Some charges may, by custom or express agreement, be passed on to the buyer, *e.g.,* weighing or inspection fees, charges for consular invoices or certificates of origin, or additional cost resulting from fluctuations in freight rates between the time of contracting and the time of shipment. See Incoterms 2000 CIF A6, B6.

If ocean freight space is at a premium, it may be advisable from the seller's perspective to agree that shipment within the contract period is subject to the availability of carriage facilities.

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e. Procurement of Insurance

§9.30 (1) Kind, Amount, and Beneficiary

The seller must procure a policy or certificate of insurance covering the same goods covered by the bill of lading. The insurance must be contracted with underwriters or insurance companies of good repute and must cover the C.I.F. price plus 10 percent. Incoterms 2000 CIF A3.

The policy or certificate must be of a kind and on the terms then current at the port of shipment. Coverage must be in the usual amount, in the currency of the contract. Com C §2320(2)(c). Official Comment 8 to UCC §2-320 refers to "insurance covering the value of the goods at the time and place of shipment." This reference should not be interpreted, however, as obligating the seller to furnish coverage for full value when local custom requires insurance for only a percentage of value. The point of the Comment appears to be that the customary coverage should be calculated on value at the time and place of shipment, as distinct from value in transit or in the hands of the buyer.

The insurance must be payable to the order of the buyer or for the account of whom it may concern to facilitate in-transit trading or hypothecation by the buyer. Com C §2320(2)(c); Official Comments 3, 9 to UCC §2-320. An "order" policy permits the buyer to endorse coverage to a purchaser or lender while the goods are in transit; an "open beneficiary" policy permits transfer of coverage without endorsement.

Because interests in the goods may shift while they are still in transit, coverage must be on the precise quantity of goods stated in the bill of lading. Blanket policies, covering shipments of goods destined for other consignees in addition to the buyer, are forbidden. Instead, negotiable certificates of insurance, by which the blanket coverage of a single policy is broken down into coverage of the individual shipments may be used because they accomplish the same purpose. These certificates are issued by the insurer. They should be distinguished from "brokers' certificates" or "cover notes," which are issued by an insurance broker and state that the goods are covered by a policy. Brokers' certificates or cover notes are considered to be sufficient only if they have gained acceptance by trade usage. See Official Comment 9 to UCC §2-320.

If the buyer trades or hypothecates the goods while they are en route and the goods have increased in value since the time of shipment, the buyer is under no duty to procure additional insurance on account of the value increase. It is up to the new buyer or lender to procure whatever additional coverage it desires. See Official Comment 8 to UCC §2-320.

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§9.31 (2) Risks Required to Be Covered

The C.I.F. seller must procure marine insurance, in the form usual or customary at the port of shipment for the kinds of goods and transportation being covered. Com C §2320(2)(c); Incoterms 2000 CIF A3. If special risks (*e.g.,* theft, pilferage, or leakage) are not covered by the usual marine insurance, the seller must insure against them only if the parties agree to this. Otherwise, the buyer bears these risks. See Official Comment 6 to UCC §2-320.

The parties should predetermine whether the marine coverage procured is to be "with average" or "free of particular average" (FPA). These are highly technical maritime terms dealing with risk of loss in the event all or part of a cargo is jettisoned. See Harb & N C §§425-432.

Under Incoterms 2000 CIF A3, the buyer may require the seller to obtain war, strikes, riots, and civil commotion insurance, if such insurance is procurable. If provided, the insurance is obtained at the buyer's expense.

The Commercial Code also requires the C.I.F. seller to procure war risk insurance coverage. Com C §2320(2)(c). The C.I.F. quoted price does not include the war risk premium; that cost fluctuates so rapidly that it is not commercially feasible to include the premium in an advance C.I.F. price quotation. Rather, the seller may add the premium charge to the C.I.F. price. Com C §2320(2)(c); Official Comment *7* to UCC §2-320.

The C.I.F. insurance coverage must cover the entire transportation of the goods to the named destination. See Official Comment 6 to UCC §2-320. Thus, if inland shipment is contemplated at any point during the journey, the policy must cover inland risks as well as those of marine transportation.

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§9.32 (3) Insuring Freight Charges

Ocean carriers sometimes use bills of lading stating that the freight charges will be considered earned "ship and/or cargo lost or not lost." A seller shipping under such a bill must insure against liability for the cost of freight as well as against loss of the goods, because if the goods are lost the buyer may still have to pay the freight charges, either to the seller as part of the C.I.F. price or to the carrier if the seller has exercised a contractual right to ship freight collect and to deduct the freight charge from the invoice price. Official Comment 8 to UCC §2-320.

If the carrier does not have a "lost or not lost" clause in the bill of lading, there is no need to insure for the freight charges. If a shipment that is lost was "freight collect," the carrier, not having earned the freight charges, cannot collect them from the buyer. If the seller prepaid freight, it must obtain a refund from the carrier; the seller cannot collect from the buyer for freight charges unearned by the carrier. Official Comments 5, 8 to UCC §2-320.

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§9.33 (4) Consequences of Failure to Insure

The buyer may waive the C.I.F. seller's obligations to procure insurance. Although the buyer normally can reject a documentary tender lacking insurance papers, if it refuses payment on some other ground at a time when the seller could still obtain insurance and its ground for refusal proves untenable, it cannot later seize on the lack of insurance to justify its conduct. Official Comment 9 to UCC §2-320. At least some of the provisions on cure (see §9.75) and waiver by failure to object (see §9.74) apply to documentary tenders under a C.I.F. agreement.

Thus, if the buyer fails to object to a documentary tender with improper or missing insurance documents until it is too late for the seller to cure the defect (*e.g.,* by procuring a retroactive policy insuring the goods "lost or not lost"), the buyer is considered to have waived its objection. Official Comment 9 to UCC §2-320.

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§9.34 f. Importance of Commercial Invoice

Under a C.I.F. contract, a commercial invoice must accompany the documentary tender. Com C §2320(2)(d)-(e); Incoterms 2000 CIF A1 (provides as an alternative its equivalent electronic message). Mistakes in description of the goods may appear in ocean bills and insurance policies prepared by employees of the carrier and the insurer, who may be unfamiliar with the language of the contract or relevant trade usages. The seller's description in the commercial invoice controls, and the documentary tender is not proper if it does not conform to the contract language. See Official Comment 10 to UCC §2-320. For discussion of cure of improper documentary tenders, see §9.75.

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§9.35 g. Procurement and Forwarding of Documents

The C.I.F. seller must also procure any other documents required to effect shipment or to comply with the contract. Com C §2320(2)(d). It is expected to obtain certificates of origin, consular invoices, and other documents issued in the country of origin or destination that the buyer needs to import the goods or to pass them in transit through another country or, on request, to assist the buyer in doing so. Incoterms 2000 CIF A10. The buyer, however, must pay all the procurement costs. Incoterms 2000 CIF B2, B6.

The seller must dispatch these ancillary documents to the buyer, along with the bill of lading, freight receipt, insurance policy or certificate, and commercial invoice, with "commercial promptness," in due form, and with any endorsement necessary to enable the buyer to deal with the goods while they are still in transit. Com C §2320(2)(e); Official Comment 11 to UCC §2-320.

A C.I.F. agreement creates a strictly documentary transaction; the buyer must pay when the documents are tendered, without inspection of the goods. Com C §§2320(4), 2513(3). See Official Comment 12 to UCC §2-320; Official Comment 5 to UCC §2-513.

Indeed, even if the goods are known to be lost, the seller may still tender the documents and compel the buyer to accept them. The buyer must pay the C.I.F. price, and then it can make its claim under the insurance policy to recover the loss. However, such a payment does not defeat the buyer's right to inspect the goods after they are delivered. See Com C §2512(2). The seller cannot rectify a deficient documentary tender by purchasing and tendering substitute goods. Com C §2320(4); Official Comment 15 to UCC §2-320. For discussion of the effect of a contract provision for payment on or after arrival, see Com C §2321(3). See also §§10.53-10.55.

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§9.36 h. Payment of Various Charges

The Commercial Code does not allocate a number of charges normally encountered in international commerce. Incoterms 2000 (see §9.15) provides that the seller pays export taxes, fees, and similar export charges, while the buyer pays landing costs, duties, taxes, and other expenses at the destination. The parties may allocate these costs differently if they choose.

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§9.37 6. C.F. & I., C. & F., C.F., and C.A.F.

The term "C.F. & I." is simply another way of saying "C.I.F." and means "cost, freight, and insurance." The terms "C. & F." and "C.F." or "C.F.R." (cost and freight) are variants of the "C.I.F." term. Com C §2320(1); Incoterms 2000 CIF A3. The risks and obligations of the parties are the same as in a C.I.F. contract, except that the seller is under no obligation to procure insurance. Com C §2320(3); Incoterms 2000 CIF A3.

It may be in the seller's business interest, however, to ensure that the buyer fully insures. Although the buyer carries the burden of insuring the shipment, the buyer may make the seller its agent to procure insurance. Official Comment 16 to UCC §2-320. If the seller fails to procure insurance, it may be liable to the buyer as an agent, but the seller's failure will not affect its right to tender a set of documents without an insurance policy and to obtain payment in accordance with the C. & F. sales contract.

PRACTICE TIP: Out of habit, Americans often use the letters "C.A.F." as the equivalent of "C. & F.," with the letter "A" standing for "and." The term "C.A.F." is not a variant of "C. & F." but rather the French equivalent of "C.I.F."; the "A" in C.A.F. denotes "assurance," which means insurance. Official Comment 17 to UCC §2-320. Therefore, the letters "C.A.F." should be avoided in favor of "C. & F."

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§9.38 7. Other C.I.F. Variants

Special terms, variations on the basic C.I.F. agreement, are sometimes used to shift certain transit risks to the seller. Essentially, these terms provide that the buyer will bear marine hazards, but the seller will bear the risks of quality and weight deterioration during shipment. Official Comment to UCC §2-321.

In the oil trade, the insertion of an "out turn" (or landed weight) clause has been understood to change the time at which risk of loss passes from the seller to the buyer, from the point of shipment to the point of destination. In these circumstances, the buyer should avoid any reference to the C.I.F. term in the contract because, by definition, it puts the risk of loss for the voyage on the buyer.

A term such as "net landed weights" or "delivered weights" means that the buyer need not pay for weight losses in transit; "out turn quality" or a similar term makes the seller responsible for the quality of goods on arrival. Com C §2321(1). Whatever the quotation, the seller must estimate the price for C.I.F. or C. & F. shipment purposes and is entitled to receive this price on tendering the documents. After the weight or condition of the goods on arrival is determined, however, the parties are expected to make an adjusted price settlement with commercial promptness. Com C §2321(1).

This procedure is consistent with trade practice if the contract provides that the price is to be adjusted on the basis of quality or quantity. If, however, the contract provides that the price is to be based on the delivered quality or quantity, the buyer may object to making payment before weight or quality is determined on arrival. Nevertheless, the Commercial Code is clear that the buyer must pay the seller's reasonable estimate of the price and must rely on the seller to estimate fairly in accordance with the obligations of cooperation (Com C §2311) and good faith (Com C §1304) inherent in all mercantile transactions.

If the contract contains any of the terms mentioned in Com C §2321(1) or a warranty of the quality or condition of the goods on arrival, the risk of ordinary alteration of the goods (*e.g.*, deterioration, shrinkage) remains with the seller during transit. Com C §2321(2). Retention of these transit risks does not affect the time or place of identifying the goods to the contract (see §§8.28-8.29, 17.32-17.37) or alter the time when the general risk of loss passes (see §9.27). Com C §2321(2).

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§9.39 8. Ex Ship or D.E.S.

The term "ex ship" means "from the carrying vessel." Com C §2322. Under the Commercial Code, it is a destination term obligating the seller to bear the risk of loss and pay all required transit expenditures (freight, export taxes, certifications, and landing charges) until the goods are unloaded from the carrying vessel. In contrast to the Code, the Incoterms 2000 term "D.E.S." (delivered ex ship) merely requires the seller to "place the goods at the disposal of the buyer on board the vessel" at the unloading port. Under Incoterms 2000, the buyer pays for the discharge from the ship.

Variants include "ex dock," "ex pier," and "ex quay," although the Code has no provision for such terms. Incoterms 2000 uses the term "D.E.Q." (delivered ex quay), with the seller bearing the cost and risks involved in bringing the goods to the named port of destination and discharging the good on the quay. The buyer is required to clear the goods for importation and pay the duty. If the parties wish to include in the seller's obligation all or part of the costs of importing the goods, then explicit provision for such an obligation must be made in the contract.

Under an ex ship quote, the seller is not required to make delivery from a particular vessel, even if one is named in the contract. Delivery from any ship that has reached the usual discharge point at the named destination will do, unless the contract explicitly restricts the seller to a specified vessel. Com C §2322(1); Official Comment 2 to UCC §2-322. The seller's obligation ends when it discharges all liens arising out of the carriage and furnishes the buyer with a direction that obligates the carrier to deliver the goods to the buyer. Com C §2322(2)(a). Risk of loss passes when the goods are unloaded. Com C §2322(2)(b). See Official Comment 4 to UCC §2-322.

If the contract calls for delivery ex ship with payment "cash against documents," the seller is entitled to payment when it furnishes the buyer with a freight receipt and direction requiring the carrier to surrender the goods. No bill of lading or insurance for the buyer's benefit is required; the goods are at the seller's risk during the voyage. Official Comment 4 to UCC §2-322. Presumably, the seller will carry marine insurance for its own benefit. Because the ex ship contract is not a documentary sale, the buyer has the right to inspect the goods before payment. See Com C §2513(1).

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§9.40 9. Ex Factory and Similar Terms

At the opposite extreme from destination terms such as "ex ship" are terms tied to the point of origin, *e.g.,* "ex factory," "ex mill," "ex mine," or "ex warehouse." The comparable term under Incoterms 2000 is "ex works." Incoterms 2000 EXW. These terms, however, are not used by the Commercial Code. The seller's obligation is only to tender delivery (see §9.44) at the specified "ex" point and to assist the buyer in procuring required export or import documents. Subsequent transportation of the merchandise is at the buyer's expense and risk.

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10. No Arrival, No Sale

§9.41 a. In General

A contract with a "no arrival, no sale" term is a destination contract with an escape hatch. See Official Comment 1 to UCC §2-324. In effect, the seller agrees to use reasonable efforts to deliver conforming goods to the buyer at the named destination with the understanding that if, without fault of the seller, the goods do not arrive, the seller will not be liable to the buyer in damages for nondelivery. The clause, however, does not permit a seller to avoid its obligations by failing to ship or by shipping nonconforming goods. Com C §2324(a).

A broader exemption from liability is suggested by Official Comment 1 to UCC §2-324, when a middleman is reselling goods that will actually be shipped by its supplier, "and this fact is known to the buyer, so that the (middleman) seller is not under any obligation to make the shipment himself." The Comment contrasts the middleman's broad exemption from liability for nonarrival or nonconformity of the goods with the exemption given to sellers who arrange their own shipments, which is limited to casualty from marine hazards.

The statute makes no such distinction; it requires every seller, middleman or otherwise, to "properly ship conforming goods." Com C §2324(a). A middleman could expressly limit its liability along the lines suggested by the Comment, *e.g.,* by agreeing only that it will use best efforts to induce a third party to ship the goods and will sell them if they arrive, but there is no statutory basis for this limitation of its obligation simply by the use of a "no arrival, no sale" term under Com C §2324.

A "no arrival, no sale" term presupposes that goods have been identified to the contract (see §§8.28-8.29, 17.32-17.37). A shipment specifically designated for the buyer must have been dispatched before it can be said that the shipment failed to arrive. If the seller simply ships goods to the port of destination without indicating that the buyer is the intended consignee, the goods may fail to arrive, but the seller is not relieved of liability, because there is no way of knowing whether the unidentified goods had been shipped in discharge of the seller's obligations to this buyer or to another. See Official Comment 2 to UCC §2-324. Identification gives the buyer an "insurable interest" in the goods, enabling it to insure against their nonarrival. Com C §2501(1). See §8.30.

If goods shipped under a no arrival, no sale contract arrive late, the seller must tender them. Official Comment 3 to UCC §2-324. If the tardiness is not the seller's fault, the buyer may not reject the goods and sue for nondelivery, but may proceed only under Com C §2613, which permits the buyer to avoid the contract or accept the goods with an allowance. Com C §2324(b). Similarly, if without fault of the seller only part of the goods arrive, or all or part of them arrive in a deteriorated condition, the buyer may proceed only as if there had been a casualty to identified goods under Com C §2613. Com C §2324(b).

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§9.42 b. To Arrive

The term "to arrive" can be, but is not necessarily, identical to "no arrival, no sale." Used in a destination contract (see §9.3), "to arrive" means the same as "no arrival, no sale" (see §9.41). In C.I.F. and C. & F. contracts, which are shipment contracts, "to arrive" usually means that the buyer refuses to bear the marine risks not covered by the agreed insurance (see §§9.30-9.31). If, however, the shipment is damaged or fails to arrive because of an uninsured risk, the buyer's rights against the seller are limited to those of a buyer under a no arrival, no sale contract, *i.e.,* the buyer may avoid the contract or accept the goods with an allowance. See Official Comment 4 to UCC §2-324.

"To arrive" may also be a time payment term, or it may negate the responsibility of a reselling seller for the goods' failing to conform to the seller's good faith description of their quality. Its meaning in a particular instance depends on the parties' intent. See Official Comment 4 to UCC §2-324.

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§9.43 c. Incompatibility With C.I.F. Term

A "no arrival, no sale" term clashes with a "C.I.F." or "C. & F." term. The attorney should avoid including both in the same agreement. The "C.I.F." term is a shipment term, providing that the buyer bears the risk of loss in transit but has insurance to reimburse it. "No arrival, no sale" is a destination term, specifying that the seller bears the risk of loss in transit but is relieved of contractual liability to the buyer under some circumstances of nonarrival. Any insurance is for the seller's benefit. The two terms cannot stand together; a court would have to disregard one or the other. For discussion of "payment after arrival" terms in a C.I.F. contract, see Com C §2321(3).

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IV. TENDER OF DELIVERY

§9.44 A. Introduction

Under a shipment contract, the seller's duties of delivery consist of putting the goods into the hands of a carrier with whom it has made a proper contract for their transportation and delivering appropriate documents and notices to the buyer. Com C §§2503(2), 2504. See §§9.5-9.9. The details of these duties vary according to particular terms in the contract (*e.g.,* F.O.B. (other than F.O.B. destination) or C.I.F.), but performance of the duties of shipment essentially completes the seller's duties of delivery.

Under a destination contract, shipment does not constitute delivery or tender of delivery but is part of the seller's preparation of the goods for delivery at the point of destination. The rules governing actual delivery or tender are similar to those applicable when the goods have not been moved before their acceptance by the buyer. Com C §2503(3). See §9.46. The discussion in §§9.44-9.50 assumes that the goods are located where physical transfer to the buyer is to occur, whether at the seller's place of business, the premises of a third party, or the terminal point of a shipment under a destination contract. Either the parties will have agreed specifically on the time and place for delivery and the acceptability of single or lot deliveries, or appropriate terms will be implied into the contract by Com C §§2307, 2308(a)-(b), and 2309(1) (see §§4.56-4.70).

If documents are required for a valid delivery of goods, they normally will be tendered through banking channels either because a bank will be collecting a draft attached to them or because the seller must present such documents to draw under a letter of credit. The dishonor of a draft will amount to a rejection of the goods or documents as well. See Com C §§2308(c), 2503(5)(b).

Although Com C §2301 states that the seller's obligation is to "transfer and deliver," its duty usually is only to "tender" delivery to the buyer. See, *e.g.,* Com C §2319(1)(b). See also Com C §§2503, 2507(1), 2511(1); §9.48. For discussion of the manner and effect of tender, see §§9.44-9.48. For discussion of various meanings of tender, see Official Comment 1 to UCC §2-503.

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B. Manner of Tender

§9.45 1. General Rule

Under Com C §2503(1), a valid tender of delivery consists of two elements:

- The seller must put and hold conforming goods at the buyer's disposition; and
- The seller must give the buyer any notification reasonably necessary to enable it to take delivery.

The manner, time, and place for tender must be in accord with the contract and the Commercial Code. Com C §2503(1). For discussion of place of delivery, see Com C §2308. See also §§4.59-4.61.

The seller must tender the goods at a reasonable hour and keep them available for the period reasonably necessary to enable the buyer to take possession. Com C §2503(1)(a). What is "reasonable" depends on trade usage and circumstances. Official Comment 3 to UCC §2-503. For discussion of the buyer's duty to furnish facilities for receipt of the goods, see Com C §2503(1)(b). See also §§10.1-10.2. The seller must permit the buyer to inspect the goods before it accepts or pays for them unless the contract contains standard shipping terms or other terms that would negate the right of inspection before payment. See Official Comment 2 to UCC §2-503; Com C §2513. See also §10.4. The seller's right to a receipt, if demanded and permitted by the contract, trade usage, or course of dealing, is governed by Com C §1303. See Official Comment 2 to UCC §2-503.

Transferring possession to a third party at the buyer's instruction constitutes delivery to the buyer as does appropriation of the goods by the buyer in the seller's absence, if ratified by the seller.

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§9.46 2. Delivery Without Movement of Goods Held by Third Party

When goods in the possession of a bailee are to be delivered without being moved, the seller can tender delivery, with or without the buyer's cooperation, either by tendering a negotiable document of title (*e.g.*, a warehouse receipt or a bill of lading) covering the goods or by procuring an acknowledgment from the bailee that the buyer is entitled to possession of the goods. Com C §2503(4)(a). The buyer then takes possession directly from the bailee. See Com C §2308(b); Official Comment 2 to UCC §2-308.

The seller may tender nonnegotiable documents of title or a record directing the bailee to tender, but the buyer may object seasonably to these forms of tender. Com C §2503(4)(b). See Com C §1205(b) for definition of "seasonably." The buyer's seasonable objection compels the seller to resort to another form of tender, presumably one that is authorized by Com C §2503(4)(a). The risk of loss and nonperformance by the bailee, however, will remain on the seller until the buyer has a reasonable time to present the document or direction. Com C §2503(4)(b). This manner of tender therefore is inferior from the seller's perspective.

The bailee's refusal also defeats the tender. If neither of the two events occurs, not only the risk of loss of the goods, but also the risk "of any failure by the bailee to honor the nonnegotiable document of title or to obey the direction," passes from the seller to the buyer. Com C §2503(4)(b). Hence a refusal, but not a failure, by the bailee defeats the tender.

This subtle distinction appears to be of little or no practical consequence. The seller's tender of delivery thus is completed whether or not the buyer actually obtains delivery or an acknowledgment of its rights from the bailee. Even while the seller retains the risk of loss, the buyer's right to the goods is paramount to the seller's right against all parties as soon as the bailee receives notice of the buyer's rights. Com C §2503(4)(b). See Official Comment 6 to UCC §2-503.

The Uniform Sales Act (former CC §1763(3)) provided that the seller's delivery obligation was not fulfilled until the bailee "acknowledges to the buyer that it holds the goods on the buyer's behalf." Although Com C §2503(4)(a), unlike Com C §2503(3), fails to incorporate the notice requirement of Com C §2503(1) or otherwise mention notice to the buyer of the bailee's acknowledgment, §2503(4)(a) was intended to continue the rule of the prior Uniform Sales Act on acknowledgment by the bailee. See Official Comment 6 to UCC §2-503. Presumably, notice continues to be required.

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§9.47 3. Interparty Delivery Without Movement of Goods

Sometimes the parties want to effect a delivery of the goods while the seller remains in possession of them. Delivery without movement when the goods are held by a third party bailee is covered elaborately in Com C §2503(4) (see §9.45), but the Commercial Code does not specifically cover tender of delivery without movement of goods that are in the seller's hands. The law is unclear on whether a seller may be a bailee for purposes of risk of loss under Com C §2509(2).

With respect to various kinds of commercial paper, the Commercial Code defines delivery as a "voluntary transfer of possession." See Com C §1201(b)(15). This definition, however, does not encompass delivery of goods. Presumably, if the seller tenders delivery by putting and holding conforming goods at the buyer's disposition and giving it any notice reasonably required and if the buyer accepts the goods, by inaction or otherwise, the seller may be treated as having completed delivery even though it retains possession and, if it is a merchant, the risk of loss. See Com C §§2503(1) (reasonable notice), 2606 (acceptance of goods), 2104(1) (merchant), 2509(3) (risk of loss).

If the buyer is in breach (*e.g.,* for failure to furnish facilities for receiving the goods (see §§10.1-10.2)), however, it bears the risk of loss for a commercially reasonable time, after which the risk reverts to the seller. Com C §2510(3). See §16.50. Commercial Code §2510(3) limits the seller's rights to any deficiency in its effective insurance coverage.

California decisions have long recognized that a seller may deliver goods even if the buyer does not take physical possession of them. See, *e.g.*, *Walden v Murdock* (1863) 23 C 540, (marking range cattle with buyer's brand was valid delivery even though cattle remained on open range); *Chaffin v Doub* (1859) 14 C 384 (reasonable time allowed to remove hay from land); *Frazier v Southern Counties Gas Co.* (1924) 66 CA 609, 226 P 833 (selection and segregation of pipe by buyer, followed by measurement and removal of threads, justified finding of delivery). For discussion of passage of title when goods are to be delivered without movement, see Com C §2401(3). See also §§8.14-8.16.

A delivery with retention of possession by the seller may be void against the seller's creditors. See Com C §2402; CC §§3440-3440.9. For discussion of the rights of third parties, especially the seller's creditors, see chap 12.

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§9.48 4. Delivery Under Destination Contract

Under a destination contract, the seller assumes complete responsibility for the means, risk, and expense of bringing the goods to their destination and does not tender delivery until their arrival. See §9.3.

The requirements for tender at destination are as follows (Com C §2503(3)):

- The seller must put and hold the goods at the buyer's disposition at a reasonable hour and for a reasonable time and give the buyer any necessary notification. Com C §2503(1). See §§9.44-9.45.
- The seller also must get conforming goods to the destination point and deliver documents in accordance with Com C §2503(4)-(5), if applicable.

If the seller has sent the goods by carrier under a negotiable bill of lading, the carrier will not relinquish the goods to the buyer except in exchange for the bill. See Com C §7403(c). See also §9.11. The buyer therefore has no concern with the carriage arrangements.

If the seller itself has transported the goods, in a truck owned by it and driven by its employee, compliance with Com C §2503(1) is normally all that Com C §2503(3) requires. Even if the contract is a shipment contract, if the seller acts as the carrier, it may retain certain risks until tender is made.

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§9.49 C. Effect of Proper Tender

A proper tender of delivery entitles the seller to the buyer's acceptance of the goods at that time. Com C §2507(1). Unless otherwise agreed, tender of delivery and tender of payment are concurrent conditions; tender of delivery is a condition to the buyer's duty to pay, and tender of payment is a condition to the seller's duty to tender and complete delivery. See Com C §§2507(1), 2511(1).

The parties, however, often agree otherwise, *e.g.,* that payment is not required at the time of delivery in "the great body of commercial contracts which carry credit terms." Official Comment 1 to UCC §2-511. Tender of delivery entitles the seller only to payment "according to the contract" (Com C §2507(1)), whether the contract makes payment due immediately or at the end of an agreed credit term.

PRACTICE TIP: For this reason, the terms of the agreement may affect the timing for bankruptcy preference purposes. 11 USC §547.

Tender of delivery is not a condition of payment if the agreement requires payment before delivery. See Official Comment 2 to UCC §2-507. Thus, if the buyer knows that the seller, a middleman, is relying on the payment to acquire the goods from a supplier, there may be an implied agreement for payment in advance. See *Patty v Berryman* (1949) 95 CA2d 159, 212 P2d 937. A prudent seller should not rely on implication of such a term.

When obligations are concurrent conditions, neither party can put the other party in default for nonperformance of the other's obligation without tendering its own performance. This concurrence of the tender of delivery and tender of payment as conditions presumably requires performance by both parties at one place and time, fixed by various sections of Commercial Code Division 2 (*e.g.,* Com C §2310 (see §§4.71-4.78)) or express agreement. See Official Comment 2 to UCC §2-511.

If the contract entitles the buyer to inspect the goods before it pays for them, the seller ordinarily performs most of the acts comprising tender of delivery (*e.g.,* shipment, notification, and sending of documents) before it makes the goods available for inspection. After the buyer has had the opportunity to inspect, the buyer's tender of payment is a condition to the seller's duty to complete delivery, *i.e.,* to give the buyer possession. Com C §2511(1); Official Comment 2 to UCC §2-503. For discussion of the buyer's right to inspect, see Com C §2513. See also §§10.3-10.18.

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§9.50 D. Excuse of Tender

In some circumstances, a seller may not be required to tender delivery to put its buyer in default. If, for example, the buyer has refused to receive the delivery, the seller is not required to perform the idle act of making a tender. *Southern Pac. Milling Co. v Billiwhack Stock Farm, Ltd.* (1942) 50 CA2d 79, 122 P2d 650. Anticipatory breach suspends the nonbreaching party's obligation to perform. Com C §2610(c). See §§16.21-16.32. For the seller's reclamation remedies under the Commercial Code on the discovery that the buyer is insolvent, see Com C §2702 and §§17.24-17.31.

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V. "PERFECT TENDER" REQUIREMENT

§9.51 A. "Perfect Tender" Rule

The importance of defects in the seller's tender of delivery (*e.g.,* in shipping arrangements, form of documents, or the goods themselves) will depend on whether the defects entitle the buyer to reject the goods.

If the buyer is not entitled to reject, the seller may be liable for damages resulting from the defects, but the seller is still entitled to receive the contract price if the goods have been accepted or damages based on the contract price if the goods have been wrongfully rejected. See Com C §§2709(1)(a), 2706, 2708(1). See also chap 18 on the seller's remedies.

If the buyer properly rejects the goods, however, the seller receives only what it can salvage by selling the goods to another buyer. Indeed, the buyer may even assert a limited claim on the goods. Com C §§2603(2), 2711(3). See §§10.44-10.47, 17.71-17.74. Often, this alternative disposition is made at a loss because the goods were intended for the buyer's special needs and do not command a ready market, because the market price has dropped below the contract price, or because there are costs of resale and the resale represents a lost opportunity (*i.e.,* the seller could have made two sales but instead made one).

If, despite the defects in the seller's tender, the goods have a market value equal to or greater than the contract price, the buyer will be unlikely to exercise its right of rejection. Thus, defects that entitle the buyer to reject the goods give the buyer the option to transfer the risk of fluctuations in market price back to the seller.

Under non-Code general contract law, a breach of contract does not entitle the innocent party to cease performance unless the breach was "material." On the other hand, Commercial Code §2601 provides that if the goods or the tender of delivery fail in any respect to conform to the contract, the buyer may:

- Reject the whole; or
- Accept the whole; or
- Accept any commercial unit or units and reject the rest.

For discussion of the meaning of "commercial unit," see Com C §2105(6).

NOTE: The principle that even slight deviations from the contract specifications of a seller's tender of delivery entitle the buyer to reject the goods is often called the "perfect tender" rule. It has been suggested that the perfect tender rule is so eroded that the law would be little changed if Com C §2601 gave the right to reject only on "substantial" nonconformity.

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§9.52 B. Exceptions to "Perfect Tender" Rule

Commercial Code §2601 expressly provides for two exceptions to the "perfect tender" rule: installment contracts (Com C §2612; see §§9.53-9.57) and agreements on limitation of remedies (see §9.59). Other significant exceptions in the Commercial Code, but not referred to in Com C §2601, are discussed in §§9.60-9.69. For discussion of the perfect tender rule and its exceptions in documentary transactions, see §§9.71-9.76.

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1. Installment Contracts: Substantial Performance

§9.53 a. Introduction

The most sweeping exception to the "perfect tender" rule of Com C §2601 is the "substantial performance" doctrine applied to installment contracts by Com C §2612. The general effect of this section is to allow rejection of installment deliveries only if a defect "substantially impairs" the value of the installment or contract to the buyer. This is a question of fact. *Stinnes Interoil, Inc. v Apex Oil Co.* (SD NY 1985) 604 F Supp 978. The test of substantial impairment is objective rather than subjective. See *Automated Controls, Inc. v MIC Enters., Inc.* (8th Cir 1979) 599 F2d 288; *Continental Forest Prods. v White Lumber Sales* (Or 1970) 474 P2d 1.

The apparent theory behind this more liberal treatment of installment sellers is that a single lapse is less important when it is part of a continuing relationship between the seller and buyer. Under an installment contract, the seller makes a substantial commitment to the buyer and may forgo other business opportunities to honor the contract. The different treatment of installment and single delivery sellers gives rise to substantial litigation over whether a contract is an installment contract. See §9.54.

NOTE: The distinction between single delivery and installment delivery contracts has been criticized as placing too much emphasis on contractual form. A series of independent single delivery contracts can also be the basis of a continuing business relationship.

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§9.54 b. Definition of Installment Contract

Any sales contract that requires *or authorizes* delivery of goods in separate lots to be separately accepted is an installment contract, even if the parties use a phrase such as "each delivery is a separate contract." Com C §2612(1); Official Comment 3 to UCC §2-612. The buyer need not be obligated to pay for each installment delivery separately; even if it pays for all the goods at one time, the bargain is an installment contract if there may be separate acceptance of separate deliveries. Com C §2612(1). See Official Comment 2 to UCC §2-612. Installment deliveries need not even be required, if they are "authorized" (*i.e.,* not precluded) under the contract. Com C §2612(1). Thus, an option in either party to call for more than one delivery makes a contract an installment contract. Apparently, circumstances outside the agreement that give a party the right to make or demand delivery in lots (*e.g.,* a letter of credit that permits partial shipments) also would make the agreement an installment contract. See Official Comment 1 to UCC §2-612. For discussion of situations in which delivery in lots may be authorized by the circumstances, see Com C §2307.

Retail installment contracts under the Unruh Act (CC §§1801-1812.20) and conditional sales contracts under the Rees-Levering Motor Vehicle Sales and Finance Act (CC §§2981-2984.4) are not installment contracts for the purposes of Com C §2612. As consumer legislation, these Acts have been left unimpaired by Commercial Code Division 2 (Com C §2102) and deal with installments of payments rather than delivery.

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§9.55 c. Buyer's Grounds for Canceling Whole Contract

Commercial Code §2612(3) provides:

Whenever nonconformity or default with respect to one or more installments substantially impairs the value of the whole contract[,] there is a breach of the whole. But the aggrieved party reinstates the contract if he accepts a nonconforming installment without seasonably notifying of cancellation or if he brings an action with respect only to past installments or demands performance as to future installments.

This section applies to the rights of both seller and buyer to cancel an entire installment contract as a result of the other party's default.

The entire contract is breached, permitting the aggrieved party to cancel, "whenever nonconformity or default with respect to one or more installments substantially impairs the value of the whole contract." Com C §2612(3). This provision was intended to broaden the test that was sometimes applied in pre-Code cases, *i.e.,* whether the nonconformity indicated that future deliveries also would fail to conform. Official Comment 6 to UCC §2-612.

For example, a basis for cancellation would exist if the buyer could obtain cover for the delayed, defective, or missing shipment only by entering into a contract that made the balance of the installment contract unnecessary or undesirable. Assume that an installment contract is for 10,000 pairs of custom-manufactured shoes, deliverable in installments of 2000 pairs per month. If a contract for 10,000 pairs is the minimum for which a manufacturer will retool, nonconformity in the first shipment, whether consisting of defects or delays, may require cover. If, however, the only available cover is for 10,000 shoes, the "value" of the entire installment contract is negated.

The language of Com C §2612(3) also appears to permit a court to find substantial impairment of the value of the whole contract based on demonstration of the seller's unreliability.

TACTICS: Until there is more explicit authority for such a holding, a buyer should not cancel an installment contract simply out of fear of future nonperformance; instead, the buyer should demand assurances under Com C §2609 (see §§16.2-16.18). See Official Comment 6 to UCC §2-612.

For discussion of the necessity for notice of cancellation, see §9.58. On substantial impairment of value under Com C §2612(3), see §9.57.

It is uncertain whether Com C §2612 initially entitles the seller to cure (see §§9.62-9.66) a defect that the buyer properly treats as giving rise to a breach of the whole contract. Arguments against the right of cure are that Com C §2612(3) omits any mention of cure and that Com C §2612(2) excludes nonconformities falling within Com C §2612(3) from those for which the seller is expressly permitted to "give adequate assurance of its cure." Com C §2612(2).

Cure is not expressly forbidden, however. As a practical matter, it seems preferable at least to allow the seller to cure within the contract time under Com C §2508(1) (see §§9.62-9.63) when it has tendered the defective installment far enough in advance to permit a timely cure. Because the seller is under no duty to perform before the contract deadline, the fact that it does so but bungles its tender should not cause it to lose its right to cure on time. The buyer can protect itself adequately by using the defective tender as a ground for demanding assurances (Com C §2609; see §§16.2-16.18). This solution seems more compatible with the underlying statutory purpose of keeping installment contracts alive as long as there is a strong possibility that the contract will be performed.

A late cure (see §9.63) of a defective installment that substantially impairs the value of the entire contract ordinarily will be precluded. The seller must have reasonable grounds for assuming that its tender would be acceptable (Com C §2508(2)). If the tender is so defective that it entitles the buyer to cancel the contract, the seller ordinarily would have no basis for this assumption. The seller may, however, reasonably have not known of the defects. For example, the seller may merely have resold unopened goods received from a previously reliable manufacturer. This should not preclude its reasonable belief that the tender would be satisfactory.

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§9.56 d. Rejection of Installment

In contrast to cancellation of the entire installment contract, the buyer's right to reject an individual installment of goods is governed by Com C §2612(2), which provides:

The buyer may reject any installment which is nonconforming if the nonconformity substantially impairs the value of that installment and cannot be cured or if the nonconformity is a defect in the required documents; but if the nonconformity does not fall within [Com C §2612(3)]… and the seller gives adequate assurance of its cure[,] the buyer must accept that installment.

A nonconformity that falls within Com C §2612(3) is one that "substantially impairs the value of the whole contract." See §9.57. If a buyer rightfully cancels the entire contract, it is also entitled to reject the last installment delivery on which the cancellation is based. The following discussion therefore is directed to the right of the buyer to reject an individual installment without canceling the whole contract. Rejection for "a defect in the required documents" (Com C §2612(2)) is discussed in §9.72. Apart from documentary defects, Com C §2612(2) precludes rejection of an installment for a trivial defect, *i.e.*, one that does not substantially impair the value of that installment, apparently even if the defect is incurable. For discussion of what constitutes a "substantial impairment" and the possibility of contractually authorizing rejection for lesser defects, see §9.57.

An installment may be rejected for a substantial nonconformity in the installment that "cannot be cured." Com C §2612(2). A nonconforming installment that does not substantially impair the value of the whole contract must be accepted, however, if "the seller gives adequate assurance of its cure." Com C §2612(2)-(3). The standards for judging the adequacy of a seller's assurance of performance (see §§16.12-16.14) also apply to the adequacy of a seller's assurance of a cure. See Official Comment 5 to UCC §2-612. If the defect is not actually cured within a reasonable time, however, the buyer may revoke its acceptance (see §§9.61, 10.32-10.34, 17.61-17.66), resuming the position it would have been in if it had rejected initially.

If Com C §2612(2) is construed as permitting the buyer to delay acceptance until it receives adequate assurance of cure, the buyer still must rely on its right to revoke acceptance if the assurance of cure is not realized. Another possible interpretation of Com C §2612(2) is that the buyer may accept conditionally. See Official Comment 3 to UCC §2-612.

Even if the buyer immediately accepts a defective, but curable, installment, it may demand assurances, thus suspending its obligation to pay for the defective installment until adequate assurance is given. Com C §2609(1). For discussion of demand of assurances, see §§16.9-16.11. Whether or not it demands assurances, the buyer presumably must notify the seller of the details of the installment's nonconformity and cooperate with the seller's efforts toward cure. See Official Comment 5 to UCC §2-612. The scope of possible cure of a defective installment under Com C §2612 may be broader than that under the general cure statute (Com C §2508). Commercial Code §2612 permits cure of a nonconforming installment by an allowance against the price (see Official Comment 5 to UCC §2-612); however, this form of cure may not be authorized by Com C §2508 (see §9.67).

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§9.57 e. Meaning of Substantial Impairment

Substantial impairment can mean impairment of the value of a single installment or impairment of the entire contract. See Com C §2612.

The value of an installment may be substantially impaired not only by defects in quality, but also, for example, because the goods are delivered late or in the wrong quantity or assortment. Official Comment 4 to UCC §2-612. Substantial impairment must be decided on a case-by-case basis. Substantial impairment (or substantial nonconformity) has been likened to the common law concept of "material breach." Among the factors that Restatement (Second) of Contracts §241 (1981) lists for determining whether the breach has been material are the following:

- The extent to which the injured party will be deprived of the benefit that it reasonably expected;
- The extent to which the injured party can be adequately compensated for the part of that benefit of which it will be deprived;
- The extent to which the party failing to perform or to offer to perform will suffer forfeiture;
- The likelihood that the party failing to perform or to offer to perform will cure its failure, taking into account all the circumstances including any reasonable assurances; and
- The extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.

The parties may define "substantiality" in the contract. By agreement, apparently trivial defects may be made substantial if the standards have a basis in reason and avoid imposing hardship by surprise. Official Comment 4 to UCC §2-612. Even an established contractual standard is subject to waiver or displacement by custom or course of performance. See Com C §§1303(f), 2209(4)-(5). See also chap 6, §§4.94-4.97.

Substantial impairment of the whole contract (see Com C §2612(3)) may arise from a single serious breach, or it may be cumulative. A continuing series of defective deliveries or payments, none sufficiently serious alone to warrant a declaration of breach, ultimately may entitle the aggrieved party to assert the other's repudiation. See Official Comment 6 to UCC §2-612.

It is difficult to determine whether a specific default or nonconformity substantially impairs the "value of the whole." If the first shipment includes an essential part of a machine that will be delivered in subsequent installments and the part is not repairable or replaceable, the failure of the first installment will be a breach of the whole contract. If the part may be obtained from an alternative source, however, this scenario is unlikely because the seller then would cure by acquiring the part. Likewise, if the buyer has a reasonable apprehension of the seller's inability or unwillingness to complete the other installments, the breach should be regarded as a breach of the whole.

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§9.58 f. Reinstatement

An installment contract breached by one or a series of defaults that impairs the value of the whole contract may be reinstated in the following three ways (Com C §2612(3)):

(1) If the aggrieved buyer accepts a nonconforming installment without "seasonably" (Com C §1205(b)) notifying the seller that the contract has been canceled (Com C §2106(4)), the contract is reinstated. The requirement that the buyer give a seasonable notification does not mean that the buyer must take immediate action, but permits it the opportunity to ponder the extent of the breach and questions concerning cure that would bar cancellation. The cancellation notice is not unseasonable if giving notice is deferred pending negotiations about cure of or adjustment for the nonconformity. If the defaulting seller asks, however, it is entitled to be told whether the contract still is in effect before it performs further. See Official Comment *7* to UCC §2-612.

(2) If the aggrieved party brings suit on past installments only, the contract is reinstated. Com C §2612(3). See Official Comment 3 to UCC §2-612. Assume that a seller's initial installments produce consequential damages and the buyer rightfully cancels the agreement, buys substitute goods at the same price, and then sues the seller for the consequential damages. A literal reading of Com C §2612(3) would treat the buyer as having reinstated the canceled contract. This unreasonable result should be avoided by construing Com C §2612(3) as reinstating the contract only if the action brought for defects in past installments also contemplates or demands future performance.

PRACTICE TIP: The buyer's attorney should allege clearly in the pleadings that the suit is not restricted to past installments, perhaps by seeking nominal damages for breach of the remainder of the contract, for declaratory relief for the cancellation of the entire contract, or both.

(3) If the aggrieved buyer demands that future deliveries be made, a canceled installment contract is reinstated. Com C §2612(3). Reinstatement through the buyer's demand for performance after actual breach must be contrasted with Com C §2610(b), which permits a party aggrieved by anticipatory repudiation to notify the other party that it will await the latter's performance, but, while waiting for such performance, resort to its remedies for breach.

Commercial Code §2612(3) reinstates the contract only if the demand for performance follows an actual breach. Commercial Code §2610(b), however, permits suit for breach only if the demand for performance is based on repudiation not yet ripened into actual breach.

Hence the notice under Com C §2610(b), given before there is a breach, is not an election of remedy, or a notification and demand, but a mandatory notice to create a breach and a right not to perform.

In contrast, notice under Com C §2612(3) is wholly voluntary and serves no purpose except to demand performance and to give the seller assurance that if it does perform, it will not be a vain act. For discussion of permissible responses to anticipatory repudiation, see §§16.27-16.32.

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2. Other Sales Contracts

§9.59 a. Contractual Limitation of Buyer's Remedy

The buyer's right to reject any tender that is less than perfect may be circumscribed by agreement of the parties. Com C §2601. Section 2601 refers to Com C §§2718-2719, the sections on contractual limitations of remedy. The reference to Com C §2718 is somewhat confusing because that section deals only with liquidated damages, not the right to reject. Presumably, this reference means that parties may include a liquidated damages clause in a contract to replace or to supplement the right to reject. Commercial Code §2719 permits contractual limitation and alteration of remedies. Commercial Code §1302(a)-(b), the general authority for changing Commercial Code provisions by agreement, also would support such a clause.

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§9.60 b. Buyer's Good Faith

It is unclear to what extent the requirement of good faith (Com C §§1304 and 2103(1)(b)) may further limit the buyer's right to reject. It is arguable that a buyer that bases rejection on a defect in the goods, when its real motive is to avoid the effect of a drop in the market price of the goods, is not "honest in fact" or observing "reasonable commercial standards of fair dealing" (Com C §1201(b)(20)), and therefore is not acting in good faith.

This argument, however, places too much importance on the buyer's state of mind and creates an uncertainty in commercial transactions that the Commercial Code generally seeks to avoid. The argument also creates opportunities for litigation (or defenses to litigation) in situations in which the seller clearly has breached. An honest revelation of the buyer's motive presumably should not undermine an otherwise legally sufficient basis for rejection. Given the California rule of law that implied covenants cannot override express provisions, the use of the "good faith" defense should be unavailing. See *Carma Developers, Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 6 CR2d 467; *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 254 CR 211.

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§9.61 c. Buyer's Right to Revoke Acceptance

The "perfect tender" rule of Com C §2601 applies only to the buyer's initial right of rejection. Once it accepts the goods, the buyer no longer may reject them. Com C §2607(2). The buyer may revoke its acceptance, but only if the nonconformity of the goods substantially impairs the value of the contract. Com C §2608(1). The buyer has this remedy of "revocation of acceptance" in place of the former remedy of rescission. Com C §2608.

A buyer that justifiably revokes acceptance obtains the rights that accompany rejection. Com C §2608(3). A revoking buyer is entitled to recover the paid purchase price of the goods of which it had revoked acceptance, the reasonable cost of transportation from the point of delivery, the reasonable cost of storage and handling, and other damages. See *S & R Metals, Inc. v C. Itoh & Co. (Am.)* (9th Cir 1988) 859 F2d 814, 818.

The buyer is not automatically required to abstain from using goods for which it has revoked its acceptance if that would unreasonably increase the buyer's damages resulting from the seller's breach, *i.e.,* if such use is necessary to mitigate the buyer's damages. See *Ibrahim v Ford Motor Co.* (1989) 214 CA3d 878, 263 CR 64; *CPC Int'l, Inc. v Techni-Chem, Inc.* (ND Ill 1987) 660 F Supp 1509, 1514. Revocation of acceptance is ineffective, however, if the goods have undergone a substantial change in condition not due to the defects. Com C §2608(2).

In addition, the buyer's postnotification use of the goods may be such an exercise of dominion or control over the goods as to constitute acceptance, overriding any purported revocation. See Com C §2606(1)(c). For example, a buyer that continued to use goods for 22 months after sending a letter of revocation was held to have accepted the goods; the unreasonably lengthy use of the goods was inconsistent with revocation of acceptance. See *Computerized Radiological Servs. v Syntex Corp.* (2d Cir 1986) 786 F2d 72, 75. A delay of more than ten years between the time when a breach should have been discovered and notification, as a matter of law, is not commercially reasonable. See *McCune v F. Alioto Fish Co.* (9th Cir 1979) 597 F2d 1244, 1252.

The buyer therefore is at risk if it uses the goods after revoking its acceptance. Such a revocation may be ineffective, limiting the buyer to its postacceptance remedies. See §§10.32-10.34.

Although acceptance cannot occur until the buyer has had an opportunity to inspect the goods (Com C §§2512(2), 2513(1), 2606(1)(b)), preacceptance inspection is not likely to reveal any but the most obvious defects. Unless the buyer is looking for escape from a declining market or is suspicious of a particular tender and can afford rigid preacceptance inspection, a tender with latent defects normally will be accepted. Thus, even for noninstallment sales contracts, rejections for trivial nonconformities tend to be confined in practice to tenders that are defective on their face. A buyer that fails to make a reasonable inspection that would have revealed the nonconformity cannot revoke.

On revocation of acceptance in general, see §§10.32-10.34, 17.61-17.66. For discussion of the similar "substantial impairment" requirement for rejection under installment contracts, see Com C §2612(2)-(3). See also §9.57.

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§9.62 d. Cure by Seller

The "perfect tender" rule of Com C §2601 is mitigated by empowering the seller to cure the nonconformity after rejection, *i.e.,* to make a new conforming delivery that the buyer must accept. Com C §2508. The right of cure apparently applies to material as well as trivial defects in the seller's tender. To exercise a right of cure, the seller must know the alleged defects. When a buyer rejects a tender, it therefore must notify the seller of the rejection, specifying all defects ascertainable by reasonable inspection and curable by the seller; any defect not so declared is waived. Com C §§2602(1), 2605(1)(a); Official Comment 2 to UCC §2-605. See §§10.36, 10.38-10.43. The seller then may be entitled to cure the identified defects. Com C §2508(1)-(2). See §§9.62-9.65.

Commercial Code §2605(1) does not expressly penalize a rejecting buyer for failing to declare defects that the seller could not have cured, absent a special request for a written statement of all defects in a transaction between merchants. See Com C §2605(1)(b). If a buyer announces curable defects and fails to state other incurable defects on which it relies for the same rejection and if the seller responds by curing the announced defects, the buyer may be estopped from relying on the unstated incurable defects to justify its rejection. See Com C §2605(1). See also §§10.38-10.43.

The seller's right to cure (Com C §2508) limits the buyer's right to reject (Com C §2602) but not the buyer's right to revoke acceptance (Com C §2608). Commercial Code §2508 gives the seller a right to cure after rejection but gives no such right after revocation of acceptance. *U.S. Roofing, Inc. v Credit Alliance Corp.* (1991) 228 CA3d 1431, 279 CR 533. Commercial Code §2608(3) equates revocation of acceptance with rejection only to the extent of the *buyer's* rights and duties toward the rejected goods (such as those under Com C §§2602(2), 2603-2604; see §§10.44-10.47, 17.51-17.66); it does not expressly permit the seller to cure after revocation of acceptance.

Although Official Comment 4 to UCC §2-608 anticipates that revocation of acceptance will be generally resorted to only after attempts at adjustment have failed, the buyer is not required expressly to notify the seller of specific defects on which it intends to rely, either when it accepts the goods (Com C §2607(3)(A); Official Comment 4 to UCC §2-607) or when it revokes acceptance (Com C §2608(2)). Good faith, however, may require a notice of revocation to include information about the defects on which the buyer relies. See Official Comment 5 to UCC §2-608.

A reason for allowing cure only after initial rejection may be that revocation of acceptance requires a nonconformity that "substantially impairs" the value of the goods to the buyer (see §9.61). Thus, the need for a right of cure after revocation of acceptance seems less pressing than it does after rejection for a possibly trivial nonconformity. A contrary argument to permit such a cure could be constructed that the buyer's duties include its "duty" to permit a cure after rejection (Com C §2508(1)), its duty of good faith (Com C §1201(b)(20)), a merchant buyer's duty to mitigate (Com C §2603), and course of performance, course of dealing, and usage of trade, if applicable (Com C §1303).

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§9.63 (1) Cure Within Contract Period

A seller that makes a nonconforming tender may attempt to cure, even without its buyer's consent, at any time before the contract performance period expires, if the seller seasonably notifies the buyer that it intends to do so. Com C §2508(1). It is unclear whether this is true if the buyer accepts but revokes the acceptance within the contract period. See §9.61.

Notification is seasonable if it is given within the time agreed or, if no time is agreed on by the parties, within a reasonable time. Com C §§1202, 1205. What is a reasonable time depends largely on the time for performance under the contract; the closer the deadline looms, the more prompt the notice must be. Official Comment 1 to UCC §2-508.

Reasonable time for notification also may depend on whether the buyer has changed its position detrimentally (*e.g.,* by entering into a second contract regarding the goods) before the seller's notification. If the buyer's change of position was based on a reasonable assumption that the seller would not cure, a court is likely to find that the seller's notice of intent to cure was not dispatched seasonably. If the contract gives the seller a specific time within which to cure, the buyer must wait until expiration of that time or ask the seller whether it intends to cure, before the buyer makes other commitments.

Once the seller sends a cure notice, even if the seller already has repossessed the nonconforming goods and refunded the price, the buyer must await the cure during the remaining contract time for performance rather than procure cover goods. See Official Comment 1 to UCC §2-508. In the absence of a contractual provision to the contrary, the risk of communication failure is on the buyer. Proper notification by the seller is effective whether or not the buyer receives it. Com C §1202(d).

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(2) Surprise and Unfair Rejection

§9.64 (a) Right to Cure

The seller has a limited right to cure a defective tender after the contract time for performance has expired. Under Com C §2508(2):

Where the buyer rejects a nonconforming tender which the seller had reasonable grounds to believe would be acceptable with or without money allowance[,] the seller may if it seasonally [sic] notifies the buyer have a further reasonable time to substitute a conforming tender.

This may arise in at least two different scenarios. In the first, the seller knowingly sends a nonconforming shipment, but believes that it would be acceptable (*e.g.,* new and improved goods, slightly different mix of sizes, slightly different transport that arrives on time, perhaps even slightly inferior goods that the seller reasonably believes the buyer will find acceptable with an adjustment). In the second, the tender is nonconforming, perhaps substantially so, but the seller does not know about the nonconformity and therefore reasonably believes that the buyer will accept the tender. Most of the cases deal with the first situation.

Whether a seller has reasonable grounds to believe that a tender will be acceptable depends on the context of the transaction. The parties' past dealings and usages of trade form the backdrop for the seller's reasonable expectations. Official Comment 2 to UCC §2-508. It may be assumed that in the absence of special circumstances, when the seller delivers nonconforming goods that are the functional equivalent of those contracted for, the seller has a reasonable cause to believe that they will be acceptable.

The Commercial Code requires only the seller's reasonable belief that the tender would be "acceptable" despite the nonconformity, not a prediction of how the buyer would react to circumstances (*e.g.,* a price drop) extraneous to the nonconformity. Com C §2508(2). If a course of performance or course of dealing between the parties or a usage of trade (Com C §1303) has permitted a nonconforming tender, and the tender in question is no more nonconforming than those the buyer or other buyers in the trade accepted in the past with or without a price adjustment, the seller would have reasonable grounds to believe that the current tender would be acceptable, even though because of a price break it might not be able to anticipate whether the tender would be accepted.

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§9.65 (b) Time to Cure

If the seller reasonably believes that rejected goods will be acceptable, it may notify the buyer "seasonably" (see Com C §1205(b)) that it will substitute a conforming tender within a reasonable time. Com C §2508(2). If no time was agreed on in the contract, seasonableness may depend largely on whether the buyer has changed its position detrimentally before the seller's notification. Absent a contrary contractual provision, however, the risk of communication failure is on the buyer. See §9.63. The seller's notification may be seasonable even though the contractual performance period has expired. See §9.64.

After giving notice, the seller has a "further reasonable time" to overcome the defective tender by making a second conforming tender (conforming, that is, in all respects except time). Com C §2508(2). Because the time for performance will have elapsed and because this provision most often will be invoked in a falling market, the period for giving "seasonable" notice and the amount of "reasonable time" for substituting a conforming tender usually should be brief to protect the buyer. See Official Comment 3 to UCC §2-508.

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§9.66 (c) Eliminating Right to Cure by Contract

According to Official Comment 2 to UCC §2-508, the "deliberate" inclusion of a clause prohibiting replacements can eliminate the seller's right to cure.

PRACTICE TIP: Because the term "replacements" may be viewed as referring to nonconforming goods that are functional equivalents or near-functional equivalents, rather than conforming goods, a desire to prohibit cure should be more carefully expressed. "Deliberate inclusion" may be interpreted to mean a clause that the parties consciously added and not one that happens to be part of a printed form. Even the buyer's conscious inclusion of the clause in a form contract may not be enough if the trade or the parties have ignored it in the past. See Official Comment 2 to UCC §2-508. To be effective, such a clause therefore may need to be bargained over or at least considered by both parties. A buyer using a form contract containing such a clause should resolve any ambiguity by making the clause conspicuous or otherwise calling it to the attention of the seller.

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§9.67 (3) Manner of Cure

With regard to the permissible manner of cure, the Commercial Code provides only that the seller, when entitled to cure, may make or substitute a "conforming" delivery or tender. Com C §2508. If the nonconformity is in the goods themselves, the seller may make a whole new tender. Presumably, the seller may also make a new tender of part of the goods to replace defective items or supply a quantity deficiency. The manner of cure is not solely up to the seller; it cannot make a substitution uncontemplated by the parties.

It is not clear whether the seller can cure a nonconformity, wholly or partially, by giving the buyer a monetary allowance not contractually provided for in the absence of a usage of trade or a similar practice in the parties' course of dealing. A seller may cure after the contract time for performance if it reasonably believed that its nonconforming tender would be acceptable when accompanied by a "money allowance." See Com C §2508(2). However, it does not necessarily follow that the seller or a court can compel the buyer to accept a monetary allowance. If the reference to an allowance in Com C §2508(2) (tender after contract time expires) were considered the basis for forcing an allowance on the buyer, the absence of such a reference from Com C §2508(1) (tender within contract time) would indicate that cure under its provisions within the contract period could not be made by monetary allowance. However, the courts are unlikely to make cure by untimely tender easier for the seller than cure by timely tender.

The existence of a statutory right to compel the buyer to accept a monetary allowance as cure seems further negated by Official Comment 4 to UCC §2-508, which indicates that the right depends on a contractual limitation of the right to reject. Allowance against the price is included in the suggested means of cure of an installment delivery under Com C §2612 (Official Comment 5 to UCC §2-612), but the right of cure under Com C §2612 is not necessarily dependent on or confined to the provisions of Com C §2508.

For example, a seller may supply inferior goods, reasonably believing that the buyer will find them acceptable with a price reduction. The buyer then has the option to accept them and claim damages (in essence, claim an allowance), or it may reject them (*i.e.,* insist on perfect tender). In the latter situation, the seller must make a second, conforming tender or breach the contract. Surely, the buyer is not required to buy that which it does not want. Such a result would not be consistent with contract law generally or the "perfect tender" rule.

If shipment has not been made in accordance with the contract, cure may not be required at all. If the wrong carrier, route, or packaging was used, in some circumstances the tender may be held sufficiently conforming to require the buyer's acceptance either because the deviation did not result in "material delay or loss" (see §§9.9, 9.68) or because it was a proper method of substitute delivery (see §9.69).

For discussion of cure of nonconformity in tendered documents, see §9.75.

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§9.68 e. Material Loss or Delay From Shipping Arrangements

Commercial Code §2504 provides, in substance, that if a seller fails either to make a proper contract for the transportation of the goods (Com C §2504(a)) or to notify the buyer (Com C §2504(c)) that the shipment has been made, the buyer may reject only if "material delay or loss ensues."

There is a view that the concluding clause in Com C §2504 modifies the "perfect tender" rule. This analysis seems to presuppose that the failure to comply with Com C §2504(a) or (c) is also a failure "in any respect to conform to the contract" (Com C §2601). Some support for this view may be found in Official Comments 2-3 to UCC §2-504. Comment 2 provides that, subject to any substitution necessary because of failure of agreed facilities as provided in the provision on substitute performance (*i.e.*, Com C §2614 (see §9.69)), the seller's contract with the carrier (see Com C §2504(a)) must conform to all express terms of the agreement. Comment 3 seems to imply that Com C §2504(a) covers agreed shipping arrangements as well as arrangements left to the seller under the rules for open contractual terms. Com C §2311(2). See §4.89.

Another view is that the final clause of Com C §2504 and the perfect tender rule (Com C §2601) are mutually exclusive. This view rests on the language of Com C §2504 itself, which provides that its duties must be fulfilled "unless otherwise agreed." Thus, Com C §2504(a) applies only to the extent that the sales contract does not specify the carrier, routing, value of the goods for shipping purposes, and other forwarding details. If the seller fails to make a reasonable shipping contract with respect to terms covered by the sales contract, the buyer cannot invoke the perfect tender rule, because the seller has not failed to conform to the contract. If the seller does violate a specification of the contract (*e.g.,* the selection of the carrier), neither Com C §2504(a) nor the material loss or delay provision applies because shipping arrangements have been "otherwise agreed" and Com C §2601 would permit rejection. For discussion of Com C §2504, see §9.9. For discussion of modification of the perfect tender rule by Com C §2614 (governing substitute delivery), see §9.69.

If there has been no harm (*i.e.,* the goods arrived on time, with no damage), how do the cure rights under Com C §2508 come into play? The seller cannot make a conforming tender. For this reason, it appears that the former interpretation (that the final clause of Com C §2504 applies notwithstanding an express agreement on shipping) is the better one.

There presumably is a similar division of opinion among commentators over applicability of the perfect tender rule to a failure to notify the buyer that the shipment has been dispatched. See Com C §2504(c). Again, the question is whether a trivial noncompliance with contractual provisions for notification permits the buyer to reject an otherwise conforming tender. Official Comment 5 to UCC §2-504 appears to indicate that Com C §2504(c) applies to the duty of notification "in all cases," including those covered by contract. That Comment asserts that Com C §2504 limits the parties' power to agree that violation of a contract provision for notification will be grounds for rejection. Such an agreement is said to be effective only if it is expressly negotiated, not a routine form provision. The Comment seems unsupported by Com C §2504 in both respects. Section 2504(c) affects notification of shipment only "unless otherwise agreed." Far from restricting agreement on the details of notification, §2504(c) appears to contemplate such agreements. Thus, to the extent that the contract provides for notification, Com C §2504(c) is inapplicable.

Arguably, departure from a contractual specification for notification is not a failure to notify under Com C §2504(c) but is a failure to conform to the contract and therefore subject to the perfect tender rule. Nonetheless, the "material loss or delay" standard should be applied, given the policies underlying the Commercial Code and the reasons set forth above, including the inability to cure (*i.e.,* if the buyer receives effective and timely notice, even in a nonconforming manner, the seller cannot cure, as is its right under Com C §2508).

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§9.69 f. Substitute Delivery

The buyer may reject not only for nonconformities in the goods but also for deviations from the agreed delivery obligations. Com C §2601. See also §9.51. The Commercial Code qualifies this right by providing that a commercial reasonable substitute must be tendered and accepted if, without fault of either party, the agreed berthing, loading, or unloading facilities fail, an agreed type of carrier becomes unavailable, or the agreed manner of delivery otherwise becomes commercially impracticable. Com C §2614(1).

Underlying Com C §2614(1) is the premise that a term on the manner of delivery usually is not essential in the sense that a quality, quantity, or time term is. The provision applies, however, only if the agreed method of delivery is truly "commercially impracticable." See Official Comment 1 to UCC §2-614. For discussion of commercial impracticability, see Com C §2615(a); Official Comment 3 to UCC §2-615. See also §§16.60-16.78. The seller then is entitled to use a "commercially reasonable substitute" that brings the agreed goods to the buyer on the agreed date. Not only may the seller compel the buyer to accept substitute performance under these circumstances, but Com C §2614(1) *requires* the seller to tender the performance. The seller cannot seek an escape from an unfavorable bargain by claiming that impracticability of the agreed manner of delivery discharged the contract.

Why is Com C §2614 necessary if the above interpretation of Com C §2504 is correct, *i.e.,* if nonconforming shipping contracts are not within the "perfect tender" rule unless material delay or loss ensues? Under this interpretation, the seller has the risk that under the alternative shipping arrangement a material delay or loss will ensue. If applicable, under Com C §2614 the seller bears the same risk (at least in shipment contracts) as the buyer. Admittedly, if the term "ensues" includes a proximate cause component, the distinction between Com C §§2504 and 2614 all but vanishes.

What manner of delivery is a commercially reasonable substitute must be determined from the viewpoint of the reluctant party. If the buyer is being compelled to accept the substitute means, it presumably need not accept one that substantially impairs the value of the goods to it under circumstances known to both parties.

For example, a substitute means for delivering turkeys that would delay their arrival beyond the middle of Thanksgiving week would be unreasonable. If the seller is being compelled to tender the substitute performance, the seller presumably is entitled to protection not only against an unreasonable increase in its shipping costs but also against impairment of its prospects of receiving payment. Because the substitute means of delivery cannot be forced on a bank under a letter of credit (see Official Comment 2 to UCC §2-614), the seller that is to be paid for the goods through a letter of credit cannot be expected to use a substitute means of delivery that fails to comply with the terms of the letter. (It may be argued that the buyer is obligated to amend the letter of credit so that the substitute means of delivery is sufficient to draw under it.) On the applicability of Com C §2614 to substituted delivery of documents, see §9.77.

If the agreed manner of delivery is commercially impracticable and no commercially reasonable substitute is available, the contract may be discharged. Com C §2615.

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§9.70 g. Federal Exception for Perishable Agricultural Commodities

Before enactment of the federal Perishable Agricultural Commodities Act (PACA; 7 USC §§499a-499s), unscrupulous wholesale buyers of perishable fruits and vegetables took advantage of the "perfect tender" rule by seizing on minor defects to reject the goods. The distant seller, with perishable produce on its hands, frequently was forced to market its crop for whatever the rejecting buyer would pay.

PACA, which governs this field under the supremacy clause (US Const art VI, §2), itself does not treat the perfect tender rule in detail, but the regulations promulgated under it do. The regulations define many of the standard mercantile shipment terms and add others. These terms generally are used as a matter of course by farmers marketing produce at distant points. Under some of these terms (*e.g.,* "F.O.B. acceptance" or "F.O.B. acceptance final"), a buyer loses its right to reject for any type of defect in the goods, no matter how serious. See 7 CFR §46.43(*l*)-(m). The buyer must accept the goods, but it then may sue for damages for the breach. *LeRoy Dyal Co. v Allen* (4th Cir 1947) 161 F2d 152. If the buyer nevertheless rejects the goods, contrary to the shipment term, it is precluded from using the nonconformity either as a defense or for recoupment in the seller's action to obtain the purchase price. *L. Gillarde Co. v Joseph Martinelli & Co.* (1st Cir 1948) 169 F2d 60.

Some terms defined in the regulations permit a limited right of rejection. See 7 CFR §46.43(i)-(k).

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VI. DOCUMENTARY TRANSACTIONS

§9.71 A. Tender and Delivery of Documents

Under the Commercial Code's provisions for mercantile shipment terms (see §9.15), C.I.F., C. & F., F.A.S., and F.O.B. vessel sales are documentary transactions. To obtain payment from the buyer, the seller ships goods but must tender documents. The seller is not entitled to payment on tender of goods, and the buyer need make no disbursements until the seller presents the proper instruments. See Com C §§2319(4), 2320(4). See also §§9.21-9.22, 9.25-9.38.

In addition to these mercantile shipment term provisions, the Commercial Code imposes an obligation on the seller under any shipment contract to obtain and to deliver or tender promptly any documents that the buyer needs to take possession of the goods. Com C §2504(b). Typical documents are bills of lading and orders for delivery out of pool car shipments. See Official Comment 4 to UCC §2-504. If the seller ships under reservation, as Com C §2310(b) ordinarily permits it to do, it has the same duty to deliver documents, but it retains a security interest in the goods by maintaining control over the documents until they are delivered to the buyer in exchange for payment or for acceptance of a draft. See Com C §2505. See also §§9.10-9.14.

If goods are in the hands of a bailee (*e.g.,* a warehouser) and are to be delivered without being moved, delivery ordinarily is tendered by transmission of documents to the buyer. See Com C §2503(4). See also §9.45. Delivery of goods held by a carrier after transportation under a destination contract requires these same formalities plus compliance with Com C §2503(1) (manner of tender). See Com C §2503(3). See also §9.48. The seller also may be able to discharge its duty to "put and hold conforming goods at the buyer's disposition" (Com C §2503(1)) by tendering the appropriate documents. See Official Comment 2 to UCC §2-503.

A common purpose of documentary delivery is to facilitate bank collection and financing; hence, the Commercial Code authorizes delivery of documents "through customary banking channels." Com C §§2308(c), 2503(5)(b). See Official Comment 3 to UCC §2-308. For discussion of bank collection of a documentary draft, see §9.11. A buyer's dishonor of a draft that accompanies documents of title is equivalent to nonacceptance or rejection of the documents. Com C §2503(5)(b). Dishonor may consist of failure (within 3 business days after presentment) to:

- Pay a draft payable on presentment or within 3 days after presentment; or
- Accept a draft payable more than 3 days after presentment.

See Com C §§2514, 3502-3505, 4503. The drawee is given an extra 3 days to pay documentary drafts because of the time that may be needed to examine the documents. If payment is made by letter of credit (see §10.61), the issuer has a reasonable time after presentation, but not more than 7 business days after its receipt of documents, to honor the letter of credit or give notice to the presenter of discrepancies in the presentation, unless the letter of credit provides for honor to be completed more than 7 business days after presentation. Com C §5108(b).

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B. "Perfect Tender"

§9.72 1. General Rule

The "perfect tender" rule, which permits the buyer to reject a tender of delivery for even slight deviation from the contract (see §9.51), is observed more strictly and with fewer exceptions when the nonconformity is in the tender of documents than it is in the tender of goods.

Commercial Code §2503(5)(a) establishes a rigid rule of perfect tender applicable to all contracts that require delivery of documents; the only exception stated is the provision on tangible bills of lading in a set (Com C §2323(2); see §9.22). Commercial Code §2503(5)(a) applies only when documents are "required" (*e.g.,* in C.I.F. contracts), not when documents are merely authorized. See Official Comment *7* to UCC §2-503. Documentary tenders that are not subject to Com C §2503(5)(a), however, are subject to the general perfect tender rule (Com C §2601; see §9.51). The exceptions to the rule for nondocumentary tenders (see §§9.52-9.70) usually are narrower for, or do not apply to, documentary tenders (see §§9.72-9.76). Counsel should ensure that the documents used in a documentary sale are generally accepted in the trade and comply exactly with the contract terms.

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2. Applicability of Commercial Code Exceptions

§9.73 a. Installment Contracts

Under an installment contract (Com C §2612(1); see §9.53), the buyer may reject an installment delivery for a *nondocumentary* nonconformity only if the nonconformity substantially impairs the value of the contract and cannot be, or is not, cured by the seller. Com C §2612(2)-(3). See §9.55. If the nonconformity in an installment delivery is "a defect in the required documents," however, the buyer initially may reject the installment (in accordance with the "perfect tender" rule), even though the documentary defect does not substantially impair the installment's value. If the seller gives adequate assurance of curing the defect and the buyer has no basis for canceling the entire contract under Com C §2612(3) (see §9.55), however, the buyer must accept the installment. Com C §2612(2). See Official Comment 3 to UCC §2-612.

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§9.74 b. Right to Revoke Acceptance

The limitations on revocation of acceptance (see §§9.60-9.61) apply with equal force to revocation of acceptance for documentary defects. The "perfect tender" rule applies only through the buyer's initial decision to reject or accept. Once the buyer has accepted, that acceptance can be revoked only for a nonconformity that substantially impairs the value of the goods to the buyer. Com C §§2601, 2607(2), 2608.

If the nonconformity is documentary, the right of revocation may be even more limited. In contrast to the general tendency to impose more severe consequences on the seller for a nonconformity in documents, Com C §2605(2) imposes on the buyer an unusually strict rule of waiver of documentary defects: If a buyer pays against documents without reserving its right to object to them later, it immediately waives defects apparent in the documents. (See Com C §1308 about the reservation of rights.)

This rule lessens the buyer's opportunity to revoke acceptance even for substantial impairment of value. It is not certain whether waiver also results from acceptance (instead of payment) of a draft. See Com C §2514. Waiver will result if acceptance is considered to be "contemporary action" that obligates the buyer to examine the documents and either take exception to or waive apparent defects. See Official Comment 4 to UCC §2-605.

Waiver under Com C §2605(2) often softens the requirement of strict conformity in documentary tenders. For waiver of the buyer's right, when goods are in the hands of a bailee, to require that delivery be tendered by negotiable document of title or the bailee's acknowledgment of the buyer's right to the goods, see Com C §2503(4)(b). See also §9.46.

The buyer must object immediately to a documentary defect (Com C §2605(2)), in contrast to "a reasonable time" allowed to notify the seller of breach based on defects in accepted goods (Com C §2607(3)(A)).

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§9.75 c. Cure

Nothing in Com C §2508 regarding cure of nonconforming tenders appears to prevent its application to cure of documentary defects as fully as to cure of nondocumentary defects (see §§9.62-9.66). If the time for performance has not expired, the seller need not show a reasonable belief of acceptability. Com C §2508(1). See §9.63. The seller's right to make a second documentary tender is consistent with the analogous right to cure documentary defects in installment deliveries under Com C §2612(2). See Official Comment 5 to UCC §2-612; §9.72. See also the express cross-reference to Com C §2508(1) in Com C §2323(2)(a), on cure of a tender of only one part of a foreign bill of lading in violation of a contract requiring a full set (discussed in §9.22). If the time for performance has expired, however, the seller cannot cure unless it reasonably believed that the documentary defect would not make the tender unacceptable (Com C §2508(2); see §§9.64-9.65). This reasonable belief may be impossible to establish because of commercial knowledge that strict compliance generally is required in a documentary transaction. See Official Comment 2 to UCC §2-508. See also §9.72. However, if the nonconformity is not known and could not reasonably be known, an admittedly unlikely situation, the seller may have cure rights under Com C §2508(2). See §§9.64-9.65.

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§9.76 d. Nonconformity in Shipping Documents

The seller under a shipment contract has three duties:

(1) To make proper shipping arrangements with the carrier (Com C §2504(a); see §9.6);

(2) To obtain and tender promptly to the buyer all necessary documents (Com C §2504(b); see §§9.7, 9.71); and

(3) To notify the buyer of the shipment (Com C §2504(c); see §9.8).

The last clause of Com C §2504 precludes rejection by the buyer for the seller's failure to perform either the first or the third of these duties unless the seller's failure is followed by material delay or loss to the buyer. See §§9.9, 9.68. The last clause does not apply to a seller's failure to obtain and promptly deliver or tender necessary shipping documents to the buyer. There seems to be a contrary implication in Official Comment 6 to UCC §2-504, which states that the clause applies to "the seller's dereliction as to any of the requirements of" Com C §2504, but this implication is not supported by the statutory text. Thus, Com C §2504 does not modify the "perfect tender" rule with respect to nonconformities in shipping documents.

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§9.*77* e. Substitute Delivery

If an agreed means of delivery becomes commercially impracticable and a commercially reasonable substitute is available, the seller must tender and the buyer must accept the substitute performance. Com C §2614(1). See §9.69. This section apparently applies to the substitution of shipping documents. The commercial reasonableness of the substitute, however, may be a disputed question of fact. See Official Comment *7* to UCC §2-503. The substitute may be unreasonable simply because financing agencies, which apparently are not bound by Com C §2614(1), will rely on the documents. See Official Comment 2 to UCC §2-614. It is questionable whether the buyer has a duty to amend, *e.g.,* the letter of credit to permit substitute performance.

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10

Buyer's Performance

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§10.1 I. BUYER'S DUTY

The performance required of the parties to a contract is governed by Division 2 of the California Commercial Code. The obligation of the seller is to transfer and deliver, and that of the buyer is to accept and pay, in accordance with the contract. Com C §2301. Tender of delivery is a condition to the buyer's duty to accept the goods and, unless otherwise agreed, to his or her duty to pay for them. Tender entitles the seller to acceptance of the goods and to payment according to the contract. Com C §2507(1).

Thus, when the seller makes a proper tender, the buyer's duty is essentially to accept and pay for the goods under the terms of the contract. This basic duty encompasses a number of obligations that arise as the sales transaction progresses. The buyer must provide for appropriate receipt of the goods, use proper means and procedures in exercising its right to inspect the goods, use appropriate standards and judgment when deciding whether to accept or reject the goods, and pay in accordance with the contract provisions or the Commercial Code.

This chapter discusses the performance obligations of the buyer under a sales contract governed by the Commercial Code in the order in which those obligations ordinarily arise in practice. The performance obligations of the seller, as well as remedies for failure to perform and other essentials of the contract, are covered in chap 9.

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§10.2 II. RECEIPT

The buyer must furnish facilities reasonably suited to the receipt of the goods, unless the parties agree otherwise. Com C §2503(1)(b). See *Overland Machined Prods. v Swingline, Inc.* (1968) 263 CA2d 642, 648, 69 CR 852 (decided under former CC §1763).

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§10.3 III. INSPECTION

The "inspection" discussed in §§10.4-10.15 refers to the buyer's inspection to ascertain whether the goods conform and the seller has performed according to the contract, and not to an examination of the goods or a sample of the goods before contracting, which could affect the warranties involved in the contract. See Com C §2513; Official Comment 9 to UCC §2-513.

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§10.4 A. Right to Inspect

Unless the parties otherwise agree, the buyer is entitled to inspect the goods before payment or acceptance in order to ascertain whether the seller has tendered conforming goods. Com C §2513(1). The buyer must pay before inspection, however, if the contract so provides or contains terms inconsistent with a right of inspection before acceptance or payment (*e.g.,* C.O.D.) or if payment is to be made against documents. Com C §2513(3); Official Comment 5 to UCC §2-513. See §§10.13-10.15. Note, however, that because the buyer always has the right to inspect before it accepts the goods, inspection normally occurs before the buyer is obligated to perform completely under the contract (*i.e.,* to both accept and pay for the goods tendered).

No agreement by the parties can displace the entire right of inspection, except when the contract is simply for the sale of "this thing." Even in a sale of "as is" boxed goods, inspection is a right of the buyer, so the price can be recovered if the boxes prove to contain some other merchandise. Official Comment 1 to UCC §2-513.

Hence, the right to inspect can be entirely eliminated only if the contract is for the sale of a specifically identified item, which the seller delivers to the buyer. See *Rudneck v Southern Cal. Metal & Rubber Co.* (1920) 184 C 274, 193 P 775 (buyer's rejection of specifically identified pile of metal shavings held wrongful because buyer was not mistaken regarding nature of pile). Even in this situation, the buyer may ascertain that the item delivered by the seller is the item identified in the contract. See Com C §2512(1); Official Comment 3 to UCC §2-512. In some industries, such as the trade in fine arts, inspections may be the most significant hurdle in the transaction and inspection methods can be quite intricate. See generally Pinkerton, *Due Diligence in Fine Art Transactions*, 22 Case W Res J Int'l L 1 (1990).

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B. Time to Inspect

§10.5 1. When Right Arises

The buyer may inspect "at any reasonable place and time and in any reasonable manner." Com C §2513(1). It is not necessary that the buyer select the most appropriate time, place, or manner to inspect or that his or her selection be the customary one in the trade or locality. Any reasonable time, place, or manner is available to him or her and the reasonableness will be determined by trade usages, past practices between the parties, and the other circumstances of the case. Official Comment 3 to UCC §2-513.

The buyer normally may inspect the goods after one of three specified events: tender, delivery, or identification. Com C §2513(1); Official Comment 2 to UCC §2-513. Inspection is also available after receipt of the goods and may be postponed after receipt for a reasonable time. Official Comment 2 to UCC §2-513. Inspection may be available to the buyer more than once if an additional inspection is necessary to provide the buyer a reasonable opportunity to inspect the goods. See §10.6.

The time at which the inspection right arises depends on what is reasonable under the circumstances:

- If the goods are not located near the buyer at the time of identification, inspection on identification is presumably unreasonable.
- If the buyer and seller are located near each other and the goods are to be shipped to a third party, inspection on the seller's premises may be reasonable. In certain circumstances, however, inspection on the seller's premises may be reasonable only if a notification from the seller invites inspection or if the agreement (including usage of trade) contemplates inspection at the seller's premises.
- If payment is not due on delivery, inspection may be reasonable after delivery.
- If payment is due on delivery, inspection can reasonably be expected to occur on identification of the goods or after payment. If perishable goods are shipped to the buyer, or if the risk of loss is on the seller, inspection on tender of the goods may be more reasonable than inspection on identification.

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§10.6 2. Duration of Right

The buyer's right of inspection continues until the buyer has had a "reasonable opportunity" to examine the goods. Com C §§2513, 2606(1); Official Comment 2 to UCC §2-513. The parties may agree on a specific time within which the buyer must inspect, as long as the agreed on time is not "manifestly unreasonable." Com C §§1302(b), 2513; Official Comment 7 to UCC §2-513. Unless the parties otherwise agree, the circumstances of the transaction determine whether the buyer has had a reasonable opportunity to inspect. Com C §§1302(b), 2513; Official Comment 7 to UCC §2-513.

PRACTICE TIP: Buyers should be advised to examine delivered goods at the earliest possible moment to preclude arguments that the right to inspect has been waived or that an unreasonable period of time has elapsed after delivery.

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§10.7 3. Hour of Inspection

Inspection may be made at any reasonable hour. Com C §2513(1); Official Comment 3 to UCC §2-513. As long as the hour selected is reasonable under the circumstances, it need not be the most appropriate hour or the customary hour for inspection. Official Comment 3 to UCC §2-513.

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§10.8 4. Effect of Payment, Acceptance, or Rejection on Right to Inspect

Payment does not terminate the buyer's right to inspect. A buyer may pay for goods and then inspect the goods, reject them, and recover the price. Com C §§2512(2), 2513, 2711; Official Comment 2 to UCC §2-513. Although acceptance or rejection of the goods terminates the buyer's right to inspect them under Com C §2513 (Com C §2606(1)), the buyer still has the right to inspect in order to lay the groundwork for a breach of warranty action (see Com C §§2607(2)-(3), 2714) or a revocation of acceptance (see Com C §2608).

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C. Place and Manner of Inspection

§10.9 1. Reasonable Place and Manner of Inspection

The buyer may inspect at any reasonable place and in any reasonable manner unless the parties otherwise agree. Com C §2513(1). The reasonableness of the place and manner of inspection is determined by trade usage, past practices between the parties, and the other circumstances surrounding the transaction, including the parties' intent as expressed in the contract. Official Comment 3 to UCC §2-513.

If the seller is required or authorized to send the goods to the buyer, the place of arrival is a reasonable place for inspection. Com C §2513(1). Hence, even if the seller's responsibilities under the contract terminate at the origin point (as in a "shipment contract" with terms such as "F.O.B. point of shipment"; see §§9.18, 10.13), the buyer may inspect at the place of destination. This result is sensible because a distant buyer would not expect to travel to the seller's location to inspect goods being shipped from that point. Moreover, nothing prevents the buyer from inspecting at the place of origin if it is reasonable under the circumstances to do so.

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§10.10 2. Exclusive Place or Manner of Inspection

A place or manner of inspection fixed by the parties is presumed to be exclusive. Com C §2513(4). If the agreed method becomes impossible, inspection must be conducted in any reasonable manner, unless the place or method agreed on by the parties was clearly intended to be an indispensable condition, the failure of which voids the contract. Com C §2513(4).

Because the Commercial Code treats the parties' agreement on these matters as exclusive, the buyer normally cannot demand places or methods of inspection other than those specified in the contract. If inspection at the specified place or in the specified manner is possible but the buyer fails to inspect the goods as agreed, the Commercial Code suggests that the buyer's failure to inspect will be "held to be an acceptance with the knowledge of such defects as [a reasonable] inspection would have revealed…." Official Comment 6 to UCC §2-513. See Com C §§2513, 2605(1). The buyer can then neither reject the goods nor revoke acceptance because of such defects. Com C §§2607(2), 2608(1).

The issue of whether a buyer is entitled to an inspection other than that provided for in an exclusive inspection provision might arise when the contract provides that the goods must pass a government inspection but remains silent regarding an inspection by the buyer itself. The buyer may be surprised to find that, by including a reference to a third party inspection in the contract, the buyer has waived its right to inspect the goods and, to conduct an inspection, must rebut the presumption of exclusivity established by Com C §2513(4).

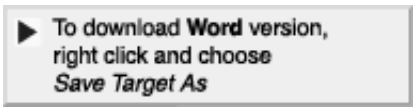
DRAFTING CONSIDERATIONS: In drafting third party inspection provisions into contracts, the attorney should ensure that the contract specifies whether the third party inspection is intended to be the exclusive means of inspection.

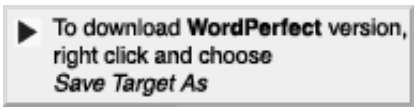
If inspection at the specified place or in the specified manner becomes impossible, the parties must examine the exclusive inspection term of the contract to ascertain whether some other method of inspection may be substituted or whether the transaction must fail. Com C §2513(4). (The term "impossible" as used in this context probably means "impracticable," although neither term is defined in the Commercial Code.) If the contract does not clearly indicate that the exclusive inspection term was intended to be an indispensable condition of the contract, the Code presumes that the parties did not intend that the contract fail in its entirety. Com C §2513(4).

Agreement on place or method of inspection does not affect statutory or contract rules on identification, delivery, or shift of risk. Com C §2513(4). Apparently, this provision is directed against pre-Code theories that the risk remained on the seller until inspection, even after the risk would otherwise have passed to the buyer. Com C §2513; Official Comment 8 to UCC §2-513.

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§10.11 3. Form: Place or Manner of Inspection





10.11-1 Place or manner of inspection

[*Alternative 1: Buyer to inspect goods*]

The parties agree that the buyer will inspect the goods at _ _[*e.g., railroad siding, point of arrival*]_ _ **by** _ _[*e.g., selecting at random* _ _[*number*]_ _ *percent of the goods for testing*]_ _**.**

[*Alternative 2: Third party to inspect goods*]

The parties agree that the goods will be inspected at _ _[*e.g., the seller's plant*]_ _ **by** _ _[*e.g., United States Department of Agriculture inspectors*]_ _**.**

[*Add if appropriate*]

[*Option 1: Further inspections permitted*]

In addition to the described inspection, the buyer may make any further reasonable inspections that it considers appropriate.

[*Option 2: Further inspections not permitted*]

The described inspection will exclude any other inspections.

[*Add if failure of inspection is intended to void the contract*]

If, through no fault of either party, the described inspection becomes impossible, this contract will terminate and neither party will have further obligations under it.

[*Add if place or method is to be exclusive*]

If the described inspection is possible but the buyer fails to inspect, the buyer _ _[*e.g., will be considered to have accepted the goods with all faults that the inspection would have revealed*]_ _**.**

Comment: A contract providing for a place or manner of inspection should clearly specify (a) whether the buyer is permitted an additional inspection and (b) the consequences if the agreed inspection fails through no fault of the parties or the buyer fails to inspect even though it could have done so. The contract should specify whether a reference to inspection of goods for some limited purpose will be construed as the only permitted inspection under the presumption established by Com C §2513(4). On the effect of inspectors' certificates and similar documents, see Com C §1307.

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§10.12 D. Expenses of Inspection

Expenses of inspection must be borne by the buyer but may be recovered from the seller if the goods do not conform and are rejected. Com C §2513(2). If the seller has breached the contract by tendering nonconforming goods, the seller must bear the reasonable cost of the buyer's inspection as "part of [the] incidental damage caused by the seller's breach." Official Comment 4 to UCC §2-513. See Com C §2715(1). If the seller has tendered conforming goods, however, its performance is completed and the buyer must absorb the expenses of inspection. Com C §2513(2). This allocation of inspection expenses may be altered by agreement. Official Comment 4 to UCC §2-513.

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E. Inspection in C.O.D. and Documentary Transactions

§10.13 1. General Rule

If the contract provides for C.O.D. ("collect on delivery") or similar delivery terms, or for payment against documents of title, the buyer is not entitled to inspect the goods before payment unless the parties otherwise agree. When terms such as C.O.D. are used, the goods are not to be delivered until the price is paid, thus making the goods unavailable for inspection before payment. The buyer is entitled to inspect, however, if payment against documents of title is due only after the goods have become available for inspection. Com C §2513(3). By agreeing to a C.O.D. or similar term, the buyer gives up its right to inspection before payment.

The buyer's right to inspect the goods before payment is also forfeited in documentary transactions in which the buyer contracts to pay against documents rather than goods, such as those in which certain mercantile shipment terms are used, including F.O.B. (meaning "free on board"), F.A.S. (meaning "free alongside"), C.I.F. (indicating that the price of the goods includes insurance and freight to the named destination), or C. & F. (indicating that the price of the goods includes freight to the named destination). For definitions of these terms, see Com C §§2319-2320. For discussion, see §§9.15-9.43.

Note, however, that in these circumstances the buyer's right to inspect is not entirely waived. Although the buyer must pay before inspection, the buyer is entitled to inspect after receipt of the goods. If the goods are nonconforming, the buyer can then exercise its rights and remedies, including the right to reject. Com C §2512(2); Official Comment 5 to UCC §2-512. In addition, if defects are apparent without inspection, the buyer may reject the shipment and refuse payment even in situations in which the buyer is obligated to pay on receipt of the goods before inspection. Com C §2512(1); Official Comments 2-3 to UCC §2-512.

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§10.14 2. Exceptions Permitting Inspection Before Payment

In documentary transactions, the goods are usually not available for the buyer's inspection when payment is due. The contract or the Commercial Code may, however, defer payment until after the goods arrive. See, *e.g.,* Com C §2310(b). If payment is deferred, the goods are then "available for inspection" before payment; Com C §2513(3)(b) permits the buyer to inspect before payment. The buyer has no right to inspect before payment, however, if payment is due against documents regardless of when the goods arrive, even in the "peculiar case in which the goods happen to arrive before the documents." Official Comment 5 to UCC §2-513. Thus, unless the contract specifically requires payment on receipt of documents regardless of when the goods arrive, the buyer has a right to inspect before payment whenever the goods are "available for inspection." Com C §2513(3)(b).

When the sales contract calls for payment against storage documents or a delivery order, rather than the standard documents of title (bills of lading or warehouse receipts), the goods are considered to be "available for inspection" within the meaning of Com C §2513(3)(b) and the buyer may inspect before making payment against the documents. Official Comment 5 to UCC §2-513.

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§10.15 3. Inspection Under Certain C.I.F. Contracts

Normally, C.I.F. and C. & F. contracts (see §10.13; Com C §2320) are documentary transactions requiring payment before inspection. Sometimes, however, such contracts include a provision for payment on or after the arrival of the goods. In these situations, Com C §2513(3), when read together with Com C §2321(3), permits the buyer to make whatever preliminary inspection is feasible before making payment against the tendered documents. If the goods are lost, however, delivery of the documents and payment are due when the goods should have arrived. Com C §2321(3).

In these situations, inspection before payment is not an absolute condition precedent to the buyer's payment obligations. If the goods are lost in transit, the seller may tender the documents and the buyer must pay against them at the time the goods should have arrived. This allocates transit risks to the buyer, who normally bears such risks in a C.I.F. contract, despite the suggestion in the contractual language that payment is due only after the arrival of the goods. See Official Comment to UCC §2-321.

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§10.16 F. Inspection in Special Situations

Two Commercial Code provisions give a right of inspection in special situations. The first, Com C §2613, addresses the situation in which identified goods suffer casualty without fault of either party. See §10.17. The second, Com C §2515, provides for inspection rights for the purpose of preserving evidence. See §10.18.

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§10.17 1. Casualty to Identified Goods

Where the contract requires for its performance goods identified when the contract is made, and the goods suffer casualty without fault of either party before the risk of loss passes to the buyer, *if* the loss is partial *or* the goods have so deteriorated as no longer to conform to the contract, the buyer may nevertheless demand inspection. Com C §2613. The buyer has the option to either treat the contract as avoided or accept the goods with due allowance from the contract price for the deterioration or the deficiency in quantity but without further right against the seller. Com C §2613.

This provision allows the buyer to demand inspection of whatever remains of the goods in order to decide whether to avoid the contract or to accept the goods with a price adjustment. The buyer's only remedy if it decides to accept the defective goods is a price reduction; the seller's performance is otherwise excused because of impossibility.

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§10.18 2. Inspection to Preserve Evidence of Goods in Dispute

Either party (or an agreed third party) can inspect goods that are the subject of controversy for the purpose of ascertaining the facts and preserving evidence. Com C §2515.

PRACTICE TIP: Clients would be well advised to exercise this right of inspection, particularly if the goods are perishable or the evidence is otherwise subject to deterioration.

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§10.19 IV. ACCEPTANCE

The buyer's two basic obligations are to accept properly tendered, conforming goods and to pay for those goods. Com C §2301. The term "acceptance" refers to the point at which certain legal consequences arise. The buyer must accept the goods that the seller tenders unless the goods or their delivery fail to conform to the terms of the contract. Note that if the buyer accepts the goods without further reservation, whether or not they conform to the contract, it must pay for them at the contract rate. Com C §2607(1). See §10.29.

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§10.20 A. Whole or Partial Acceptance

If the goods or the tender of delivery fail in any respect to conform to the contract, the buyer may reject the entire tender, accept the entire tender, or, if the goods are commercially divisible, accept any commercial unit or units and reject the rest. Com C §2601. Thus, the buyer is given a right of partial acceptance, even if the goods do not conform to the contract. The buyer can accept (at the contract price) any quantity of units or combination of conforming and nonconforming goods in the tender and reject the rest. The buyer is limited, however, to acceptance of "commercial units" (Com C §2601(c)). That term is defined as a unit of goods that by commercial usage is a single whole for purposes of sale, and division of which materially impairs its character or value on the market or in use. Com C §2105(6). A commercial unit of goods may be a single article (as a machine) or a set of articles (as a suite of furniture or an assortment of sizes) or a quantity (as a bale, gross, or carload) or any other unit treated in use or in the relevant market as a single whole. Com C §2105(6).

Further, acceptance of a part of any commercial unit of goods is an acceptance of that entire unit. Com C §2606(2). A buyer may not, for example, accept only one piece of a three-piece suite of furniture; the acceptance of one piece is considered an acceptance of all three pieces. Official Comment 5 to UCC §2-606. To allow a buyer to accept less than a commercial unit would "leave the seller with only components of a commercial unit, which would have [a] severely reduced market value." *S & R Metals, Inc. v C. Itoh & Co. (Am.)* (9th Cir 1988) 859 F2d 814, 817 (applying California law).

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B. What Constitutes Acceptance?

§10.21 1. Basic Rule

Acceptance occurs when the buyer shows by words, action, or inaction an intent to retain the goods, whether or not the buyer is obligated to do so. Commercial Code §2606(1) sets forth the three circumstances that constitute an acceptance of goods:

(1) After a reasonable opportunity to inspect the goods, the buyer signifies to the seller that the goods are conforming or that he or she will take or retain them in spite of their nonconformity;

(2) After a reasonable opportunity to inspect the goods, the buyer fails to make an effective rejection of the goods; or

(3) The buyer performs any act inconsistent with the seller's ownership, although if that act is wrongful as against the seller, it is an acceptance only if ratified by the seller.

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§10.22 a. Acceptance by Affirmative Action

A buyer usually signifies its acceptance by receiving, retaining, and paying for goods after an inspection reveals the goods to be conforming. The buyer may accept by signifying to the seller that the goods conform or that the buyer will take or retain the goods despite a nonconformity. Acceptance need not be verbal. The Commercial Code's use of the word "signifies" rather than "advises" or "informs" implies that acceptance by conduct is possible. For example, if a contract is F.O.B. shipping point, with inspection at the point of dispatch, and the buyer inspects at the dispatch point and permits the goods to move forward, the buyer's actions are likely to be interpreted as an acceptance of the goods.

Payment may be evidence of an intent to accept but is not conclusive of acceptance. Payment made after tender is always one circumstance that tends to signify the acceptance of the goods but, in itself, it can never be more than one circumstance and is not conclusive. Official Comment 3 to UCC §2-606. Accordingly, the attorney should advise clients to withhold payments for goods of doubtful acceptability.

The buyer may accept conditionally. A conditional communication of acceptance always remains subject to its expressed conditions. Official Comment 3 to UCC §2-606. For example, if the seller's tender was insufficient in quantity, the buyer may condition its acceptance of the goods on receipt of the remainder. See Com C §2608(1)(a).

A buyer can accept previously rejected goods by communicating its acceptance to the seller. Official Comment 4 to UCC §2-606. Whether this post-rejection acceptance is effective is optional with the seller; the buyer may not change its position and successfully assert that it has accepted unless the seller has retendered the goods or taken affirmative action indicating that he or she is holding the tender open. Official Comment 4 to UCC §2-606. See Official Comment 2 to UCC §2-601.

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§10.23 b. Acceptance by Inaction

The parties may agree that the buyer's inaction for a specified period following tender or inspection will constitute acceptance. Even without such an agreement, the buyer's failure to act after the delivery or tender of goods may be considered an acceptance of the goods if the buyer has had a reasonable opportunity to inspect the goods and has failed to make an effective seasonable rejection. Com C §2606(1)(b). ("Seasonable" means at or within the time agreed, or if no time is agreed, at or within a reasonable time. Com C §1204(3).) If there has been no reasonable opportunity to inspect the goods, however, the buyer's inaction does not result in acceptance. See *Neil Norman, Ltd. v William Kasper & Co.* (1983) 149 CA3d 942, 947, 197 CR 198. Consequently, if the buyer intends to reject the goods, it must do so within a reasonable time after delivery or tender and must seasonably notify the seller of the rejection. Com C §2602(1).

Taken together, Com C §§2602(1) and 2606(1)(b) indicate that a reasonable time for rejection must continue at least until after the buyer has had a reasonable opportunity to inspect and presumably until the buyer has been permitted to assimilate its findings and give notice of rejection. Official Comment 1 to UCC §2-602. Whether and when the buyer has exhausted its opportunity to inspect turns on what is reasonable under the circumstances, including prior dealings, custom, and the terms of the contract. Abnormal conditions such as rapid market changes can shorten the time within which the buyer must act. For example, when perishable goods start to decay, the reasonable time for rejection expires relatively quickly. *Ehlers v Bihn* (1925) 71 CA 479, 235 P 673. Negotiations and compromise attempts extend the reasonable time period. Official Comment 4 to UCC §2-602.

The buyer's failure to inspect at an agreed place or by an agreed method may also amount to acceptance through inaction. See Com C §2513(4).

The parties may agree that acceptance will occur without further action by the buyer on the occurrence of a specified event. For example, in *SHA-I Corp. v City & County of San Francisco* (9th Cir 1980) 612 F2d 1215, the parties agreed that acceptance of a data-processing system would occur automatically on the completion of a 30-day acceptance test as long as the system completed the test at a 95-percent level of effectiveness. Following completion of the test at that level of effectiveness, the buyer was considered to have accepted the system and "became obliged to pay the contract price." 612 F2d at 1218.

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§10.24 c. Acceptance by Acts Inconsistent With Seller's Ownership

The buyer accepts the goods if it performs any act inconsistent with the seller's ownership. Com C §2606(1)(c). Case law provides some guidance on which acts are inconsistent with the seller's ownership. Resale to a third party was held to be inconsistent with the seller's ownership in *Commonwealth Propane Co. v Petrosol Int'l, Inc.* (6th Cir 1987) 818 F2d 522, aff'd (1990) 901 F2d 1314. See also *Gladium Co. v Thatcher* (1928) 95 CA 85, 272 P 340. In *C. F. Smith, Inc. v Bushala* (ND Cal 1964) 232 F Supp 178, however, the resale of only a small fraction of the goods without knowledge of defects was held not to be an acceptance. See also *Mayer v Northwood Textile Mills, Inc.* (1951) 105 CA2d 406, 233 P2d 657.

Acts performed for the purpose of inspection are normally not considered to be inconsistent with the seller's ownership. Thus, the following actions did not constitute acceptance: operating a piece of machinery to ascertain its condition (see *Sherman v Ayers* (1912) 20 CA 733, 130 P 163); operating a data-processing system for an agreed-on 30-day test period (see *SHA-I Corp. v City & County of San Francisco* (9th Cir 1980) 612 F2d 1215); and testing a 3.5 percent sample of an entire shipment of bentonite (see *Figueroa v Kit-San* (Idaho Ct App 1992) 845 P2d 567). In a case decided under CC §1794 (which provides buyers in consumer transactions with the remedies available to buyers under the Commercial Code), the court held that a buyer's continued use of a mobilehome, after giving notice of rescission and demanding another home without defects, did not constitute acceptance. See *Troensegaard v Silvercrest Indus.* (1985) 175 CA3d 218, 220 CR 712.

The use of machinery for 22 months after revocation of acceptance, however, was held to be an acceptance. See *Computerized Radiological Servs. v Syntex Corp.* (2d Cir 1986) 786 F2d 72, 75. Applying California law, the court stated that a buyer who revokes acceptance must begin the search for replacement goods with reasonable dispatch and may not put off purchase of replacement goods until a seller offers ideal financial terms.

Altering the goods without the seller's consent amounted to acceptance in *Mardikian v Parador Mining Co.* (1961) 192 CA2d 747, 13 CR 793. See also *L & M Fabricators v Pabcor, Inc. (In re L & M Fabricators*) (Bankr WD Penn 1990) 114 BR 100 (acceptance occurs when buyer permits goods in its exclusive possession to be changed or altered; heat treating of bolts constitutes acceptance).

Acts that the buyer is permitted or required to do to reject goods under Com C §§2602(2)(b), 2603-2604, and 2711(3) do not result in acceptance. See Com C §§2603(3), 2604; Official Comment 4 to UCC §2-606.

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2. Sale on Approval and Sale or Return Contracts

§10.25 a. Sale on Approval

A sale on approval is one in which goods are delivered to the buyer for use during a trial period on the understanding that, even though the goods conform, the buyer may return them. Com C §2326(1)(a).

The ordinary retail sales contract is not a bailment, and the general presumption runs against a delivery to a consumer as being a sale on approval. The fact that the seller permits a customer to return goods for a refund is a benefit to the customer, but does not in and of itself suggest that the parties intended the seller to retain an interest in the goods until some time after they are delivered to the customer, and does not convert a routine sale with a right to return into a sale on approval. *Wilson v Brawn* (2005) 132 CA4th 549, 33 CR3d 769.

Special provisions govern acceptance in sales on approval. Acceptance can take place in the usual ways; in addition, the buyer is considered to have accepted the goods if it does not notify the seller seasonably (*i.e.,* at or within the agreed-on time or, if no time is agreed on, at or within a reasonable time; see Com C §1205(b)) of its election to return the goods. Com C §2327(1)(b).

The buyer's use of the goods, which might in a normal contract situation be considered an act inconsistent with the seller's ownership and thus an acceptance, is not an acceptance in a sale on approval if the use is "consistent with the purpose of trial." Com C §2327(1)(b). The language of Com C §2327(1)(b) implies that uses inconsistent with the purpose of trial will result in acceptance. Using a machine in normal production after completing testing procedures, for example, might be a use so inconsistent "with the purpose of trial" that it would result in acceptance. Com C §2327(1)(b).

PRACTICE TIP: Counsel should make explicit the parties' understanding of what procedures and uses may be used in the course of the trial.

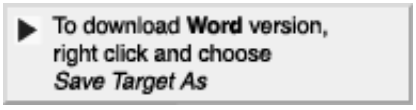
The right of partial acceptance of a nonconforming delivery (see Com C §2601(c)) does not extend to the election to accept or return conforming goods sold on approval. The buyer may decline to accept any of the goods, even if they conform (Com C §2326(1)), but if they do conform and the buyer accepts any part of them, the buyer accepts all of them. Com C §2327(1)(b).

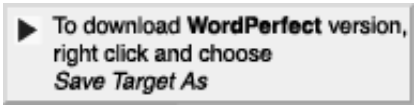
A transaction may be structured so that only part of the goods are sent under an approval term; another part of the goods may be sent under a normal mercantile contract, subject to the normal rules of acceptance and rejection.

On risk of loss in a sale on approval, see Com C §2327(1)(a), (c).

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§10.26 (1) Form: Contract Provision Requiring Notification of Return





10.26-1 Contract provision requiring notification of return

The parties agree that if _ _[*e.g., the buyer does not notify the seller in writing/the seller does not receive written notice in its office*]_ _ **by** _ _[*time*]_ _ **on** _ _[*date*]_ _**, that the buyer elects to return the goods sold under this contract, the buyer will be considered to have accepted** _ _[*e.g., all the goods shipped*]_ _**.**

[*Add if certain uses are to be made consistent or inconsistent with purposes of trial*]

The buyer may _ _[*e.g., operate the machine for one month for not more than eight hours per day*]_ _**. Any other or further use of the goods will be considered inconsistent with the purposes of trial and will constitute acceptance of the goods.**

[*Add if risk of loss is shifted*]

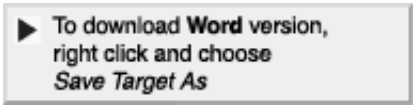
Whether or not the buyer accepts the goods, it will bear the risk of their loss or damage from the time that the seller ships them until the seller regains possession of them.

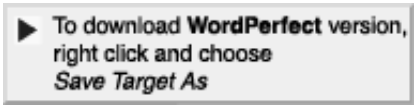
Comment: If the parties agree on the time for a trial period, an action must be performed within that time to be seasonable. Com C §1205(b). Risk of communication failure may be placed on either the seller or the buyer. On what constitutes notice, see Com C §1202. The parties may want to (a) describe the uses that will or will not be considered consistent with the purpose of trial, (b) shift the risk of loss, or (c) make other changes in the special sale on approval rules that would otherwise apply under Com C §2327.

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Source: Business Law/California UCC Sales and Leases/10 Buyer's Performance/§10.27 (2) Form: Notice of Election to Return Goods

§10.27 (2) Form: Notice of Election to Return Goods





10.27-1 Notice of election to return goods

This is to notify you that we elect to return the goods sold on approval under our contract with you dated _ _[*date of contract*]_ _.

[*Add if appropriate*]

Unless we receive other shipping instructions from you by _ _[*date*]_ _, we will ship _ _[*specify shipping data*]_ _.

Comment: Seasonable notification of the election to return is required by Com C §2327(1)(b). Shipping data may be included for the seller's convenience. If desired, the parties can provide that the buyer may return goods without giving notice.

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§10.28 b. Sale or Return Contracts

Goods may be sent for resale under a contract provision that the buyer may return all or some commercial unit. Com C §§2326(1)(b), 2327(2). In these "sale or return" contracts, acceptance of the goods occurs either if the buyer does not act seasonably (see Com C §1205(b)) to return them or if the goods are no longer in substantially their original condition (Com C §2327(2)(a)). In effect, the latter provision may mean that the buyer carries the practical risk of deterioration of the goods.

On other aspects of sale or return contracts discussed elsewhere in this book, see §§10.51 (disposition of goods), 7.6 (statute of frauds and parol evidence rule), and 12.55 (rights of buyer's creditors).

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3. Effect of Acceptance

§10.29 a. Effect of Acceptance on Payment Obligation

A buyer is not obliged to accept a tender of nonconforming goods. See Com C §§2503, 2507. If the buyer does accept all or part of such a tender, however, the buyer must pay for the goods at the contract rate, whether or not the goods conform to the terms of the contract. Com C §2607(1). If the unit price is specified in the contract, the buyer must pay that price for each unit accepted. If the contract sets only an aggregate price, Official Comment 1 to UCC §2-607 suggests that the price of any part accepted must be reasonably apportioned.

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§10.30 b. Effect of Acceptance on Right to Reject Goods

Acceptance of goods by the buyer precludes rejection of the goods accepted. Com C §2607(2). If acceptance is made with knowledge of a nonconformity, acceptance cannot be revoked because of the nonconformity unless the acceptance was based on the reasonable assumption that the nonconformity would be seasonably cured. Com C §2607(2). However, the buyer still may be able to revoke its acceptance in some circumstances. See §10.32.

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§10.31 c. Effect of Acceptance on Right to Damages

Acceptance does not impair any other remedy for nonconformity that the buyer may have (Com C §2607(2)); the buyer's action in damages for breach of warranty thus remains available after acceptance (Com C §2714(1)). In addition to its warranty remedy, a buyer that has accepted goods may set off from the contract price (which it must pay under Com C §2607(1)) the damages resulting from the seller's breach. Com C §2717. The buyer must, however, notify the seller of the breach "within a reasonable time after he or she discovers or should have discovered any breach… or be barred from any remedy." Com C §2607(3)(A).

Thus, if a buyer has accepted a nonconforming delivery and is unable to revoke its acceptance (see §10.32), the buyer may, if it gives proper notice, either offset its damages from the contract price or pay the contract price and sue to recover damages. As a practical matter, offsetting the damages is normally preferable.

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4. Revocation of Acceptance

§10.32 a. Grounds for Revocation of Acceptance

The buyer may revoke acceptance of a lot or commercial unit if the nonconformity substantially impairs the value of the lot or unit to the buyer and either (Com C §2608(1)):

- The buyer accepted, knowing of the nonconformity but reasonably assuming that it would be seasonably cured, and it was not; or
- The buyer's acceptance was reasonably induced, before the buyer discovered the nonconformity, by the seller's assurances or by the difficulty of discovery.

An example of the difficulty-of-discovery exception is provided by *S & R Metals, Inc. v C. Itoh & Co. (Am.)* (9th Cir 1988) 859 F2d 814. In that case, the court held that the buyer's revocation of acceptance of a shipment of steel was proper even though revocation occurred approximately five months after acceptance, because the defect in the steel was latent and could not have been discovered before that time except through a testing process that would have substantially reduced the value of the steel.

Note that the buyer can claim damages even if the buyer has not rejected the goods and has no ground for revocation of acceptance of the goods. See Com C §§2607(2), 2714(1). If, while in the buyer's control, the goods substantially deteriorate because of their own defects, the buyer's right to revoke acceptance is not impaired, and the seller bears the risk of loss. See Com C §§2510(2), 2608(2).

See generally Garland, *Determining Whether a Nonconformity Substantially Impairs the Value of Goods: Some Guidelines*, 26 UCC LJ 129 (Fall 1993).

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§10.33 b. Time Limit for Revocation of Acceptance

Revocation is not effective until the buyer notifies the seller of its intent to revoke. Any revocation must occur within a reasonable time after the buyer discovers, or should have discovered, the ground for it, and before any substantial change in condition of the goods that is not caused by their own defects. Com C §2608(2).

What constitutes a reasonable time depends on the facts and circumstances of the case. Because revocation of acceptance usually occurs only after repeated attempts at adjustment or cure, and because a buyer should not be penalized for continued patience with a seller that promises to cure a nonconforming delivery, the time for revocation in most cases could reasonably be expected to extend beyond the seller's final assurance of conformity or ability to cure. For example, in *Ibrahim v Ford Motor Co.* (1989) 214 CA3d 878, 263 CR 64, the court held that a buyer's use of an allegedly defective automobile for 28,000 miles before finally surrendering the vehicle to the seller did not preclude rejection or rescission, because the buyer and seller had repeatedly attempted to fix the vehicle from almost the time of delivery and because "reasonable continued use of motorized vehicles does not, as a matter of law, prevent the buyer from asserting rescission (or its [UCC] equivalent, revocation of acceptance)." 214 CA3d at 897, 263 CR at 76. See also *U.S. Roofing, Inc. v Credit Alliance Corp.* (1991) 228 CA3d 1431, 1445, 279 CR 533, 540 (factors include extent to which buyer will be inconvenienced while seller makes repair and whether nonconformities have undermined buyer's confidence in goods).

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§10.34 c. Effect of Revocation of Acceptance

A rightful revocation of acceptance places the buyer in the position it would have occupied had it rejected the goods: The risk of loss is on the seller (to the extent of any deficiency in the buyer's effective insurance coverage), and the buyer may recover any amount paid for the goods as well as damages for breach. Com C §§2510(2), 2608(3).

After the buyer revokes acceptance, Com C §2608 may entitle the seller to cure the breach. See *U.S. Roofing, Inc. v Credit Alliance Corp.* (1991) 228 CA3d 1431, 1444, 279 CR 533 (no right to cure under Com C §2508, but Com C §2608(1)(a) "permits a cure"). See also Sebert, *Rejection, Revocation, and Cure under Article 2 of the Uniform Commercial Code: Some Modest Proposals*, 84 Nw U L Rev 375, 392 (1990) (many courts hold no right to cure on buyer's revocation, but "respectable number" of courts hold to contrary).

The buyer's continuing use of the goods after revocation of acceptance may be considered to be acceptance. If so, the buyer may be precluded from again revoking its acceptance on the basis of the same defects, because the buyer would have known about the defects at the time of the second acceptance. See Com C §§2606, 2607(2), 2608. In addition, the seller retains "a recoupment right of setoff for the buyer's use of the good[s] beyond the time of revoking acceptance." *Ibrahim v Ford Motor Co.* (1989) 214 CA3d 878, 898, 263 CR 64.

For a notice of revocation of acceptance, see form 17.65-1.

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V. REJECTION

A. Buyer's Right to Reject

§10.35 1. Time and Manner of Rejection

If the seller's tender conforms to the contract in all respects, the buyer has an affirmative duty to accept the goods tendered. If the seller tenders nonconforming goods, however, the buyer may reject all or part of the goods in the manner set forth in Com C §2602(1). This section provides that the rejection of goods must be within a reasonable time after their delivery or tender. The rejection is ineffective unless the buyer seasonably notifies the seller. Com C §2602(1).

Because failure to reject usually results in acceptance, the buyer must take affirmative action to avoid acceptance. Official Comment 1 to UCC §2-602. What constitutes a "reasonable time" depends on "the nature, purpose and circumstances" of the action to be taken. Com C §1204(2). Those circumstances include the agreement of the parties, the prior course of dealing, usage of trade, and other factors. See *Electrical Power Sys., Inc. v Argo Int'l Corp.* (ND Okla 1994) 864 F Supp 1080 (goods accepted when buyer's purported rejection was communicated more than three months after payment became due). The parties may agree on what constitutes a reasonable time as long as the specified time is not "manifestly unreasonable." Com C §1302(b).

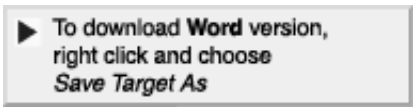
The buyer must give the seller "seasonable" notice of rejection; rejection is ineffective unless the buyer does so. Com C §2602(1). An action is taken "seasonably" when it is taken at or within the time agreed, or if no time is agreed on, at or within a reasonable time. Com C §1205(b). See form 17.59-1 for a notice of rejection.

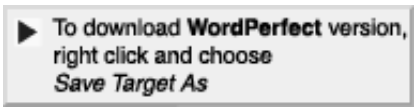
When documents are required (not merely authorized) in the transaction, rejection occurs if a draft accompanying or associated with the documents is dishonored. Com C §2503(5)(b). If the draft is dishonored after the goods have been delivered (*e.g.,* by nonpayment after the draft is accepted), the parties' rights should be the same as if payment had been made by a subsequently dishonored check. See §10.60.

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Source: Business Law/California UCC Sales and Leases/10 Buyer's Performance/§10.36 2. Form: Time and Manner of Rejection

§10.36 2. Form: Time and Manner of Rejection





10.36-1 Time and manner of rejection

For rejection of goods tendered under this contract to be effective, the seller must receive written notice of that rejection at _ _[*address for receipt of notice*]_ _ within _ _[*number*]_ _ _ _[*hours/days*]_ _ after _ _[*tender/delivery/inspection*]_ _ of the goods, identifying the goods rejected and this contract and describing all defects of the goods on which the buyer intends to rely.

Comment: This clause shifts the risk of loss of the notice to the buyer, requiring that the seller actually receive the notice. A time set by the parties controls if it gives the buyer reasonable time for inspection. Com C §1204(1); Official Comment 1 to UCC §2-602. The seller may want the asserted defects to be described in the notice to assist it in curing them. See Com C §2605. Use of this clause assures the seller that the notice will go to the proper office and that the seller will have an opportunity to cure the defects.

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§10.37 B. Eliminating Right to Reject by Contract

The buyer and seller may agree in advance to limit the buyer's right to reject goods. See Com C §2719(1)(a). If, however, a seller attempted to take advantage of a "no rejection" clause by delivering wholly nonconforming goods, the Commercial Code's general obligation of good faith (Com C §1304) would almost certainly sustain a buyer's rejection despite the clause. Within the confines of normal commercial practice, however, a no rejection clause would probably be enforced, but the use of such a clause would not prevent a buyer from offsetting its damages for nonconformity against the price (Com C §2717) or from recovering damages for the seller's breach (Com C §2714(1)). Such a clause would merely preclude the buyer from forcing possession of the goods back to the seller. See *Pacific States Steel Corp. v Isaacson Iron Works* (9th Cir 1963) 320 F2d 645, in which the court held that, under California law, a shipment of steel "without recourse" to a buyer with whom the seller had experienced unwarranted rejection problems in the past could be rejected by the buyer if the seller delivered something other than steel.

DRAFTING CONSIDERATIONS: The seller's attorney should consider the use of a clause forbidding rejection when it would be expensive or difficult for the seller to deal with rejected goods or when the price of the goods may drop suddenly before delivery, tempting a buyer to reject wrongfully.

A clause providing that the buyer's exclusive remedy is repair or replacement probably will not protect a seller that fails to cure within a reasonable time. A seller's failure to effect a timely cure may cause a repair-or-replacement clause to "fail of its essential purpose" within the meaning of Com C §2719(2). Specifically, the statute provides that when circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided within the code. Com C §2719(2).

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§10.38 C. Specification of Defects

In connection with rejection, the buyer's failure to state a particular defect that is ascertainable by reasonable inspection precludes the buyer from relying on the unstated defect to justify rejection or to establish breach in two instances (Com C §2605(1)):

(1) When the seller could have cured it if stated seasonably; or

(2) Between merchants, when the seller has after each rejection made a request in writing for a full and final written statement of all defects on which the buyer proposes to rely.

In these two situations, a buyer must state the defects on which its rejection is based or be barred from relying on those defects either to justify rejection or to establish breach. This requirement does not apply if the defects are not ascertainable by reasonable inspection.

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§10.39 1. Curable Defects

When the defect in a tender is one that could have been cured by the seller, a buyer who merely rejects the delivery without stating his or her objections to it is probably acting in commercial bad faith and seeking to get out of a deal that has become unprofitable. The policy of the Commercial Code in such circumstances is that the seller's right to correct his or her tender be protected. See Official Comment 2 to UCC §2-605.

The buyer must inform the seller of all curable defects that would be ascertainable by a reasonable inspection. See *Lockheed Electronics Co. v Keronix, Inc.* (1981) 114 CA3d 304, 170 CR 591, in which the court held that, if defects are ascertainable and the seller can remedy the defects by sending other goods, the buyer must put the seller on notice of the defects in order to rely on those defects in a claim of breach for defective goods. Commercial Code §2508 delineates defects that are curable by the seller. For a discussion of cure, see §§9.62-9.67.

On its face, Com C §2605(1)(a) does not require the buyer to state defects that the seller has no right to cure under Com C §2508. Such a situation could occur, for example, if the time for performance has expired and the parties have agreed that strict performance is required, or if the seller, though entitled to cure, is physically unable to do so (*e.g.,* the seller of Christmas trees cannot deliver them in time for Christmas). In such circumstances, a statement should be unnecessary under Com C §2605(1)(a), and the failure to furnish such a statement should not preclude the buyer from relying on the defects.

PRACTICE TIP: Clients would be well advised to resolve doubts in favor of making such a statement. If the buyer intends to accept goods that contain incurable defects, however, the buyer should reserve its rights regarding the nonconformities. If the buyer furnishes a statement listing curable defects, the buyer should also list all known incurable defects in the statement. Otherwise, the buyer could be deemed to be estopped, or prohibited by its obligation of good faith (see Com C §1304), from relying on the unstated known incurable defects to justify rejection or a claim for a reduction in the price based on the nonconformity.

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§10.40 2. Seller's Demand for Specification

A buyer must also state defects when the contract is "between merchants" (see Com C §2104(3)) and the seller makes a written demand that the buyer make a full and final written statement of all defects in the rejected goods on which the buyer proposes to rely. Com C §2605(1)(b). Any defect ascertainable by reasonable inspection that is not specified in the reply is foreclosed as the basis for rejection or claim of breach.

The buyer must make its written statement of all defects within a reasonable time. Com C §§2309(1), 2605(1)(b). What constitutes a reasonable time depends on the function that the statement of defects is intended to serve. On the one hand, if it is used as a form of pretrial discovery device, a substantial lapse of time would presumably be reasonable. On the other hand, much less time should be permitted for the reply if the seller makes the demand for a statement of defects to determine whether it should take possession of and resell the goods.

PRACTICE TIP: The seller may link the demand for a statement of defects to a disposition problem to force an early (and perhaps incomplete) response. The buyer will contend that, because the reply binds it in the resolution of the dispute, it should have time to prepare the reply without undue pressure, and that in the meantime the seller's purpose can be served by a preliminary statement of defects. If the seller pressures the buyer for a reply, the buyer will probably want to assert clearly that any statement it furnishes is intended to be preliminary only and neither full nor final. The parties could resolve the problem beforehand by providing a period within which the buyer must specify defects, or by eliminating altogether the right to reject or revoke acceptance.

The parties' attorneys should recommend that their clients make the practices affected by Com C §2605 subject to a routine procedure, because this is the point at which the outlines of any litigation are drawn. For example, any mail received by a buyer demanding a statement of defects of rejected goods could be turned over to a responsible official for reply, who would not answer it without first consulting counsel.

The demand for a statement of defects could conceivably be used to tactical advantage by a seller that plans to claim that the rejection could not have been reasonably expected in order to become eligible to invoke Com C §2508(2). Note that a notice of intent to substitute, coupled with a demand for a statement of defects, may have the effect of extending the time within which the seller may substitute a conforming tender under Com C §2508(2).

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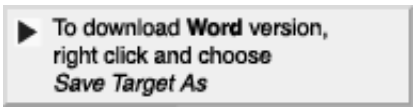
§10.41 3. Unstated Defects in Documentary Transactions

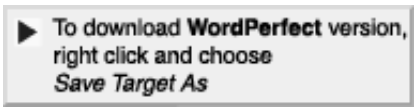
A buyer may waive its right of rejection in one additional instance. If the buyer pays against documents without reserving its rights, the buyer cannot recover the payment for defects apparent in the documents. Com C §2605(2). If defects in documents are apparent, the buyer must refuse to pay or must reserve its rights. Com C §1308. If the buyer does neither, it effectively waives the defects.

PRACTICE TIP: Clients should be advised to institute a routine, but effective, procedure for reserving rights at the time of payment. "Such words as 'without prejudice,' 'under protest' or the like are sufficient." Com C §1308.

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§10.42 4. Form: Statement of Defects





10.42-1 Statement of defects

The inspection we have been able to make has disclosed the following defects, on which we intend to rely in rejecting the _ _[*describe goods*]**_ _ that you shipped under our contract with you dated _ _**[*date of contract*]**_ _: _ _**[*List defects*]**_ _.**

[*Add if appropriate*]

This is not to be construed as a full or final statement of defects.

Comment: A statement such as this may be made either voluntarily or in response to the seller's written demand. All known defects should be listed.

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§10.43 5. Form: Request for Full and Final Statement of Defects

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

10.43-1 Request for full and final statement of defects

We understand that you have rejected goods that we tendered under the contract for sale between us dated _ _[*date of contract*]_ _. Under California Commercial Code §2605, we request that you furnish us _ _[*, no later than _ _[date*]_ _,]_ _ with a full and final statement of all defects on which you propose to rely.

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D. Buyer's Rights and Duties After Rejection

§10.44 1. Introduction

After a proper rejection (see Com C §2602; §10.35) or a revocation of acceptance (see Com C §2608(3); §§10.32-10.34), the buyer's rights and duties with respect to the goods are altered significantly. After rejection, any exercise of ownership by the buyer with respect to any commercial unit is wrongful as against the seller. If the buyer has before rejection taken physical possession of goods in which the buyer does not have a security interest, he or she is under a duty after rejection to hold them with reasonable care for a time sufficient to permit the seller to remove them. The buyer, however, has no further obligations with regard to goods rightfully rejected. Com C §2602(2). When the seller has no agent or business at the place of rejection, a merchant buyer who has rejected goods has other obligations. Com C §2603; see §10.47. See §10.46 about the buyer's options if the seller does not provide instructions for the goods after the buyer's rejection.

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Source: Business Law/California UCC Sales and Leases/10 Buyer's Performance/§10.45 2. Security Interest for Expenditures

§10.45 2. Security Interest for Expenditures

After rightful rejection or justifiable revocation of acceptance, a buyer has a security interest in goods in its possession or control for any payments made on their price and for any expenses reasonably incurred in their inspection, receipt, transportation, care, and custody. Com C §2711(3). The nature of this interest, its relation to Division 9 of the Commercial Code, and the procedure for its realization are discussed in chap 17. The buyer may hold the goods and resell them in the same manner as an aggrieved seller may resell goods under Com C §2706 (see §§17.38-17.46). Com C §2711(3).

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§10.46 3. Buyer's Duty to Hold Goods

A buyer in possession of rightfully rejected goods who has no security interest in them must hold them with reasonable care for a time sufficient to permit the seller to remove them. Com C §2602(2)(b). Official Comment 2 to UCC §2-602 provides that, beyond the buyer's duty to hold rejected goods with reasonable care for the seller's disposition, Com C §2602 generally relieves the buyer from any duties with respect to the goods, except when the circumstances impose the limited obligation of salvage.

Except for duties imposed on merchant buyers in certain situations (see Com C §2603; §10.47), the buyer is not required to do anything further with the goods. If rejected goods being held for the seller's disposition are destroyed or damaged without the buyer's fault, the buyer is not responsible to the seller for either their price or their value. See Com C §2510(1); Official Comment 1 to UCC §2-510.

Whether a sufficient time for removal has elapsed under Com C §2602(2)(b) depends on the circumstances. Important factors in determining whether a seller has had enough time to remove the goods include the bulk and nature of the goods, their rate of deterioration or depreciation, weather conditions, distances, communication facilities, and the availability of transportation.

If the seller gives no instructions within a reasonable time after notification of rejection, the buyer may dispose of the goods by reshipping them to the seller or by storing or reselling them for the seller's account. Com C §2604. Presumably the buyer may continue to hold the goods, using reasonable care, even after expiration of a reasonable time without instructions. Although premature resale could expose the buyer to liability, the Commercial Code intends to accord all reasonable leeway to a rightfully rejecting buyer who is acting in good faith. Official Comment to UCC §2-604.

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§10.47 4. Disposition of Goods by Merchant Buyer

Commercial Code §2603(1) lists the circumstances in which merchant buyers are required to take affirmative action toward the disposition of rightfully rejected goods. Under that section, the buyer's duty is to do no more than hold the goods unless three factors coexist:

(1) The buyer is a merchant, a professional who deals in goods of the kind or holds himself or herself out as having knowledge or skill peculiar to the practices or goods involved. Com C §2104(1); Official Comment 2 to UCC §2-104.

(2) The seller has no place of business or agent at the market of rejection. "Agent" is broadly construed by Official Comment 2 to UCC §2-603 to include a financing agency handling the documents or any other representative on whom the seller might reasonably call to act in its behalf.

(3) The goods are in the "possession or control" of the buyer. This language is construed in favor of the seller by Official Comment 2 to UCC §2-603 to mean that the buyer is in possession and control of the goods even if the buyer has to exert some effort to obtain them and direct their disposition. The effort, however, must not be such that the buyer cannot "practicably effect control without undue commercial burden."

If all three conditions exist, the buyer must follow any reasonable instructions received from the seller. The buyer may be asked to reship, store, deliver to a third party, or resell the goods. Official Comment 1 to UCC §2-603.

If the goods are perishable or threaten to decline in value speedily, the merchant buyer must try to sell them even without instructions. Com C §2603(1); Official Comment 1 to UCC §2-603. See also 7 USC §499b(3), part of the Perishable Agricultural Commodities Act (PACA) (7 USC §§499a-499s), which makes it unlawful for any commission merchant to discard, dump, or destroy without reasonable cause, any perishable agricultural commodity received in interstate commerce.

To be "reasonable," the seller's instructions must include indemnity for expenses if the buyer demands such indemnification. Com C §2603(1); Official Comment 3 to UCC §2-603. Thus, if the seller gives instructions for the disposition of the goods but does not furnish indemnity for expenses after the buyer requests assurance of indemnity, the seller's instructions are regarded as not reasonable and need not be followed. This suggests that the buyer need not make expenditures on behalf of the seller in returning the goods.

The Commercial Code does not specifically authorize the buyer to demand compensation for its services as a condition to its following the seller's instructions. If the seller does not give instructions or the instructions are not reasonable, but the buyer nevertheless disposes of the goods, the buyer is entitled to reimbursement from the seller or out of the proceeds of the sale for reasonable expenses of caring for and selling the goods. Com C §2603(2). If the expenses of the sale include no selling commission paid to a third party, the buyer is entitled to a commission that is usual in the trade, or, if there is none, to a reasonable sum not exceeding 10 percent on the gross proceeds. Com C §2603(2).

A buyer that fails to sell despite a duty to do so can be held liable for damages under the general remedies provision of Com C §1305(b). Official Comment 5 to UCC §2-603. The damages would be the difference between the amount that the seller would have realized had the buyer fulfilled its duty and the proceeds that the seller actually obtains from a later sale of the goods. Com C §1305(a). If the goods have perished because of the buyer's failure to sell, the damages will be the amount that the seller would have realized had the buyer sold the goods in a timely fashion. See, *e.g., Allied Grape Growers v Bronco Wine Co.* (1988) 203 CA3d 432, 445, 249 CR 872 (seller entitled to difference between contract price and resale price after buyer's repudiation of grape sales contract).

The reselling buyer operating without the benefit of the seller's instructions is held only to the mercantile standard of good faith, which means both honesty in fact and observance of reasonable commercial standards of fair dealing. Com C §§1201(b)(20), 2603(3). Therefore, the buyer's reasonable decisions on the appropriateness and mechanics of the sale should ordinarily be accepted. The buyer should have at least the freedom given the aggrieved seller by Com C §2706. See Official Comment 2 to UCC §2-706 (Official Comment 4 to UCC §2-706 (2003)). If the seller has provided the buyer with instructions, the buyer can avoid liability by following those instructions.

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§10.48 E. Salvage

If rightfully rejected goods are not perishable and do not threaten to decline in value speedily, both merchant and nonmerchant buyers have the option to store, reship, or resell goods. Com C §2604. If the seller gives no instructions within a reasonable time after notification of rejection, the buyer may store the rejected goods for the seller's account or reship them to him or resell them for the seller's account with reimbursement as provided in Com C §2603(2). Com C §2604. Such action is not acceptance or conversion. According to Official Comment to UCC §2-604, Com C §2604 is designed to accord all reasonable leeway to a rightfully rejecting buyer acting in good faith.

The legislature intended Com C §2604 to protect the buyer if it takes reasonable action in good faith with respect to rightfully rejected goods. Under pre-Code law, the buyer ran the risk of accepting or converting the goods if almost any action was taken toward them. This discouraged the buyer from acts of salvage that might have reduced the seller's loss. See Official Comment to UCC §2-604.

Note that the buyer's right to act under Com C §2604 is conditioned on three circumstances: (1) The goods are nonconforming; (2) the buyer duly notified the seller of its rejection; and (3) the seller failed to give the buyer instructions for disposing of the goods. When the transaction has reached the point at which all three circumstances are present, the buyer should be allowed significant latitude in dealing with the goods, because the seller has not acted to preserve any interest it may have in the goods. However, destruction of rightfully rejected goods, even when they are nonconforming, likely exceeds this latitude. See *Whitaker's Inc. v C.B.C. Enters., Inc.* (ED Va 1993) 820 F Supp 242. But see *Home Shopping Club, Inc. v Ohio Int'l Ltd.* (Fla Cir Ct 1994) 27 UCC Rep Serv 2d 433 (destruction of nonconforming and unsafe goods seven months after rejection was not unreasonable).

The buyer has a security interest in goods rightfully rejected for any expenses reasonably incurred in dealing with the goods. Com C §2711(3). If these expenses exceed the proceeds from disposition of the goods, the buyer may look to the seller for reimbursement under the general damages provisions of the Commercial Code. Com C §§2711(1)(b), 2713(1), 2715(1).

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§10.49 F. Right to Use Goods After Rejection

After the buyer has rejected the goods, any exercise of ownership by the buyer over any commercial unit is wrongful as against the seller. Com C §2602(2)(a). If the buyer acts as though it owns the goods after it has rejected them, it subjects itself to probable liability for either the contract price or conversion damages, at the seller's option. See *Computerized Radiological Servs. v Syntex Corp.* (2d Cir 1986) 786 F2d 72 (applying California law). The force of this result may be dampened by the fact that Com C §2602(2)(a) operates on "commercial units," with the result that a wrongful act confined to a commercial unit will not result in acceptance or conversion of other units in the same delivery.

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§10.50 1. Title After Rejection

Rejection of the goods, whether justified or not, revests title in the seller. Com C §2401(4). Revesting of title following rejection has no consequences under the Commercial Code; Com C §2401(4) is included to accommodate bodies of law (*e.g.,* sales taxation) that rely on title concepts for their operation. For example, a seller hoping to reduce its exposure to environmental liability may wish to establish the passage of title to the buyer at the earliest possible moment.

DRAFTING CONSIDERATIONS: Under these circumstances, the seller may attempt to negotiate a contractual provision that conditions the buyer's right to obtain a refund or replacement of defective goods on the buyer's proper disposal of the goods, such as the following (25 UCC LJ 49 at 55):

> **The seller shall not be obligated to provide a refund or furnish a like quantity of conforming goods unless the buyer provides documentation of the proper disposal of the goods claimed to be defective, concerning which disposal the buyer shall indemnify the seller against any liability however incurred.**

If, however, the buyer hopes to ensure that title revests in the seller as early as possible (for purposes other than the Commercial Code), it may wish to negotiate a provision such as the following (25 UCC LJ at 58):

> **If the goods are nonconforming, the seller shall continue to bear risk of loss as to them until cure of the defect or acceptance. Title to any goods that are rejected on receipt or retention of which is refused by the buyer, or acceptance of which is justifiably revoked, shall revest in the seller, whereupon the seller shall bear all responsibility for the goods and liability under all applicable environmental laws, including liability for disposal of the goods, against which the seller shall indemnify the buyer.**

Because the buyer need only effect a rejection or "other refusal" to receive or retain the goods, whether or not justified in order to revest title in the seller, Com C §2401(4) may help the buyer ensure early revesting of title for noncommercial purposes.

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§10.51 2. Sale on Approval and Sale or Return Contracts

Special rules apply to the disposition of rejected goods in "sale on approval" and "sale or return" contracts. Com C §2326(1). These are contracts that give the buyer the right to return goods even though they conform to the contract. A transaction is a sale on approval if the goods are delivered primarily for the buyer's use. Com C §2326(1)(a). A transaction is a sale or return if the goods are delivered primarily for resale. Com C §2326(1)(b).

In a sale on approval, the buyer can avoid further liability under the contract by giving the seller notice of its election to return the goods. Return of the goods is then carried out at the seller's risk and expense. Com C §2327(1)(c); Official Comment 4 to UCC §2-327. In a sale or return contract, the buyer must return the goods to the seller at the buyer's own risk and expense and do so seasonably. Com C §2327(2); Official Comment 4 to UCC §2-327.

In either case, the parties are free to agree that the buyer will dispose of the goods in some other way or will follow disposition instructions sent by the seller on request. As in other sales, a merchant buyer must follow the seller's reasonable instructions concerning disposition of the goods. See Com C §2603. See also §10.47.

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§10.52 VI. PAYMENT

The discussion in §§10.53-10.71 addresses performance aspects of making payment at the proper time and place. It assumes that the parties have agreed on a time and place for payment or that, absent such an agreement, these provisions have been inserted into the contract by the "open payment" provisions of the Commercial Code (see Com C §2305).

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A. Tender of Payment

§10.53 1. Tender of Payment as Condition to Seller's Obligations

Tender of payment is a condition to the seller's duty to tender and complete any delivery, unless otherwise agreed. Com C §2511(1). The requirement of payment against delivery, however, is applicable to noncommercial sales generally and to ordinary sales at retail although it has no application to the great body of commercial contracts that carry credit terms. Official Comment 1 to UCC §2-511.

Provisions in Commercial Code Division 2 dealing with time and manner of payment under specified circumstances include:

- Com C §2310 (open time for payment or running of credit; shipment under reservation);
- Com C §2319(4) (payment under F.O.B. or F.A.S. terms);
- Com C §2320(4) (payment under C.I.F. or C. & F. terms);
- Com C §2511 (payment by a check that is conditional);
- Com C §2512 (payment before inspection);
- Com C §2514 (delivery of documents on payment); and
- Com C §2614(2) (failure of payment because of foreign government regulation).

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§10.54 2. Manner of Tendering Payment

In the usual formal tender, the buyer demands that the seller tender delivery of the goods, and the buyer tenders payment in exchange for their release. If the seller demands cash, the seller must give the buyer an extension of time reasonably necessary to procure it; otherwise (subject to agreement), tender of payment may be by any means, or in any manner, current in the ordinary course of business. Com C §2511(2).

A formal tender is not required, however, if a tender of payment would clearly be a futile gesture. The buyer's offer to pay in exchange for delivery is effective to put the seller in default if the seller fails to deliver. See, *e.g., Fronings, Inc. v Johnston Feed Serv.* (8th Cir 1978) 568 F2d 108. On the sufficiency of various methods of tender, see §§9.44-9.50.

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§10.55 3. Agreement on Method of Payment

If the parties have expressly agreed on a manner of payment, tender of payment in some other way may not be sufficient. In *Garcia v Berman* (1943) 62 CA2d 112, 144 P2d 55, a buyer who paid by personal check rather than certified check, as required by the contract, was held to have waived strict performance of the contract by the seller. This result is consistent with the Commercial Code; because Com C §2511(2) may be modified by agreement, the parties may specify a particular means of payment. See Com C §1302(a).

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B. Payment Before Inspection

§10.56 1. When Required

In documentary transactions (including sales under F.O.B. vessel, F.A.S. vessel, C.I.F., or C. & F. terms (see Com C §§2319(1)-(2), 2320(1); see also §§9.21-9.38, 10.13)), it is presumed, subject to contrary agreement, that the seller will tender documents and the buyer will pay before inspection of the goods. Com C §§2310(c), 2319(4), 2320(4). In a variation on C.I.F. and C. & F. terms, if the contract provides for payment on arrival, the buyer may make a preliminary inspection before payment, if one is feasible. Com C §2321(3).

In all other shipment contracts, the seller may ship under reservation unless the parties have otherwise agreed. If the seller does so, the buyer may inspect the goods before making payment, unless the contract terms call for payment against documents. Com C §§2310(b), 2513(3)(b).

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§10.57 2. Effect on Buyer's Right to Inspect

By consenting to a C.O.D. term or to certain documentary transactions, the buyer may agree to pay before inspection. Com C §2513(3). See §10.56. By making payment under these circumstances, the buyer usually does not accept the goods, impair its right to inspect the goods, or lose any of its remedies. Com C §2512(2); Official Comments 5-6 to UCC §2-512.

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§10.58 3. Refusal to Pay for Obviously Nonconforming Goods

If the contract has a C.O.D. term or creates a documentary transaction, the seller is usually entitled to payment before inspection even though the goods are nonconforming (unless the nonconformity appears without inspection). Com C §§2512(1), 2513. See §10.13. Risks that the seller would normally bear are thus shifted to the buyer. Official Comment 1 to UCC §2-512.

If the buyer somehow learns before inspection that the goods are nonconforming, however, Com C §2512 does not apply. Com C §2512(1)(a). Such a nonconformity may be obvious from the goods themselves or from the surrounding circumstances. For example, the delivery may be late, a short weight may appear from routine weighing before unloading, or the boxes or shipping cartons containing the goods may be broken or damaged. Such simple physical observation by the buyer does not constitute inspection. See Official Comment 2 to UCC §2-512.

When the buyer does not pay in such a situation, the seller will be unable to compel payment. See Com C §2709. A seller's suit for damages for breach of contract would be fruitless even though the buyer has not paid, because the buyer retains its right to inspect following payment and, if the goods are nonconforming, to recover damages for the nonconformity. Com C §2512(2).

A buyer also can be excused from making payment against documents if, despite the tender of the required documents, the circumstances would justify injunction against honor under Com C §5109(b). Com C §2512(1)(b). Commercial Code §5109(b) allows a court to enjoin the honor of presentation of documents that appear regular on their face but are subject to claims that they are forgeries, materially fraudulent, or that honoring the presentation would facilitate a material fraud.

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C. Payment by Various Means

1. Payment by Check

§10.59 a. Sufficiency of Tender

Tender of payment is sufficient when made by any means or in any manner current in the ordinary course of business, unless the seller demands payment in legal tender and gives any extension of time to the buyer reasonably necessary to procure it. Com C §2511(2).

Official Comment 4 to UCC §2-511 recognizes that payment by check is a "commercially normal and proper" method of payment. Widespread use of checks in commercial transactions has led the courts to recognize that a tender by check is sufficient unless the seller objects when the tender is made. See, *e.g., Debruyn Produce Co. v Richmond Produce Co.* (*In re Richmond Produce Co.)* (Bankr ND Cal 1990) 112 BR 364, 375 n2. However, payment by money order may not be sufficient because it does not necessarily constitute an unconditional promise or order to pay a sum certain of money. *General Motors Acceptance Corp. v Breault* (NY Sup Ct 1994) 23 UCC Rep Serv 2d 1158 (public office money certificate a "conditional" promise to pay).

Recognizing that the demands for payment in legal tender are so unusual that few buyers would be prepared to meet them without advance warning, the Commercial Code in effect gives the buyer a right to cure. See Official Comment 3 to UCC §2-511. A seller that makes a demand for cash is probably seeking to force a breach, an objective that Com C §2511(2) properly thwarts. See, *e.g., Chrysler Credit Corp. v Barnes* (Ga Ct App 1972) 191 SE2d 121. If a seller wants cash because of the buyer's threatened insolvency, for example, the seller should have no objection to holding the goods and extending the buyer's time to obtain the cash.

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§10.60 b. Payment by Subsequently Dishonored Check

Payment by check "is conditional and is defeated as between the parties by dishonor of the check on due presentment." Com C §2511(3). Thus, if a buyer gives a check that is subsequently dishonored, the buyer may not retain or dispose of the goods. Com C §2507(2). Although Com C §2507(2) gives no explicit remedy for dishonor, a seller paid by a dishonored check can ordinarily repossess its goods from the buyer. *Citizens Bank v Taggart* (1983) 143 CA3d 318, 191 CR 729.

If the instrument is dishonored, the seller may sue on either the dishonored instrument or the contract of sale if the seller has possession of the instrument and is the person entitled to enforce it. Com C §3310(b)(3); Official Comment 3 to UCC §3-310.

If the right to enforce the instrument is held by someone other than the seller, the seller cannot enforce the right to payment of the price under the sales contract, because that right is represented by the instrument, which is enforceable by someone else. Com C §3310(b)(4); Official Comment 3 to UCC §3-310. See also Official Comment 6 to UCC §2-511.

A good faith purchaser from the buyer that gives value for the goods prevails over a seller that receives a bad check for the goods. Com C §2403(1)(b). An attaching creditor of the buyer does not prevail, however, over a seller that receives a bad check in payment in a "sale on approval" (see §10.15). Com C §2326(2); *Citizens Bank v Taggart, supra* (seller, paid with bad check, was able to recover automobile seized by judgment creditor of buyer).

The result is different, however, if the goods are sold to the buyer on a "sale or return" basis and the seller is paid with a dishonored check. Com C §2326(2)-(3). See *Minor v Stevenson* (1991) 227 CA3d 1613, 278 CR 558, in which a dealer had bought a car for resale but stopped payment on the check that he gave the owner. A creditor levied on the car and prevailed over the owner. The court found that this was a sale or return and therefore that Com C §2326 controlled rather than Com C §2511, even though the car was not returnable by the dealer. On rights of buyer's creditors in sale or return transactions generally, see §12.55.

PRACTICE TIP: The result in this case could have been avoided had the owner filed a financing statement covering the car. Com C §2326(3)(c); *Minor v Stevenson* (1991) 227 CA3d 1613, 1621, 278 CR 558.

If payment is made by postdated check and the rights of third persons have not intervened, the seller's rights on dishonor are the same as though the check were a payment rather than a credit instrument. Official Comment 6 to UCC §2-511. As far as third persons are concerned, however, the Comment suggests that the transaction be treated as a sale on credit. In that case, the seller's rights to the goods when the check is dishonored are governed by Com C §2403(1)(b) and, if the buyer is insolvent, Com C §2702.

On payment by check and the consequences of dishonor, see 4 Witkin, Summary of California Law, *Sales* §§155-156 (10th ed 2005).

NOTE: In *Charles v Lundgren & Assocs.* (9th Cir 1997) 119 F3d 739, the Ninth Circuit Court of Appeals held that the Fair Debt Collection Practices Act (15 USC §§1692-1692p) applies to collection of a dishonored check used as payment by a consumer for personal, family, or household purposes. 15 USC §1692a(5).

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§10.61 2. Payment by Letter of Credit

A sales transaction in which payment is to be made by letter of credit rests on three contracts in what might be described as a triangular arrangement. The first is the contract for the sale of goods between the seller and buyer. The second, a separate agreement best described as a contract of reimbursement, is between the buyer and the issuer of the letter of credit (often a bank), in which the buyer (the bank's "customer") agrees to pay the issuer the amount paid by the issuer under the letter of credit, plus charges, and the issuer agrees to issue a letter of credit to the seller. The third is the letter of credit issued by the issuer in favor of the seller (the "beneficiary"), in which the issuer obligates itself to pay the seller on a proper presentation of documents. See Com C §5108(a), (f)(1).

If the issuer does not honor the draft or other demand for payment properly presented under the letter of credit, the seller may sue directly on the letter of credit, which is the primary obligation of the issuer. The seller must comply *strictly* with the terms of the credit; if the seller deviates from the terms, even though its performance amounts to substantial performance under Com C §2612 or constitutes a legitimate substitute delivery under Com C §2614 insofar as the contract of sale is concerned, the seller will not be entitled to payment under the letter of credit. Com C §5108. See Official Comment 1 to UCC §5-108. Strict compliance is determined with reference to the "standard practice" of financial institutions that regularly issue letters of credit. Com C §5108(a). It does not mean slavish conformity to the letter of credit's terms. See, *e.g.*, *New Braunfels Nat'l Bank v Odiorne* (Tex Ct App 1989) 780 SW2d 313, 316 (beneficiary could collect when draft requested payment on "Letter of Credit No. 86-122-5" and letter of credit specified "Letter of Credit No. 86-122-S," holding strict compliance does not demand oppressive perfectionism).

If the contract provides for payment by letter of credit, and the buyer fails to furnish the letter of credit seasonably, the buyer is in breach of the sales agreement. ("Seasonably" means "at or within the time agreed or if no time is agreed at or within a reasonable time." Com C §1205(b).) If the buyer delivers a proper letter of credit to the seller, the buyer's obligation to pay is suspended but not extinguished; if the letter of credit is not honored after the seller delivers the conforming goods, the seller may look directly to the buyer for payment after giving seasonable notice of dishonor. Com C §2325(2). See Official Comment 1 to UCC §2-325 (Official Comment 2 to UCC §2-325 (2003)). In this way, the risk of the issuer's insolvency remains with the buyer.

If the sales contract provides that payment must be by "letter of credit" or "banker's credit," the terms are presumed to mean (unless otherwise agreed) an irrevocable credit issued by a financing agency of good repute and, if the shipment is overseas, of good international repute. Com C §2325(3); Official Comment 2 to UCC §2-325. If the contract of sale provides for a "confirmed credit," the seller is entitled to a direct obligation ("confirmation") from a bank or other financing agency of good repute doing business in the seller's financial market. Com C §2325(3). This could be the buyer's own bank. See Official Comment 3 to UCC §2-325. For further discussion of letters of credit, see chap 13.

PRACTICE TIP: The Commercial Code rules on letters of credit (Division 5, revised effective January 1, 1997) and documents of title (Division 7) overlap the documentary sale transaction rules and must be taken into account. The attorney should also consult ICC Uniform Customs and Practices for Documentary Credits: UCP 600 (rev ed 2007). A copy of this publication of the International Chamber of Commerce can be obtained from the ICC Publishing Corp., 1212 Avenue of the Americas, New York, NY 10036. The 2007 revision of this 2006 publication is ICC Publication No. 681E. The URL for the ICC's website is http://www.iccbooks.com/Product/intbanking.aspx. A letter of credit may state that it is subject to the provisions of UCP 600, and, if it does, UCP 600 will control any inconsistencies between the UCC and UCP 600. Com C §5116(c).

DRAFTING CONSIDERATIONS: Because the seller must strictly comply with the terms of the credit, the letter of credit should be simple and internally consistent but explicit concerning its key elements (*e.g.,* the nature and content of required documents, the amount, the expiration date, transferability, and the right to make partial draws).

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§10.62 3. Payment by Credit Card

Tender of payment by credit card is probably not a sufficient tender unless payment by credit card is "current in the ordinary course of business." Com C §2511(2). Although this is true in many consumer transactions, it is not in most commercial ones.

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§10.63 4. Barter Transactions

The price can be made payable in money or otherwise. If it is payable in whole or in part in goods, each party is a seller of the goods that each is to transfer. Com C §2304(1). Thus, if either party fails to transfer goods in accordance with its contract obligation, the other party has the remedies of an aggrieved buyer. See *Commonwealth Edison Co. v Allied Chem. Nuclear Prods.* (ND Ill 1988) 684 F Supp 1429.

DRAFTING CONSIDERATIONS: To avoid confusion, contracts for barter transactions should identify the parties by name rather than by the generic descriptions "buyer" and "seller."

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§10.64 5. Payment in Realty

Under Com C §2304(2), if the price of the goods is to be paid wholly or partially through a conveyance of real property, the transfer of the goods and the seller's obligations with reference to them are subject to the Commercial Code. The transfer of the interest in realty or the transferor's obligations in connection with it, however, are not subject to the Commercial Code.

Thus, the Commercial Code applies to the transfer of the goods but defers to local real property law for the realty conveyance. But see Official Comment 3 to UCC §2-304, which indicates that the complexities of these situations may be such that each situation must be analyzed in the light of the underlying reasons in order to determine the applicable principles.

Commercial Code §2304(2) may present difficult administrative problems when mixed realty and personalty are conveyed as part of a single transaction. If, for example, the "price" in an oral commodity purchase is the transfer of a business, including both real and personal property, the transfer of the realty may be unenforceable, while transfer of the personalty is enforceable under the Commercial Code's liberalized statute of frauds (Com C §2201). In such a situation, damages based on personalty alone would probably be inadequate, because the value of the personalty without the realty is unlikely to reflect the value of the whole as a going concern.

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§10.65 6. Payment in Foreign Currency

If a contract provides for payment in foreign currency, the question arises whether, in calculating damages after breach, the court should apply the exchange rate prevailing on the date of the breach or on the date on which judgment is rendered. Under California law, the choice between the date of breach and the date of judgment is made according to the jurisdiction in which the plaintiff's cause of action or the defendant's obligation arose. *Pecaflor Constr. v Landes* (1988) 198 CA3d 342, 243 CR 605.

If the obligation arose entirely under foreign law, the judgment-day rule applies, and damages incurred in foreign currency are converted into dollars at the rate prevailing on the date of final judgment. If the plaintiff has a cause of action under American law, however, the breach-day rule applies, and the applicable rate is the prevailing rate when the cause of action arose. *Levi Strauss & Co. v Aetna Cas. & Sur. Co.* (1986) 184 CA3d 1479, 1487, 237 CR 473.

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§10.66 7. Failure of Means of Payment Because of Government Regulation

Domestic or foreign government regulation such as changes in exchange rates, restrictions on currency exchanges, or price controls may result in failure of the agreed-on means of payment. When this happens, the seller can withhold or stop delivery unless the buyer provides a means or manner of payment that is a commercially substantial equivalent. Com C §2614(2). If the buyer has already taken delivery of the goods, however, payment by the means or in the manner provided by the regulation discharges the buyer's obligation unless the regulation is discriminatory, oppressive, or predatory. Com C §2614(2).

The basic scheme of this section is to permit the seller to keep the goods if they are still within its control, unless the buyer furnishes payment that is the substantial commercial equivalent of what was bargained for by the seller. If the seller has delivered the goods, it is bound by the government regulation and must accept the devalued currency, payment in frozen funds, or the like in discharge of the buyer's contractual obligation, unless the regulation is "discriminatory, oppressive or predatory." Com C §2614(2). The Commercial Code does not elaborate on the nature of regulations that would qualify under these terms.

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D. Effect of Payment and Nonpayment

§10.67 1. Effect on Rights in Goods

As against a seller that is entitled to and demands payment on delivery, a buyer has a right to retain or dispose of goods only if it pays for them. Com C §2507(2). The unpaid seller can repossess the affected goods. See *Citizens Bank v Taggart* (1983) 143 CA3d 318, 191 CR 729. An unpaid seller's rights are inferior to the rights of a good faith purchaser from a buyer that gives value for the goods. Com C §2403(1). See *Citizens Bank v Taggart, supra*. See also §10.60.

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§10.68 2. Effect on Seller's Performance

A buyer that fails to make a payment due on or before delivery of a particular shipment is in breach with respect to the goods affected, and the seller may resort to its remedies. Com C §2703. For remedies, see chap 17.

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§10.69 3. Effect on Buyer's Remedies

Payment for goods delivered under a sales contract is evidence of acceptance but does not by itself constitute acceptance. Official Comment 3 to UCC §2-606. If the goods are not delivered, are rightfully rejected, or are accepted but the acceptance is later rightfully revoked, the buyer can recover any payment made and exercise its other remedies. Com C §2711. Further, if the buyer accepts, retains, and pays for the goods but the goods are defective, the buyer may give notice of breach and sue for damages. Com C §2714.

If the buyer pays on presentation of documents and does not make an express reservation of rights, the buyer waives its right to recover payment for defects apparent in the documents. Com C §2605(2). Note that payment without reservation constitutes an absolute acceptance of the documents only; the buyer's remedies for defects in the goods are not impaired. Official Comment 4 to UCC §2-605; Official Comment 5 to UCC §2-512.

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E. Payment Under Installment Contracts

§10.70 1. Defaulted Payments

Under an installment delivery contract in which payment is due on or before delivery (by agreement or under Com C §2307), the buyer's failure to pay for a particular installment entitles the seller to resort to its remedies regarding the affected goods. Com C §2703. If the buyer defaults on payment for an installment, the key issue is whether the buyer's breach substantially impairs the value of the whole contract and thus excuses the seller from all future performance (Com C §2612(3)) or whether the seller must continue making deliveries and pursue its action (Com C §2709(1)(a)) for the unpaid installment.

If the buyer's default in payment for one or more installments "substantially impairs" the value of the whole contract to the seller, the entire contract has been breached. Com C §§2612(3), 2703. It is not readily discernible from either the Commercial Code or the Comments which circumstances constitute substantial impairment. Nonpayment for an installment might impair the value of a contract either by creating financial difficulties for the seller or by giving the seller reasonable apprehension that the buyer will fail to make future payments. The merely apprehensive seller is permitted to demand assurance of performance. Com C §2609. See Official Comment 6 to UCC §2-612. See also §§16.2-16.18.

Substantial impairment of the entire contract should certainly result if nonpayment of an installment creates financial difficulties for the seller. For example, if the seller has pledged the contract as security for a loan, nonpayment of an installment may result in financial difficulties for the seller and therefore substantially impair the entire contract. Even if the seller is confident that the buyer will eventually pay and in the meantime is caused no financial difficulties, nonpayment of an installment might substantially impair the value of the entire contract. For example, as a consequence of the nonpayment, the seller may be unable to assign the contract for financing, particularly when the seller's continued performance requires such financing. The substantiality of the impairment of the contract presumably is judged according to the seller's own circumstances or at least those within the contemplation of the parties when the contract was made.

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§10.71 2. Late Payments

The seller's acceptance of late payments from an installment buyer has several effects. Com C §2612(3). If the seller accepts a late payment without notifying the buyer of cancellation, brings an action on past installments only, or demands future performance only, the seller reinstates the contract even if the buyer's late payment amounted to a breach of the whole contract. The seller's acquiescence in the buyer's "course of performance" may also be regarded as either a waiver or a modification of the contract. Com C §1303(f). The seller may not suddenly declare the buyer to be in breach for failure to make timely payments when the seller has until then been accepting late payments under the contract. If the seller accepted late payments or delivered installments under a previous contract, the same result would be reached by application of the Commercial Code's "course of dealing" rule. See generally Com C §1303.

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11

Assignment of Rights and Delegation of Duties

David V. Otterson

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I. DEFINITIONS AND DISTINCTIONS

§11.1 A. Assignment and Delegation

Commercial Code §2210 discusses assignment and delegation. This section of the Code is not intended to be comprehensive, however; it covers only some of the problems arising from assignments and delegations of contracts for the sale of goods. See Official Comment 7 to UCC §2-210. Other sections of the Code, other statutes, and case law govern other problems arising from assignments and delegations and from contracts other than those for the sale of goods. See §11.4.

The Code does not define either "assignment" or "delegation," but definitions of these terms can be found in Restatement (Second) of Contracts §316, Comment (c) (1981), which defines assignment as the transfer of a right by the owner (the obligee or assignor) to another person (the assignee). Delegation of performance may be effective to empower a substitute to perform on behalf of the obligor. The obligor, however, remains subject to the duty until it has been discharged by performance or otherwise.

Remedies, with or without resort to a tribunal (*i.e.,* self-help), fall within the Code's definition of "rights" (Com C §1201(b)(32), (34)) and therefore can be assigned.

The Code designates parties to both assignments and delegations either as the "assignor" or the "assignee." See Com C §2210(5). For the sake of clarity and consistency, the discussion that follows adopts these labels and refers to the other party to the original contract as the "nonassigning party" (when rights are assigned) or the "nondelegating party" (when duties are delegated).

Many attorneys fail to address the distinction between the assignment of rights under the contract and the delegation of duties under the contract. The Code sharply differentiates these concepts, prescribing the circumstances under which each is permitted or prohibited and describing the legal effects of each:

- Generally, contracts are freely assignable. Com C §2210(2); Official Comment 1 to UCC §2-210 (Official Comment 2 to UCC §2-210 (2003)). See §11.5.
- An assignment transfers rights to the assignee and away from the assignor. A delegation transfers duties to the assignee, but the assignee and assignor both remain liable. Com C §2210(1). See §§11.9, 11.19-11.22.
- All delegations, but not all assignments, can be prohibited by agreement. Com C §2210(1). See §§11.10-11.11, 11.23.
- An assignment of "the contract" or "all of the rights in the contract" generally constitutes a delegation of performance, and the assignee's acceptance constitutes its agreement to perform the delegated duties. Com C §2210(5). See §11.17.
- A prohibition on "assignment" of a contract is a prohibition of delegation only, unless the context indicates otherwise. Com C §2210(4). See §§11.10, 11.23.
- A delegation, but not an assignment, specifically gives the nondelegating party the right to require assurances. Com C §2210(6). The demand does not result in a novation. Unless the nondelegating party receives assurances within a reasonable time after demand, not exceeding 30 days, that party can treat the contract as repudiated. Com C §2609(4) (allowing nondelegating parties to escape from the original agreement or renegotiate it if assurances are not provided). See §§11.20, 16.2-16.18.

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§11.2 B. Financing Assignments Governed by Division 9

A financing assignment is the discounted sale (assignment) to a bank or other financial institution (the assignee) of a seller's rights to payment under a sales contract and carries no delegation of duties to the assignee, even if the assignment is not technically "security" for a loan or other separate obligation. Com C §2210(4); Official Comment 5 to UCC §2-210; *Black v Sullivan* (1975) 48 CA3d 557, 564, 122 CR 119.

Financing assignments are subject to Division 9 of the Commercial Code and particularly to Com C §§9406(d) and 9408, which restrain the nonassigning party from prohibiting financing assignments. See Com C §2210(2)-(3). This policy further protects the financing assignee by taking financing assignments out of the realm of Com C §2210(2), the Code provision that allows parties to agree to prohibit all assignments and prohibits any assignment that would materially increase the risk to the nonassigning party. See §11.14.

The nonassigning party can protect against claims by the assignee by inserting in the contract a provision for withholding part of the purchase price until satisfactory completion of the stated performance.

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§11.3 C. Novation

Related to assignment and delegation is novation. A novation is a substitution by agreement of a new obligation for an existing one with intent to extinguish the latter agreement. *Davies Mach. Co. v Pine Mountain Club, Inc*. (1974) 39 CA3d 18, 24, 113 CR 784; CC §1530. A novation can change the duties of a party or substitute new parties that become liable for performance or entitled to rights. CC §1532. A novation may be established by express consent or by the conduct of the nonassigning party. *Tarter v MonArk Boat Co*. (ED Mo 1977) 430 F Supp 1290, 1293, aff'd (8th Cir 1978) 574 F2d 984. The intent to create a novation must clearly appear for it to be enforceable as such; a new payment arrangement, without more, is insufficient to establish a novation. *Davies Mach. Co. v Pine Mountain Club, Inc., supra*; *Hunt v Smyth* (1972) 25 CA3d 807, 819, 101 CR 4.

PRACTICE TIP: An assignor generally prefers a novation to an assignment, because a novation (but not an assignment) relieves the assignor of continuing liability. Conversely, the nonassigning party should be aware that agreeing to the novation reduces the number of parties that the nonassigning party can look to for performance.

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Source: Business Law/California UCC Sales and Leases/11 Assignment of Rights and Delegation of Duties/§11.4 D. Limited Scope of Com C §2210

§11.4 D. Limited Scope of Com C §2210

The Commercial Code addresses only certain aspects of the assignment of rights and the delegation of duties under a contract. Problems not covered by Com C §2210 include:

- Partial assignments, which may or may not be permissible under the Code. See §11.5.
- The requirements, if any, of a notice of assignment to the nonassigning party and application against the assignee of the nonassigning party's defenses against the assignor. See Official Comment 7 to UCC §2-210; CC §§955-955.1, 1459.
- Rights of successive assignees. Official Comment 7 to UCC §2-210. See CC §955.1.
- Formal aspects of assignments. Official Comment 7 to UCC §2-210. See 1 Witkin, Summary, *Contracts* §709.
- Assignments for the benefit of creditors. See CCP §§493.010-493.060; 1 Witkin, Summary, *Contracts* §710-711.
- Defenses between the parties. See 1 Witkin, Summary, *Contracts* §§735-736.

Some gaps in the Code relating to assignments of accounts unaccompanied by a delegation of performance are filled by provisions of Division 9 of the Code (Secured Transactions). See generally Secured Transactions in California Commercial Law Practice (2d ed Cal CEB 2001).

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II. ASSIGNMENT OF RIGHTS

§11.5 A. Principles of Assignment

All contract rights may be assigned unless (Com C §2210(2)):

- The parties expressly agree to prohibit the assignment (see §§11.10-11.11); or
- The assignment would materially and adversely affect the nonassigning party (see §11.14).

Doubts regarding assignments are resolved in favor of permitting them.

Because enforceability of partial assignments is not addressed in Com C §2210, it is governed by non-Code law. See Com C §1103(b). A partial assignee cannot enforce its own claim separately; the nonassigning party can object to being exposed to multiple suits on the same claim. The partial assignee can enforce the claim against the nonassigning party by joining the assignor and any other partial assignees as parties to the action. See 1 Witkin, Summary of California Law, *Contracts* §733 (10th ed 2005).

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§11.6 B. Scope of Assignment

When making an assignment for consideration, the assignor makes implied warranties under common law principles, such as the following:

- The assignor has the right to make the assignment;
- The assignor will not take any action that would interfere with the assigned right;
- The assigned right is valid and genuine, according to its terms;
- The assigned right exists and is not subject to any defenses other than those stated or apparent at the time of the assignment;
- The assignment is based on adequate and sufficient consideration;
- The right assigned was not procured by fraud or was not otherwise made invalid; and
- All evidence of the right provided to the assignee is genuine.

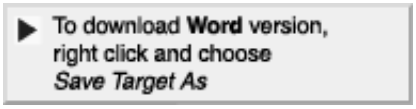
The purchase of a warranted product does not necessarily include an assignment of warranty rights regarding the product. *Gold'n Plump Poultry, Inc. v Simmons Eng'g Co*. (8th Cir 1986) 805 F2d 1312, 1316 (mere sale of product not assignment of warranty). Therefore, if the buyer of a product wants the right to enforce warranties, that right should be specifically assigned.

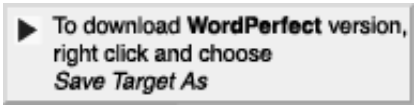
When drafting assignment documents, the attorney should consider and include related provisions, *e.g.,* how the terms of the assigned contract may be changed and how notices are to be given after assignment. The documents should also provide for giving the nonassigning party notice of the assignment, if appropriate. See Com C §9406(b).

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Source: Business Law/California UCC Sales and Leases/11 Assignment of Rights and Delegation of Duties/§11.7 1. Form: Assignment of Rights Excluding Delegation of Duties

§11.7 1. Form: Assignment of Rights Excluding Delegation of Duties





11.7-1 Assignment of rights excluding delegation of duties

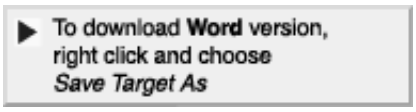
This assignment transfers the assignor's rights only and does not transfer the assignor's duties. The assignor will continue to perform its duties at the assignor's expense according to the terms of the assigned contract. The assignee does not undertake to perform any duties imposed on the assignor by the assigned contract.

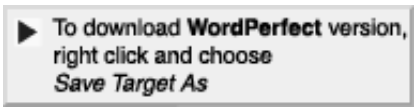
Comment: An assignment of "rights" includes an assignment of "remedies," with or without resort to a tribunal. See Com C §1201(b)(32), (34).

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Source: Business Law/California UCC Sales and Leases/11 Assignment of Rights and Delegation of Duties/§11.8 2. Form: Consent to Assignment of Rights

§11.8 2. Form: Consent to Assignment of Rights





11.8-1 Consent to assignment of rights

The undersigned, _ _[*name of consenting party*]_ _, agrees to the assignment by _ _[*name of assignor*]_ _ to _ _[*name of assignee*]_ _ of its rights to and under the agreement between _ _[*name of assignor*]_ _ and _ _[*name of nonassigning party*]_ _, dated _ _[*date of agreement*]_ _.

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§11.9 C. Effect of Assignment on Parties

After assignment, the assignee stands in the shoes of the assignor. *Collins Co. v Carboline Co*. (Ill 1988) 532 NE2d 834, 839. The assignee is entitled to all the assignor's rights assigned, whether or not the assignment is accompanied by a delegation. *Tarter v MonArk Boat Co*. (ED Mo 1977) 430 F Supp 1290, 1293, aff'd (8th Cir 1978) 574 F2d 984. The assignee takes subject to all burdens of the contract and all defenses that the nonassigning party had to the contract at the time of assignment. See *Melchior v New Line Prods., Inc.* (2003) 106 CA4th 779, 131 CR2d 347 (relying in part on CC §§1589, 3521); 1 Witkin, Summary of California Law, *Contracts* §735 (10th ed 2005).

An assignment that is prohibited by agreement (see §§11.10-11.11) or invalid because of its adverse material effect on the nonassigning party (see §11.14) does not affect the validity of the assignment as between the assignor and assignee if the nonassigning party chooses to honor it. Because these protections are for the benefit of the nonassigning party, they are enforceable only by the nonassigning party. See *Johnston v Landucci* (1942) 21 C2d 63, 130 P2d 405; 1 Witkin, Summary, *Contracts* §717. The assignee may have a cause of action against the assignor if the assignor breached any implied warranties. See §11.6. If the assignment is made without recourse, the assignee cannot go against the assignor for the nonassigning party's nonperformance.

An account debtor/nonassigning party can demand proof of the assignment before making payment to the assignee. If sufficient proof is not given, the nonassigning party is entitled to pay the assignor instead of the assignee. Com C §9406(c). The Ninth Circuit has ruled that the rights of a secured party/assignee under UCC §9-406 do not apply to an account debtor's agent. *Nationwide Transp. Fin. v Cass Info. Sys., Inc.* (9th Cir 2008) 523 F3d 1051.

But see CC §1804.2, relating to retail installment sales, which provides that the nonassigning party can raise all defenses against the assignee that could be raised against the assignor, except that, unless the parties agree otherwise, the assignee's liability is limited to the amount of the debt owed to the assignee at the time of the assignment. The assignee has recourse against the assignor for any liability incurred under this provision.

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D. Assignment Prohibited by Parties' Mutual Agreement

§11.10 1. Narrow Construction of Contractual Prohibition

Parties to sales contracts governed by the Commercial Code may limit or prohibit altogether their right to assign their contract rights, subject to certain restrictions. Com C §2210(2)-(4). Commercial Code §2210(4) narrowly construes contractual provisions restricting the right to assign, however, so that general prohibitions do not limit assignment. A prohibition of assignment of the contract is to be construed as barring only the delegation to the assignee of the assignor's performance, unless the circumstances indicate the contrary.

Circumstances could permit an assignment prohibition to be construed as covering some assignments of rights not specified by the parties. Com C §2210(4). To avoid ambiguities, the attorney should therefore be specific in identifying any rights that cannot be assigned.

Assignments of rights to something other than money can be freely prohibited; even an assignment of a contractual right to money can be prohibited by sufficiently explicit language, unless payment of money is all that remains to be done under contract. *Benton v Hofmann Plastering Co*. (1962) 207 CA2d 61, 66, 24 CR 268. See also 4 Witkin, Summary of California Law, *Sales* §42 (10th ed 2005).

If an agreement provides that an assignment can be made only with the consent of the nonassigning party, it is unclear whether that consent can be unreasonably withheld. Because of the requirement of good faith and fair dealing present in every contract (Com C §1304), the California Supreme Court might impose a reasonableness standard in a sales contract whenever one party has the right to grant or withhold its consent to an assignment. But see *Bergquist v Anderson-Greenwood Aviation Corp.* (*In re Bellanca Aircraft Corp.)* (8th Cir 1988) 850 F2d 1275, 1285, in which the court reasoned that because the Code expressly authorizes parties to a sales contract to prohibit assignment, the parties can allow consent to assignments to be unreasonably withheld. See also *Carma Developers, Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 6 CR2d 467.

PRACTICE TIP: A contractual clause stating that an agreement is binding on, and inures to the benefit of, the parties' successors and assigns could be interpreted as indirectly authorizing assignment. Therefore, such a clause should include a reference to a nonassignment clause, if appropriate.

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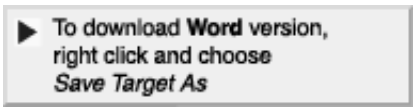
§11.11 2. Limitation on Power to Restrict Assignment

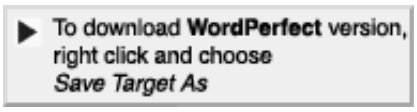
Parties cannot effectively prohibit assignment of a right to damages for breach of the whole contract or a right arising out of the assignor's due performance of the entire obligation. Com C §2210(2). A right arising out of the assignor's due (*i.e.,* proper) performance of its entire obligation could be a right to something other than money. For example, a buyer that has paid the entire price of goods could not be prohibited by agreement from assigning the right to receive delivery. *Benton v Hofmann Plastering Co*. (1962) 207 CA2d 61, 66, 24 CR 268, 274; 1 Witkin, Summary of California Law, *Contracts* §717 (10th ed 2005). If an assignor performs all obligations before making the assignment, there are no duties to be delegated and thus no issues regarding delegation. Official Comment 3 to UCC §2-210.

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Source: Business Law/California UCC Sales and Leases/11 Assignment of Rights and Delegation of Duties/§11.12 3. Form: Prohibition of Assignment of Rights

§11.12 3. Form: Prohibition of Assignment of Rights





11.12-1 Prohibition of assignment of rights

Each of the parties, with cognizance of California Commercial Code §2210(4), agrees that it will neither assign its rights nor delegate its duties under this agreement_ _[*./,*]_ _

[*Add if prohibition is not to be absolute*]

without the prior written consent of _ _[*name of other party*]_ _**, which** _ _[*may not be unreasonably withheld or delayed/may be withheld in the sole and absolute discretion of* _ _[*name of party*]_ _]_ _**.**

[*Continue*]

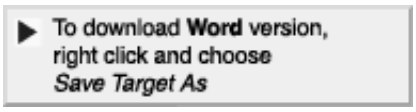
This prohibition of assignment and delegation extends to all assignments and delegations that may lawfully be prohibited by agreement. Any attempted assignment or delegation _ _[*without the consent of the other party*]_ _ **will be void.**

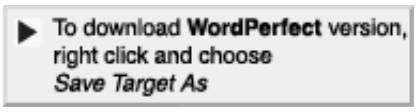
Comment: By referring to Com C §2210(4) and mentioning both assignment of rights and delegation of duties, this clause clearly states that the parties intend to prohibit both. On prohibition or restriction of delegation, see §§11.23-11.26. The last sentence makes any attempted assignment unenforceable. If this sentence were not included, a prohibited assignment could be enforceable and the nonassigning party's only recourse would be to pursue a cause of action against the assignor for breach of contract.

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Source: Business Law/California UCC Sales and Leases/11 Assignment of Rights and Delegation of Duties/§11.13 4. Form: Assignment Expressly Permitted

§11.13 4. Form: Assignment Expressly Permitted





11.13-1 Assignment expressly permitted

Each of the parties to this agreement may assign _ _[*describe assignable rights, e.g., all or part of its rights under this agreement*]**_ _.**

[*Add if there are conditions to assignment or requirements for an effective assignment*]

If any assignment is made, _ _[*specify conditions or requirements, e.g., consent from or notice to another party*]**_ _.**

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Source: Business Law/California UCC Sales and Leases/11 Assignment of Rights and Delegation of Duties/§11.14 E. Assignment Prohibited Due to Adverse Effect on Nonassigning Party

§11.14 E. Assignment Prohibited Due to Adverse Effect on Nonassigning Party

An assignment that has not been prohibited by agreement of the parties may nevertheless be unenforceable if it treats the nonassigning party unfairly by (Com C §2210(2)):

- Materially changing the nonassigning party's duty;
- Materially increasing the nonassigning party's burden or risk; or
- Materially impairing the nonassigning party's chance of obtaining return performance.

In most instances, an assignment that is prohibited because it would result in a material increase in the nonassigning party's burden or risk, or a material impairment of the nonassigning party's chance of obtaining return performance, is one that includes a delegation of performance. The assignment may be prohibited, however, even if there is no delegation of performance. For example, assignment of a buyer's right to delivery of goods without delegation of the duty of payment may have an adverse effect on the nonassigning party, but ordinarily a seller's assignment of rights to payment does not materially increase the nonassigning party's risk. See Official Comment 4 to UCC §2-210.

An assignment also may be precluded if the effect on the nonassigning party is material. For example, if the bargained-for performance that was assigned was uniquely within the capability of the assignor (*e.g.,* based on the assignor's unique skills, special offerings, or personality), such an assignment could change the essential terms of the contract. See, *e.g., The UCC and Contract Law: Some Selected Problems*, 105 U Pa L Rev 836 (1957) (location of buyer could increase seller's rights or burdens because of impairment of right to cure). See §11.26 for further discussion of delegation prohibited by the Commercial Code.

It may be difficult to prove a material effect on the nonassigning party because of the protections offered to the parties by the Code. Although rights under output, requirements, and exclusive dealing contracts entail personal discretion, these rights may be assignable. The good faith standards imposed on these contracts (Com C §2306(1)) and the nonassigning party's right to demand assurances from the assignee (Com C §2210(6)) protect the nonassigning party from a material change. See Official Comment 4 to UCC §2-210. Similarly, exclusive dealing contracts contain a "best efforts" requirement (Com C §2306(2)), and therefore an assignment will not necessarily result in a material change.

PRACTICE TIP: Even if assignment is not expressly prohibited under the terms of the agreement, an assignee should consider obtaining the nonassigning party's written consent to the assignment to protect against later claims that the assignment is unenforceable due to an alleged adverse effect on the nonassigning party.

A party can assign a right to damages for breach of the whole contract or a right arising out of the assignor's performance of its entire obligation, despite agreement to the contrary. Com C §2210(2). See §11.11. Generally, such a right can be assigned despite an assertion of increased burden on the nonassigning party.

DRAFTING CONSIDERATIONS: To ensure that an agreement will not be assigned, the parties should include a clause prohibiting assignment without written agreement rather than rely on a court to determine later that the assignments had a material effect on the nonassigning party. The clause should also recite why it is reasonable to prohibit assignment.

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§11.15 F. Waiver of Prohibition on Assignment

A prohibition against assignment is for the benefit of the nonassigning party and therefore is only enforceable by the nonassigning party. The prohibition, like any other contract clause, may be waived by the nonassigning party, whether the restrictions on assignability are based on the agreement of the parties (Com C §2210(1)) or on an adverse material effect on the nonassigning party (Com C §2210(2)). See CC §3513. The nonassigning party can also waive the restrictions on assignability imposed for its benefit. Com C §2210(2).

A waiver of the assignment prohibition is implied if the nonassigning party deals directly with the assignee. *Trubowitch v Riverbank Canning Co*. (1947) 30 C2d 335, 182 P2d 182. If the nonassigning party chooses to honor the assignment, the assignor cannot attack the assignment on the ground that it was contrary to assignment prohibitions. *Johnston v Landucci* (1942) 21 C2d 63, 130 P2d 405.

For discussion of waivers and retraction of waivers, see §§6.12-6.22.

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III. DELEGATION OF DUTIES

§11.16 A. Principles of Delegation

The Commercial Code favors the freedom of the parties to delegate performance. A party may perform his duty through a delegate unless (1) otherwise agreed or (2) the other party has a substantial interest in having his original promisor perform or control the acts required by the contract. Com C §2210(1).

This statute balances the policy of free alienability of contracts against the policy of protecting the nondelegating party's right to preserve the bargain it made. *Sally Beauty Co. v Nexxus Prods. Co*. (7th Cir 1986) 801 F2d 1001, 1006. Thus, the parties may agree to prohibit delegation (see §11.23), and some duties are not delegable even if the contract is silent on the issue (see §11.26).

Delegation may be permitted implicitly by circumstances, even in the absence of an agreement to delegate. A party that wants to have the right to delegate should establish or clarify the right to do so through a clause specifically permitting delegation, however, so that there is no later question of the enforceability of the delegation. See §11.25.

A party may want to have the right to subcontract a part of the work on the goods or a portion of the production, without retaining control over it; the parties may limit the permission accordingly. For partial prohibition of delegation clause, see form 11.24-1.

The nondelegating party has certain rights after delegation:

- The right to continue to look to the assignor for performance of the contract (Com C §2210(1));
- The right to look to the assignee for performance of the contract (Com C §2210(5)); and
- The right to demand assurances from the assignee without prejudice to any rights against the assignor (Com C §2210(6)).

See §§11.19-11.22.

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§11.17 B. Delegation Implied by Assignment

An assignment of "the contract" or all the assignor's "rights under the contract," or a similar assignment worded in general language, includes a delegation of duties, unless the parties specify to the contrary or the circumstances show that no delegation was intended. Com C §2210(5). The assignee may then be liable to the nondelegating party for performance, unless the instrument of assignment specifically excludes delegation. For a clause excluding delegation, see form 11.24-1.

The circumstances surrounding financing assignments preclude delegation. If an assignment is not clearly and purely "financing" in nature, however, an assignee runs a risk that delegation may be implied. See §11.2.

If delegation is not clearly excluded either in the instrument of assignment or because the assignment is unmistakably a financing assignment (see §11.2), it may be uncertain whether the parties intended to delegate performance. If the assignment is ambiguous, the parol evidence rule may come into play. See chap 7.

Factors that are examined to ascertain whether a delegation was intended include the following:

- **Is the assignee in the same kind of business as the assignor?** If the assignee is in the same line of business as the assignor, it is more likely that the parties intended delegation of performance under the contract. If the assignor is only a broker and has no manufacturing facilities, it is unreasonable to suppose that the assignor intended for the assignee to perform a manufacturing contract.
- **Are the provisions in the assignment document inconsistent with assignment alone or with delegation?** Specification of manufacturing details in the assignment or the reference to manufacturing details in the principal contract should be sufficient to show that the parties contemplated delegation. Any suggestion that the assignor would continue to perform (*e.g.,* a clause for notifying the assignee of completion of performance) implies that performance was not to be delegated.
- **Does the underlying contract permit delegation, permit assignment but forbid delegation, or remain silent on the subject?** The principal contract, although not controlling the rights of the assignor and assignee (see §11.22), may aid in construing the assignment document. For example, if the principal contract approved assignment but not delegation, the parties probably intended to assign rights but not to delegate duties.
- **Have the parties delegated duties in similar transactions, or is the contract a kind under which duties are customarily delegated in the trade?** Course of performance is applicable in construing a contract. Com C §1303.

PRACTICE TIP: The assignee of contract rights that does not intend to assume contractual duties should be certain that those duties are not inadvertently delegated to it. See Com C §2210(5).

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Source: Business Law/California UCC Sales and Leases/11 Assignment of Rights and Delegation of Duties/§11.18 C. Form: Express Delegation of Performance

§11.18 C. Form: Express Delegation of Performance

▶ To download **Word** version, right click and choose *Save Target As*

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11.18-1 Express delegation of performance

The assignee will perform at its own expense all the duties imposed on the assignor by the contract. The assignee will indemnify, defend, and hold harmless the assignor from and against all liability, claims, demands, damages, costs, and expenses (including reasonable attorney fees and court costs) arising out of an asserted failure by the assignee to perform according to the terms of the contract.

Comment: This clause obligates the assignee to indemnify the assignor for costs of defense against claims for the assignee's breach even if the defense is successful and no breach is established. For discussion of rules interpreting indemnity clauses, see CC §2778.

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§11.19 D. Effect of Delegation

If an assignment includes the delegation of duties, acceptance of the assignment is a promise to perform, regardless of whether any benefits have been received. Com C §2210(5). But see CC §1589 (Acceptance of Benefits Assumes Burdens). Under pre-Code and non-Code contract law, completion of the assignment may or may not imply a promise by the assignee to perform the duties of the contract, but acceptance of benefits implies consent to obligations. See 1 Witkin, Summary of California Law, *Contracts* §731 (10th ed 2005). If the assignee accepts the assignment by entering into an assignment contract, the formation of that contract is governed by general contract law rather than the Commercial Code. Division 2 of the Code, Com C §§2101-2801, applies generally to "transactions in goods" (Com C §2102) and limits "contract" and "agreement" to those "relating to the… sale of goods" (Com C §2106(1)). Because the term "goods" excludes "things in action" (Com C §2105(1)), a contract to assign a sales contract is outside the scope of Division 2.

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§11.20 1. Between Nondelegating Party and Assignee

The nondelegating party has several classes of rights against the assignee:

- The assignee's acceptance of a delegation constitutes a promise to perform that is enforceable by the nondelegating party. Com C §2210(5). The nondelegating party has the same remedies against the assignee that it has against the assignor. The delegation gives the nondelegating party the right to demand assurances of performance from the assignee without showing any other grounds for insecurity. Com C §§2210(6), 2609(1). The exception to this rule is a delegation that the nondelegating party has specifically agreed is a modification rather than a delegation. The nondelegating party's demands for, or receipt of, assurances from the assignee do not affect the nondelegating party's rights against the assignor (Com C §2210(6)); the assignor is still liable for performance or damages if the assignee is in breach (Com C §2210(1)). See §11.21.
- The nondelegating party need not make payments to the assignee until it receives notice of the assignment. Com C §9406(a).

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§11.21 2. Between Nondelegating Party and Assignor

An express delegation imposes liability for performance on the assignee, but it does not relieve the assignor of liability. Com C §2210(1). See *Quaker Alloy Casting Co. v Gulfco Indus*. (ND Ill 1988) 686 F Supp 1319, 1335 (referring to delegation as assignment of obligation). The assignor's liability to the nondelegating party continues to be primary liability. If the assignee fails to perform, the assignor may be liable in damages and remains subject to other remedies available to the nondelegating party, *e.g.,* specific performance (Com C §2716) and the right to demand assurances (Com C §2609). The assignor can be freed entirely from the contract only if the nondelegating party agrees to a novation extinguishing the assignor's liability. See CC §§1530-1532. See §11.3.

The Commercial Code does not discuss how changes in contract terms made by the assignee and the nondelegating party may affect the assignor's liability. Unless the assignee was made the assignor's agent for purposes of modifying the original contract or the assignor otherwise agreed to modifications, the assignor presumably would not be held liable on the modified contract. The assignor remains bound to the terms of the original contract, absent novation.

PRACTICE TIP: If modification of delegated duties is likely to occur, the issue should be addressed in the delegation agreement. For example, should the assignee agree not to make any modifications without notice to, or consent from, the assignor?

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§11.22 3. Between Assignor and Assignee

The assignee's acceptance of the delegation of duties is the assignee's promise to perform, enforceable by the assignor as well as the nondelegating party. Com C §2210(5). See §11.19. At the time the assignee assumes the duties of performance, the assignor's relation to the assignee becomes that of a surety to a principal debtor. *Cutting Packing Co. v Packers' Exch*. (1890) 86 C 574, 577, 25 P 52, 53. See 1 Witkin, Summary of California Law, *Contracts* §740 (10th ed 2005). The assignor generally proceeds against the assignee for protection against liability to the nondelegating party. If sued by the nondelegating party for breach of contract, the assignor can cross-complain against the assignee and, if necessary, bring the assignee into the action as an additional party. As surety, the assignor can compel the assignee to perform (CC §2846) and can recover from the assignee any amounts that the assignor has paid to the nondelegating party on account of the assignee's failure to perform, together with costs and expenses (CC §2847).

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§11.23 E. Delegation Prohibited by Parties' Mutual Agreement

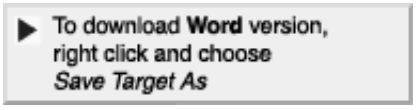
The parties may prohibit delegation of duties in a contract. Com C §2210(1). General language barring assignment of "the contract" is construed to bar delegation of duties but, depending on the circumstances, may or may not be construed to bar assignment of rights also. Com C §2210(4). See §11.10. Instead of relying on general language, the attorney should clarify the parties' rights by including in the contract specific clauses regarding delegation.

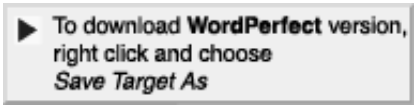
Prohibitions of delegation may cover all or only some of the assignor's duties under the contract. For example, the nondelegating party may be willing to let the assignor delegate some operations (*e.g.,* painting the goods) but may want all other operations performed by the assignor. Similarly, the nondelegating party might permit a portion but not all of the goods to be manufactured or furnished by someone other than the original contracting party.

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Source: Business Law/California UCC Sales and Leases/11 Assignment of Rights and Delegation of Duties/§11.24 1. Form: Prohibition of Delegation of Duties

§11.24 1. Form: Prohibition of Delegation of Duties





11.24-1 Prohibition of delegation

Neither party may delegate all or part of its duties under this agreement

[*Add if prohibition is not to be absolute*]

without the prior written consent of _ _[*name of other party*]_ _**, which** _ _[*may not be unreasonably withheld or delayed/may be withheld in the sole and absolute discretion of* _ _[*name of party*]_ _]_ _**.**

[*Continue*]

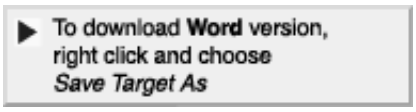
Each party, or its employees, will perform all its duties under this agreement _ _[*except* _ _[*specify*]_ _]_ _**. This prohibition of delegation extends to all delegations that may lawfully be prohibited by agreement. Any attempted delegation** _ _[*without the consent of the other party*]_ _ **will be void.**

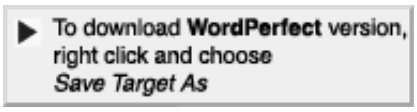
Comment: The last sentence makes any attempted assignment unenforceable. If this sentence were not included, a prohibited delegation could be enforceable and the nondelegating party's only recourse would be to pursue a cause of action against the assignor for breach of contract. See §11.10 for discussion of consent in the context of assignments.

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Source: Business Law/California UCC Sales and Leases/11 Assignment of Rights and Delegation of Duties/§11.25 2. Form: Delegation Expressly Permitted

§11.25 2. Form: Delegation Expressly Permitted





11.25-1 Delegation expressly permitted

Each of the parties to this agreement may delegate _ _[*describe delegable duties, e.g., all or part of its duties under this agreement*]**_ _. Delegation of performance will not create reasonable ground for insecurity.**

[*Add if there are conditions or requirements for an effective delegation*]

If any delegation is made, _ _[*specify conditions or requirements, e.g., consent from or notice to another party*]**_ _.**

Comment: The second sentence of this clause waives the nondelegating party's right to use the permitted delegation as a ground for demanding assurances from the assignee or assignor. See Com C §§2210(6), 2609. The sentence does not affect the nondelegating party's right to demand assurances for insecurity on grounds other than the delegation.

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§11.26 F. Delegation Prohibited by Commercial Code

Delegation is prohibited, even in the absence of an agreement prohibiting delegation, if the nondelegating party has a substantial interest in having the assignor control the performance. Com C §2210(1). Generally, contracts for personal services or those requiring the exercise of personal skill or discretion fall within the scope of this statute. For example, a buyer of custom-made goods may want them manufactured by a seller known for careful, dependable work rather than by an unknown party who may do careless work. The number of situations that show a substantial interest against delegation is limited, however, because (1) even after delegation the assignor remains liable to perform (see Com C §2210(1)) and (2) the nondelegating party has the right to demand assurances from the assignee (see Com C §2210(6)).

An exclusive dealing distributorship contract imposes a "best efforts" requirement on the parties. Com C §2306(2). See §§4.48-4.51. Under this type of contract, a distributor cannot delegate its duties to an entity wholly owned by a competitor or potential competitor of the nondelegating party without the consent of the nondelegating party. *Sally Beauty Co. v Nexxus Prods. Co*. (7th Cir 1986) 801 F2d 1001, 1007 (manufacturer should not be required to leave distribution of product to competitor).

PRACTICE TIP: It is prudent not to rely on Com C §2210(1) to prevent delegation. Unless there are strong countervailing considerations, a party that wants personal performance or personal control over performance by the other party should specifically prohibit delegation in the contract. See §11.24.

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Source: Business Law/California UCC Sales and Leases/11 Assignment of Rights and Delegation of Duties/§11.27 G. Waiver of Prohibition Against Delegation

§11.27 G. Waiver of Prohibition Against Delegation

A prohibition of delegation of duties under the contract, like any other contract clause, may be waived by the nondelegating party for whose benefit the prohibition was imposed. See CC §3513. For discussion of waivers and their retraction, see §§6.12-6.22.

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Source: Business Law/California UCC Sales and Leases/12 Rights of Third Parties/Chapter Outline

12

Rights of Third Parties

Helen Milowe

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§12.1 I. SCOPE OF CHAPTER

This chapter discusses the relative rights of buyers and third parties in goods that are the subject of a sales transaction. Third parties whose interests are covered include:

- **Former owners.** A third party may claim (1) that at the time of sale its ownership interest in the goods was superior to any interest claimed by the seller or (2) that it had not authorized the seller to transfer the goods to a buyer. The buyer's rights against the owner may depend not only on the type of buyer but also on the owner's dealings with the seller. Com C §2403. See §§12.2-12.27.

- **Seller's creditors.** The seller's creditors may be entitled to reach the goods by attachment, levy, or other process despite their sale or promised sale to a buyer. Com C §§2402, 2502, 2716. The trustee of an insolvent seller may claim an interest in the goods for the bankruptcy estate to satisfy the claims of the seller's creditors. See §§12.28-12.51.

- **Buyer's creditors.** The buyer's creditors or a consignee's creditors may be entitled to attach or levy on the goods, subject to the seller's right to reclaim the goods. Com C §§2326, 2702, 9319. See §§12.52-12.67.

- **Financing agencies.** A third party may advance or assume responsibility for the price of the goods and thereby become entitled to exercise the seller's rights against the buyer. Com C §§2506, 2707. See §§12.68-12.72.

For additional discussion of third party rights, see chaps 17 (prelitigation remedies) and 18 (litigation remedies). Rights of secured parties are discussed extensively in Secured Transactions in California Commercial Law Practice (2d ed Cal CEB 2001).

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II. BUYERS AND THIRD PARTIES

§12.2 A. Rules Concerning Buyers' Rights

When competing claims arise after a sale or attempted sale of the goods, the primary questions to answer in resolving any conflict are: What are the rights of the buyer, and how do the buyer's rights match up against those of others who are claiming an interest in the goods? The following principles apply to those issues:

- All buyers acquire whatever title the seller has or has the power to transfer. The buyer of a limited interest generally acquires rights only to the extent of that interest. Com C §2403(1). See §§12.3-12.5.

- Good faith purchasers for value receive good title even if the seller has voidable title. Com C §2403(1). On voidable title, see §§12.6-12.10.

- When the goods were entrusted by their owner to the seller, and the seller is a merchant dealing in goods of that kind, a buyer in ordinary course of business obtains all the rights of the party who entrusted the goods. Com C §2403(2)-(3). See §§12.11-12.14.

- A good faith purchaser for value (see §§12.16-12.19) takes free of the owner's rights under non-Commercial Code rules when it buys from a person given indicia of ownership or apparent authority to sell by the owner. See §12.15.

- A buyer in ordinary course of business (see §§12.20-12.26) obtains the goods free of any security interest created by the seller, even if the buyer is aware of the existence of the security interest, as long as the buyer has no knowledge that the transfer is in violation of that security interest. Com C §9320(a).

- Buyers whose rights are provided for in Commercial Code Division 6 (bulk transfers), Division 7 (documents of title), or Division 9 (secured transactions) are entitled to the additional protections set forth in those divisions. See §12.27.

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§12.3 1. When Good Title Obtained From Seller

A buyer typically obtains whatever title the seller has or has power to transfer. The buyer of a limited interest acquires rights only to the extent of that interest. Com C §2403(1). Consequently, if the seller has no title to the goods, or has no power to transfer them, a buyer cannot obtain good title and cannot in turn transfer good title to a third party. This rule applies when the transferred goods are stolen. See §12.4.

The Commercial Code essentially adopts the "stolen goods/no title" rule but adds the following modifications:

- A seller with "voidable title" can pass good title to a good faith purchaser for value even though the seller acquired the goods through "fraud punishable as larcenous." Com C §2403(1)(d). See §§12.6-12.10.

- A merchant to whom the goods have been entrusted can pass good title to a buyer in ordinary course of business even though the merchant's procurement or disposition of the goods was "larcenous." Com C §2403(2)-(3); Official Comment 2 to UCC §2-403. See §§12.11-12.14.

Both of these exceptions, however, are based on the seller's obtaining the goods through a voluntary transfer by their owner. See §12.5.

NOTE: Larceny by trick or device is "the appropriation of property, the possession of which was fraudulently acquired." *People v Ashley* (1954) 42 C2d 246, 258, 267 P2d 271.

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§12.4 a. Void Title for Stolen Goods

A thief has void title; the transferee of a thief gets void title also, whether or not the transferee is aware that the goods are stolen. Com C §2403(1). See §12.3.

EXAMPLE: In *Suburban Motors v State Farm Mut. Auto. Ins. Co.* (1990) 218 CA3d 1354, 268 CR 16, a thief stole an automobile from its owner, altered the vehicle identification number, and asked the California Department of Motor Vehicles to issue a new certificate of title under the altered identification number. The vehicle passed through a succession of innocent owners until it was bought by the plaintiff used car dealer. The defendant in the action was the original owner's insurer, which claimed entitlement to the car because it had paid for the original owner's loss. The insurer prevailed over the used car dealer, even though the dealer had been misled by a laundered certificate of title.

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§12.5 b. Good Title Requires Voluntary Transfer by Owner

For a seller with voidable title (see §§12.6-12.10) or a merchant entrusted with goods (see §§12.11-12.14) to pass good title to the buyer, the transfer of goods by the owner must be voluntary. "Voluntary" in this context means that even though the seller received the goods through deceitful or larcenous means, they were given up by the owner's voluntary act. If the seller obtained possession without the owner's consent, the rule precluding transfer of title by a thief holds true. *Naftzger v American Numismatic Soc'y* (1996) 42 CA4th 421, 49 CR2d 784. See §12.4.

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§12.6 2. Seller With Voidable Title

A person with voidable title has power to transfer a good title to a good faith purchaser for value. Com C §2403(1). The elements that constitute a good faith purchaser for value are defined in Com C §§1201 and 1204. See §§12.16-12.19.

Title to goods is "voidable" when the party from whom the goods were obtained has the right to avoid the transfer and reclaim the goods. Voidability can result from the transferor's incapacity or from fraud, misrepresentation, duress, coercion, mistake, or the like. See CC §§1565-1579, 1689-1693; Com C §1103(b).

NOTE: Presumably, the rule on passing of good title by a seller with voidable title also applies to contracts in which the seller is a minor or an incompetent subject to disaffirmance or rescission under Fam C §§6701-6713 and CC §§38-40. See 4 Witkin, Summary of California Law, *Sales* §233 (10th ed 2005).

Voidable title is also created in a transferee in the four situations identified in §§12.7-12.10. In each of these situations, the policy of the Commercial Code is to prefer the "downstream" good faith purchaser for value over the original owner, on the theory that the original owner could have protected itself by closer investigation of the transferee in the original transaction.

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§12.7 a. Seller Deceived About Transferee's Identity

When goods have been delivered under a transaction of purchase, the transferee has the power to transfer good title to a good faith purchaser for value even though the seller was deceived about the identity of the transferee. Com C §2403(1)(a).

EXAMPLE: In *Charles Evans BMW, Inc. v Williams* (Ga App 1990) 395 SE2d 650, an impostor purchased a car with a fraudulent cashier's check. Posing as the owner of the car, the impostor then sold the car to a car dealer. The court held in favor of the car dealer against the original owner of the car, reasoning that the owner was not deprived of the car by theft but rather was deceived about the identity of the purchaser. Thus, the owner conveyed voidable rather than void title to the impostor, and the impostor had power to transfer good title to a good faith purchaser for value.

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§12.8 b. Delivery in Exchange for Dishonored Check

When goods have been delivered under a transaction of purchase, the transferee has the power to transfer good title to a good faith purchaser for value even though the delivery was in exchange for a check that was later dishonored. Com C §2403(1)(b).

EXAMPLE: In *English v Ralph Williams Ford* (1971) 17 CA3d 1038, 95 CR 501, dealer *A* acquired a car from dealer *B* in exchange for a check that was later dishonored. The court ruled that because dealer *A* had voidable title and could pass good title to a good faith purchaser for value, dealer *B* could not get the car back from a subsequent purchaser.

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§12.9 c. Cash Sale

When goods have been delivered under a transaction of purchase, the transferee has the power to transfer good title to a good faith purchaser for value even though the parties agreed that the transaction would be a "cash sale." Com C §2403(1)(c).

EXAMPLE: Many sales agreements and invoices contain provisions such as the following: "No title to the goods will pass to the buyer until the seller receives full and complete payment for the goods. Receipt of a check will not be considered payment until the check is honored." The effect of the provision would make the transaction a "cash sale," which gives the buyer voidable title and the power to pass good title to a good faith purchaser for value.

Despite the power of the parties to vary the effect of Commercial Code provisions by agreement (Com C §1302(a)), a provision such as this would not be held to affect third party rights adversely. See Official Comment 2 to former UCC §1-102. If the original seller reserves title until it is paid in full, that reservation of title will likely be treated as a security interest only. The priority status of the seller's interest in this situation vis-à-vis third parties would then be determined by Com C §9324.

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§12.10 d. Delivery Procured by Fraud

When goods have been delivered under a transaction of purchase, the transferee has the power to transfer good title to a good faith purchaser for value even though the delivery was procured through fraud punishable as larcenous under criminal law. Com C §2403(1)(d).

EXAMPLE: In *Rudiger Charolais Ranches v Van De Graaf Ranches* (9th Cir 1993) 994 F2d 670, rancher *A* purchased over 300 head of cattle from a third party, who had obtained them from rancher *B* by fraud and had never paid for them. The third party therefore had voidable title to the cattle. The third party did not pass good title, however, because the purchase was not in good faith. See §12.17.

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§12.11 3. Goods Entrusted to Merchant

Any entrusting of goods to a merchant who deals in goods of that kind gives the merchant power to transfer all the entruster's rights in the goods to a buyer in ordinary course of business. Com C §2403(2). The requirements for entrusting are provided in Com C §2403(3). See §§12.12-12.14.

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§12.12 a. Definition of Entrusting

"Entrusting" includes any delivery of goods for purposes of sale, obtaining offers to purchase, locating a buyer, or the like. Com C §2403(3). Entrusting also may occur when the owner allows another party to retain possession of goods previously delivered, for the same purposes. Com C §2403(3).

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§12.13 b. Entrusting Must Be for Sale Purposes

An owner will lose to a buyer in ordinary course only if the owner entrusted the goods to a merchant for the purposes described in Com C §2403(3). Thus, a merchant who has received goods solely for purposes of repair or appraisal cannot sell them to a buyer in ordinary course to the detriment of the owner.

PRACTICE TIP: California attorneys who deal with entrustings in other states should remember that Com C §2403(3) differs from the official text of UCC §2-403(3), which may be in force elsewhere. California's version has a purpose-of-sale limitation; the official text does not. Thus, in states that have adopted the official text, a dealer of goods that were left merely for purposes of repair or warehousing could pass good title to a buyer in ordinary course of business. See, *e.g., Canterra Petroleum, Inc. v Western Drilling & Mining Supply* (ND 1987) 418 NW2d 267.

In *Budget Rent-A-Car v Bergman* (1981) 121 CA3d 256, 175 CR 286, a dealer who had leased the plaintiff's car sold it to an innocent purchaser. The court held that no entrusting had occurred, because the plaintiff had not given the dealer possession "for the purpose of sale, obtaining offers to purchase, locating a buyer, or the like," as required by Com C §2403(3). Consequently, the dealer had no power to transfer title to a buyer. See also *Mercedes-Benz Credit Corp. v Johnson* (2003) 110 CA4th 53, 1 CR3d 396 (delivery of leased automobile to lessee dealer is not entrustment of goods that would enable dealer to transfer good title to third party purchaser). In *Chartered Bank v Chrysler Corp.* (1981) 115 CA3d 755, 171 CR 748, a manufacturer-owner entered into a field warehouse agreement with a yacht sales company, which subsequently sold the owner's boat instead of simply warehousing it. Finding that no entrusting had occurred, the court held that no sale had been made in the ordinary course of business.

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§12.14 c. Party to Whom Goods Are Entrusted Must Be Merchant

For the buyer in ordinary course to prevail over the owner/entruster, the goods must have been entrusted to "a merchant who deals in goods of that kind." Com C §2403(2).

NOTE: The Commercial Code text and comments do not require the entruster to know that it is entrusting goods to a merchant. No California court has held that the entruster must know that it is dealing with a merchant.

If the seller is not a merchant, or if the purchaser does not qualify as a buyer in ordinary course, non-Commercial Code statutes and principles of agency or estoppel will decide whether the owner or buyer prevails. Com C §1103(b).

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§12.15 4. Seller With Apparent Ownership or Authority to Sell

The seller's power to convey good title can be conferred by non-Commercial Code rules. Com C §1103(b). For example, the seller may have actual or ostensible authority to sell the goods as an agent for the owner (CC §§2295-2326) or as a factor (CC §§2026-2030, 2367-2369). See Official Comment 1 to UCC §2-403.

The general non-Commercial Code rule is that a good faith purchaser for value takes free of the owner's rights when it buys from a person given indicia of ownership or apparent authority to sell by the owner. See *McKee v Peterson* (1963) 214 CA2d 515, 29 CR 742; 4 Witkin, Summary of California Law, *Sales* §230 (10th ed 2005).

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§12.16 B. Good Faith Purchaser for Value

A buyer's status as a "good faith purchaser for value" is important for purposes of two Commercial Code provisions:

- A person with voidable title has power to transfer good title to a good faith purchaser for value. Com C §2403(1). See §12.6.
- A seller's right to reclaim goods when it discovers that the buyer is insolvent is subject to the rights of a buyer in ordinary course or other good faith purchaser from the insolvent buyer. Com C §2702(3). See §12.67.

The Commercial Code does not specifically define the term "good faith purchaser for value" as a whole, but all the component parts are defined in Com C §§1201 and 1204. See §§12.17-12.19.

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§12.17 1. Good Faith

Generally, "good faith" as required of a good faith purchaser for value (see §12.16) means "honesty in fact and the observance of reasonable commercial standards of fair dealing." Com C §1201(b)(20).

NOTE: With the enactment of revised Article 1 in 2006, California adopted the objective standard of "good faith" that applies in all of the recently revised UCC articles (except revised Article 5).

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§12.18 2. Purchaser

"Purchase" for purposes of determining whether a party to a transaction is a good faith purchaser for value (see §12.16) is broadly defined to include taking by sale, lease, discount, negotiation, mortgage, pledge, lien, security interest, issue or reissue, gift, or any other voluntary transaction creating an interest in property. Com C §1201(b)(29). "Purchaser" for these purposes means a person who takes by purchase. Com C §1201(b)(30).

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§12.19 3. For Value

The giving of "value" for purposes of determining whether a party to a transaction is a good faith purchaser for value (see §12.16) includes the taking of property in return for any consideration sufficient to support a simple contract, as well as the taking of property in partial or total satisfaction of, or as security for, a preexisting claim. Com C §1204(2), (4).

A commitment to extend credit can amount to giving value. Com C §1204(1). This provision applies primarily to transactions with financing agencies that make advances against property held as collateral. Official Comment 44 to former UCC §1-201.

A purchaser also gives value when it becomes liable for a specific amount of money by taking delivery under a preexisting purchase contract, thereby converting a contingent into a fixed obligation. Com C §1204(3).

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§12.20 C. Buyer in Ordinary Course of Business

A buyer in ordinary course of business is protected in the following situations:

- **When it buys from a merchant or bailee.** The purchased goods may be either owned by the merchant or entrusted to the merchant/bailee by their third party owner. Com C §2403(2); Official Comment 2 to UCC §2-403. For discussion of entrusting, see §§12.11-12.15.

- **When it buys fungible goods from a warehouse**. The goods must be sold and delivered by a warehouse who is also in the business of buying and selling such goods. The buyer takes free of any other party's claim on the goods under a warehouse receipt, even though the warehouse receipt has been duly negotiated. Com C §7205.

- **When it buys goods subject to a security interest created by the seller.** The buyer takes free of the security interest even if the buyer is aware of the existence of the security interest. Com C §9320(a). If, however, the buyer knows that the transfer of the goods is in violation of the terms of that security interest, the buyer does not qualify as a buyer in ordinary course. Com C §1201(b)(9).

The buyer in ordinary course takes free only of a security interest created by its seller. Com C §9320(a); Official Comment 3 to UCC §9-320; *Security Pac. Nat'l Bank v Goodman* (1972) 24 CA3d 131, 100 CR 763. If the security interest was created by a party more remote in the chain of possession, the goods remain subject to it unless the disposition was authorized by the secured party. Com C §9315(a); *Gordon v Hamm* (1998) 63 CA4th 1324, 74 CR2d 631 (owner entrusted motor home to dealer for sale; dealer absconded with buyer's payment; motor home remained subject to security interest of owner's lender).

NOTE: Buyers of farm products are covered by Com C §9320(a), although they are generally excluded by UCC §9-320(a) and versions adopted in other states.

In the sale of an aircraft, however, the California supreme court has held that the buyer is charged with knowledge of existing security interests recorded in the Federal Aviation Administration (FAA) Aircraft Registry and takes subject to them, whether or not the transfer is in violation of those interests. See *Dowell v Beech Acceptance Corp.* (1970) 3 C3d 544, 91 CR 1. But see *Gary Aircraft Corp. v General Dynamics Corp. (In re Gary Aircraft Corp.)* (5th Cir 1982) 681 F2d 365.

The definition of "buyer in ordinary course of business" is discussed in §§12.22-12.25. When buyer in ordinary course status attaches is discussed in §12.26.

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§12.21 1. Definition of "Buyer in Ordinary Course"

For purposes of the protections afforded by provisions described in §12.20, the Commercial Code generally defines "buyer in ordinary course of business" as "a person that buys goods in good faith, without knowledge that the sale violates the rights of another person in the goods, and in the ordinary course from a person, other than a pawnbroker, in the business of selling goods of that kind." Com C §1201(b)(9).

The good faith requirement is discussed in §12.22. Buying in ordinary course is discussed in §12.23. The requirement of a merchant seller is discussed in §12.24.

A buyer in ordinary course of business may buy for cash, by exchange of other property, or on secured or unsecured credit, and may acquire goods or documents of title under a preexisting contract for sale. "Buyer in ordinary course of business" does not include a person that acquires goods in a transfer in bulk or as security for, or in total or partial satisfaction of, a money debt. Com C §1201(b)(9). See §12.25.

PRACTICE TIP: Merchants as well as nonmerchants can be buyers in ordinary course of business. *Taft v Jake Kaplan, Ltd. (In re Dexter Buick-GMC Truck Co.)* (Bankr D RI 1980) 2 BR 253 (auto dealer was buyer in ordinary course of business). Merchants who are pawnbrokers, however, specifically cannot be buyers in ordinary course. Com C §1201(b)(9).

"Buyer in ordinary course of business" is a more narrowly defined category than "good faith purchaser for value." For the rights of a good faith purchaser for value, see §12.16. For the definition of good faith purchaser for value, see §§12.17-12.19.

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§12.22 a. Good Faith Buyer

A buyer in ordinary course must act in good faith and must have no knowledge that the sale violates the rights of another person in the goods. Com C §1201(b)(9). It is not the buyer's knowledge of the *existence* of a security interest, but rather its knowledge that the sale is a *violation* of that interest (not waived by the secured party's words or conduct), that defeats its protection as a buyer in ordinary course. Com C §9320(a); Official Comment 3 to UCC §9-320. See §12.20.

EXAMPLE: In *Producers Cotton Oil Co. v Amstar Corp.* (1988) 197 CA3d 638, 242 CR 914, the purchaser of a sugar beet crop was held not to be a buyer in ordinary course, because it paid another party for harvesting the crop without the secured party's consent to that use of the proceeds. The buyer knew that the secured party's consent was necessary and that a subordination agreement should have been signed before making the payment.

The buyer in ordinary course must also be a good faith purchaser. Thus, bad faith collusion between the seller and buyer will disqualify a purchaser from being a buyer in ordinary course of business. *Sierra Fin. Corp. v Brooks-Farrer Co.* (1971) 15 CA3d 698, 93 CR 422.

The attorney should keep in mind that the good faith standard is different for merchants and nonmerchants. See §12.17.

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§12.23 b. Sale in Ordinary Course of Business

To qualify for protection (see §12.20), the buyer must have purchased the goods "in ordinary course of business." A transfer of all of a corporation's assets is not a sale in the ordinary course of business, but is a bulk sale, subject to Division 6 of the Commercial Code. *Bank of the W. v Commercial Credit Fin. Servs.* (9th Cir 1988) 852 F2d 1162, 1169 n6. Other examples of nonqualifying sales are:

- Sale in distress at an obvious loss price or a sale in liquidation (*American Nat'l Bank v Cloud* (1988) 201 CA3d 766, 772, 247 CR 325),
- Execution sale (*National Shawmut Bank v Vera* (Mass 1967) 223 NE2d 515),
- Sale to a related corporation (*Morey Mach. Co. v Great W. Indus. Mach. Co.* (5th Cir 1975) 507 F2d 987; *Taylor Motor Rental, Inc. v Associates Discount Corp*. (Pa Super Ct 1961) 173 A2d 688).

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§12.24 c. Merchant Seller

The requirement that the goods be bought from a person "in the business of selling goods of that kind" (Com C §1201(b)(9)) has the effect of limiting the "buyer in ordinary course" classification (see §12.20) to purchasers of inventory from merchants, whether they are retailers, wholesalers, or manufacturers. Com C §2403; Official Comment 2 to UCC §2-403; Official Comment 3 to UCC §9-320.

EXAMPLE: In *American Nat'l Bank v Cloud* (1988) 201 CA3d 766, 247 CR 325, a purchaser failed to qualify as a buyer in ordinary course when he bought raisins from the sons of a raisin grower (even though the raisins were actually the property of the raisin grower), because the sales were isolated events and the sons were not established raisin sellers themselves.

Buyers of oil, gas, and minerals at the wellhead or minehead need not prove that the seller is in the business of selling those goods to qualify as buyers in ordinary course, because the seller is conclusively presumed to be in the business of selling those goods. Com C §1201(b)(9).

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§12.25 d. New Value Given

To qualify as a buyer in ordinary course (see §12.20), the buyer must give new value for the goods. Satisfaction of a preexisting money debt is expressly excluded. Com C §1201(b)(9).

NOTE: This "new value" requirement is intended as a protection for the seller's inventory financer. If the rule were otherwise, and the buyer who received goods in satisfaction of a preexisting money debt were permitted to keep the goods free of security interests, the effect would be to enable the unsecured buyer to bootstrap itself into priority over the secured creditor who relies on the inventory and its proceeds for security. See *U.S. v Handy & Harman* (9th Cir 1984) 750 F2d 777, 781.

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§12.26 2. When "Buyer in Ordinary Course" Status Attaches

The Commercial Code does not specify when "buyer in ordinary course" status attaches, and no California court has decided this issue. Related Code sections specify the time of fixing the buyer's rights and the time of passing of title.

- If the goods are in the possession of a bailee and are to be delivered without being moved, the buyer's rights become fixed in relation to the bailee and all third persons when the bailee receives notice of the transfer. Com C §2503(4)(b).

- If the goods are not to be moved, title may pass to the buyer on delivery of the documents (Com C §2401(3)(a)) or, if the goods are identified and no documents are to be delivered, when the goods are contracted to be sold (Com C §2401(3)(b)). Title can also pass by the parties' agreement as soon as the goods have been identified to the contract. Com C §2401(1).

Under the law of most jurisdictions, passing of title is not necessary for "buyer in ordinary course" status to accrue (*Carey Aviation, Inc. v Giles World Mktg., Inc.* (D Mass 1985) 46 BR 458; *Rex Fin. Corp. v Mobile Am. Corp.* (Ariz App 1978) 580 P2d 8).

NOTE: The definition of "buyer in ordinary course of business" does not require actual delivery of the goods. See §12.21. The omission of any reference to delivery was presumably deliberate; the Commercial Code does specify "delivered" goods for buyers of fungible goods in the ordinary course from a warehouse. Com C §7205. See §12.20.

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§12.27 D. Rights of Buyers in Bulk Transfers

Other divisions of the Commercial Code also govern the rights of buyers. For example, a transferee of a bulk transfer that has not met the requirements of Division 6 can nevertheless convey good title to the goods to a good faith purchaser for value (see §12.16) who has no notice of noncompliance. Com C §6107(h).

The transferee of a bulk transfer cannot qualify as a buyer in ordinary course of business (see §12.20), but it may take free of an unperfected security interest if it gives value and receives delivery of the goods without knowledge of the security interest and before the interest is perfected. Com C §9317(b). However, a secured party with a purchase money security interest who perfects by filing within 20 days after a debtor acquires possession of collateral has priority over a bulk transferee who acquires the collateral in the interval between the attachment of the purchase money security interest and its perfection by filing. Com C §9317(e). See Secured Transactions in California Commercial Law Practice, chap 4 (2d ed Cal CEB 2001).

On bulk sales generally, see chap 14.

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III. RIGHTS OF SELLER'S CREDITORS

§12.28 A. Creditors' Rights Against Buyers

After the sale or promised sale of goods, the seller's creditors may have rights superior to the buyer in the following circumstances:

- The seller retains possession of the goods and retention of possession is fraudulent or void under non-Commercial Code law. Com C §2402(2). See §§12.29-12.36.
- The sale is a fraudulent transfer. Com C §2402(3)(b). See §§12.37-12.43.
- The seller is insolvent and the creditor has a perfected security interest. Com C §2402(3)(a). See §§12.47-12.49.

The seller's creditors may include secured and unsecured creditors, lien creditors, and a trustee in bankruptcy. Com C §1201(b)(13).

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§12.29 B. Retention of Possession by Seller

When a seller keeps possession of goods after their sale, the seller's creditors can be misled into thinking that the seller still owns them. Acting on that mistaken belief, a creditor might be induced to advance funds against the seller's inventory, not realizing that ownership of some or all of it has already passed to a third party buyer. The Commercial Code protects the seller's creditors in this situation by allowing them to void the sale if "a retention of possession by the seller is fraudulent or void under any rule of law of the state where the goods are situated." Com C §2402(2).

In California, the rule of law is CC §§3440-3440.9. See §§12.30-12.32. Exceptions to the fraudulent retention rule are discussed in §§12.33-12.36.

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§12.30 1. Fraudulent Retention Rule

Civil Code §3440(a) provides that "every transfer of personal property… not accompanied by an immediate delivery followed by an actual and continued change of possession of the property, is void as against the transferor's creditors." Parties benefiting by the rule against retention of goods after sale include (CC §3440(a)):

- Secured and unsecured creditors of the seller at the time of the transfer, and those who become creditors while the seller remains in possession of the goods;
- The creditors' successors; and
- Other purchasers in good faith from the seller subsequent to the transfer.

The requirement of immediate delivery is discussed in §12.31. The requirement of actual and continued change of possession is discussed in §12.32.

NOTE: A trustee in bankruptcy qualifies as a protected party under 11 USC §544(b), which permits a trustee to avoid any transfer of an interest of the debtor in property that is voidable under applicable nonbankruptcy law by an unsecured creditor. *International Canning Mach., Ltd. v Murrieta Hot Springs (In re Murrieta Hot Springs)* (Bankr CD Cal 1980) 6 BR 73.

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§12.31 a. Immediate Delivery

The requirement of "immediate delivery" has been construed to mean "within a reasonable time having due regard to the nature and circumstances of the case." *International Canning Mach., Ltd. v Murrieta Hot Springs (In re Murrieta Hot Springs)* (Bankr CD Cal 1980) 6 BR 73, 77, quoting *Integrated, Inc. v Alec Fergusson Elec. Contractors* (1967) 250 CA2d 287, 295, 58 CR 503. See *Raddatz v Hedgpeth* (1963) 223 CA2d 633, 35 CR 855 (transfer of mill equipment and machinery was void when there was no evidence that the buyers accepted any delivery after six months); *Shepherd v Gamble* (1950) 95 CA2d 890, 214 P2d 403 (one-week delay in moving disabled 11-1/2 ton tractor did not constitute fraudulent retention). If the goods are located some distance from the buyer, a reasonable time will be allowed to secure them. *Feeley v Boyd* (1904) 143 C 282, 76 P 1029. However, a buyer is not allowed a reasonable time to remove harvested crops from the field. *Urick v Guitron* (1936) 15 CA2d 523, 59 P2d 636.

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§12.32 b. Actual and Continued Change of Possession

Whether an adequate change in possession of the goods has occurred is a question of fact, depending in part on the character of the property. However, the change of possession must be actual and open. *Southern Cal. Collection Co. v Napkie* (1951) 106 CA2d 565, 235 P2d 434; *McCaffey Canning Co. v Bank of America* (1930) 109 CA 415, 435, 294 P 45.

Symbolic delivery and unobservable transfer of possession are insufficient. See *O'Connor v O'Connor, Rice & Barnes* (1941) 44 CA2d 1, 111 P2d 656 (purported transfer of possession by changing signs or labels on goods, without moving them, held not sufficient); *International Canning Mach., Ltd. v Murrieta Hot Springs (In re Murrieta Hot Springs)* (Bankr CD Cal 1980) 6 BR 73 (only evidence of transfer of boilers was entry in seller's business records; boilers were not moved by buyer for over two years after sale; trustee in seller's bankruptcy had rights superior to buyer).

Although CC §3440(a) does not specifically prohibit constructive delivery, actual delivery will be required if the nature of the property and the parties' situation make actual delivery practicable. See *Black & White Cattle Co. v Granada Cattle Servs., Inc. (In re Black & White Cattle Co.)* (9th Cir 1986) 783 F2d 1454 (constructive delivery of healthy cattle, by tagging and segregation of animals at feed yard, did not satisfy "possession" and "delivery" requirements of CC §3440(a)).

Removal of bulky articles from the seller's property is not always necessary. *Rosenthal v Taylor* (1927) 87 CA 399, 262 P 395 (sufficient change of possession for buyer to purchase two dismantled pumps, assemble and move them to shed belonging to seller, store them there, and take several parts away with him).

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2. Exceptions to Fraudulent Retention Rule

§12.33 a. Retention by Merchant in Current Course of Trade

The Commercial Code provides an exception to the rule against fraudulent retention of goods by the seller for retention of possession in good faith and current course of trade by a merchant seller for a commercially reasonable time. Com C §2402(2). See also CC §3440.9. In *Gardner v Sullivan & Crowe Equip. Co.* (1971) 17 CA3d 592, 94 CR 893, the court held that the Com C §2402(2) exception to CC §3440 did not apply, because the seller who retained possession of the goods was not a merchant.

EXAMPLE: In *Martin Marietta Corp. v New Jersey Nat'l Bank* (D NJ 1981) 505 F Supp 946, aff'd in part and remanded in part (3d Cir 1981) 653 F2d 779, the purchaser of 136,657 tons of sand left 62,443 tons stockpiled on the seller's premises. The evidence established that the sand was expensive and difficult to move and that rail transportation was preempted during the period in question. The stockpiling was specifically mentioned in the seller's balance sheet, a copy of which was later received by the creditor, laying claim to the sand as inventory. The buyer had posted signs around the stockpile proclaiming its ownership. There was no evidence of bad faith by the seller or buyer or fraudulent intent to trick creditors. Holding that the seller's creditor could not void the transaction, the court ruled in favor of the buyer's claim.

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§12.34 b. Filing and Publication

The requirement of CC §3440(a) that the goods be immediately delivered does not apply to transfers for which the seller or transferee files a financing statement before the transfer and publishes notice of the intended transfer at least ten days earlier. The notice need be published only once, in a newspaper of general circulation in the judicial district in which the goods are located. The notice should contain the names and addresses of the transferor and transferee, describe the goods to be transferred, and indicate where and when the transfer will be made. CC §3440.1(h)(2).

Even if these filing and publication requirements are complied with, however, the transfer will be void as against another buyer in ordinary course of business from the seller. CC §3440.3. This might happen, for example, when a seller on the brink of bankruptcy sells the same goods to two different parties to meet cash needs. Should that occur, the second buyer is favored if it is a buyer in ordinary course. The first buyer is left with an action for conversion against the seller, because the first buyer should have taken steps to obtain possession of the goods when they were purchased.

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§12.35 c. Sale-Leaseback by Seller

If, after sale, the property is immediately leased by the seller from the buyer, there need not be an immediate delivery followed by an actual and continued change of possession. For this sale/leaseback exception to apply, the buyer must have purchased the property for value and in good faith. CC §3440.1(k); Com C §10308(c).

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§12.36 d. Other Exceptions to Fraudulent Retention Rule

Other exceptions to the fraudulent retention rule include the following:

- Property not in the possession of the seller at the time of sale is excepted as long as the buyer later acquires possession of the property. *Beblen v Mackie* (1952) 113 CA2d 132, 247 P2d 847.
- Ships or their cargoes are excepted if they are at sea or in a foreign port. CC §3440.1(b).
- Wines and brandies are excepted in certain situations. See CC §3440.1(d).
- Property exempt from enforcement of a money judgment is excepted from operation of this rule. CC §3440.1(f).
- Things in action, the sale of accounts, chattel paper, payment intangibles, promissory notes governed by the UCC, security interests, contracts of bottomry or respondentia, standing timber, and personal property not located within California at the time of transfer are excepted under conditions set forth in the statute. See CC §3440.1(a), (c), (g), (i).
- The rights of a good faith purchaser for value who buys the goods from the buyer or a successor of the buyer are unaffected by the fraudulent retention rule as long as the seller is not in possession of the goods at the time of the sale. CC §3440.4.
- The rights of a secured party who acquires a security interest in the goods from the buyer or a successor of the buyer are unaffected by the fraudulent retention rule as long as the seller is not in possession of the goods when the interest is granted or, if the seller is in possession, the secured party files a financing statement and publishes notice of the intended transfer at least ten days earlier. CC §3440.5.

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§12.37 C. Fraudulent Transfers of Goods

The seller's creditors may prevail over the buyer if identification or delivery of the goods is made in satisfaction of a preexisting claim and would constitute a fraudulent transfer or voidable preference under "any rule of law of the state where the goods are situated." Com C §2402(3)(b). In California, the rule of law is the Uniform Fraudulent Transfer Act (UFTA) (CC §§3439-3439.12). See §§12.38-12.43.

For discussion of the avoidance of fraudulent transfers in bankruptcy, see Debt Collection Practice in California §12.66 (2d ed Cal CEB 1999); Secured Transactions in California Commercial Law Practice §§6.71-6.77 (2d ed Cal CEB 2001).

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§12.38 1. Definition of Fraudulent Transfer

A transfer (or the incurrence of an obligation to transfer) is fraudulent in relation to a present or future creditor in the following circumstances:

- The debtor made the transfer with actual intent to hinder, delay, or defraud any creditor. CC §3439.04(a)(1). A transfer that is fraudulent for this reason, however, may not be voidable by the creditor. See §12.43.
- The debtor made the transfer without receiving reasonably equivalent value in exchange and (1) was engaged or about to engage in a transaction for which the debtor's remaining assets were unreasonably small in relation to the transaction or (2) intended to incur or reasonably should have believed that it would incur debts beyond the debtor's ability to repay. CC §3439.04(a)(2).

A transfer is also considered to be fraudulent in relation to a present creditor if the debtor did not receive reasonably equivalent value in exchange and was insolvent or became insolvent as a result of the transfer. CC §3439.05.

The creditor's remedies for a fraudulent transfer are discussed in §§12.39-12.42. The rights of transferees of a fraudulent transfer are discussed in §§12.43-12.46.

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§12.39 2. Remedies of Creditors

A defrauded creditor (or a successor to a creditor) may obtain the following in an action for relief:

- Avoidance of the transfer or obligation to the extent necessary to satisfy the creditor's claim. CC §3439.07(a)(1). Avoidance of a transfer or obligation is subject to the limitations of CC §3439.08. See §§12.43-12.46.
- An attachment or other provisional remedy against the transferred assets or proceeds under CCP §§481.010-493.060. CC §3439.07(a)(2).
- An injunction against the debtor, the transferee, or both, against further disposition of the transferred assets or proceeds. CC §3439.07(a)(3)(A).
- Appointment of a receiver to take charge of the asset or its proceeds. CC §3439.07(a)(3)(B).
- Any other relief required by the circumstances. CC §3439.07(a)(3)(C).

Additional remedies are available in certain situations. See §§12.40-12.42.

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§12.40 a. Attachment

If a creditor has commenced an action on a claim against the debtor, the creditor may attach the transferred assets or proceeds if the remedy of attachment is available and the property is subject to attachment under applicable law. CC §3439.07(b).

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§12.41 b. Execution

If a creditor has obtained a judgment against a debtor, the creditor may levy execution on the transferred asset or proceeds. CC §3439.07(c).

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§12.42 c. Assignment

A creditor who is an assignee of a general assignment for the benefit of creditors may exercise available rights and remedies under CCP §493.010 for the benefit of creditors whose rights are asserted by the assignee. CC §3439.07(d).

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§12.43 3. Rights of Transferees

A transfer made or obligation incurred by the debtor with actual intent to hinder, delay, or defraud a creditor is not voidable under CC §3439.04(a)(1) against "a person who took in good faith and for a reasonably equivalent value or against any subsequent transferee or obligee." CC §3439.08(a). Certain protections also apply to transferees of voidable transfers. See §§12.44-12.46.

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Source: Business Law/California UCC Sales and Leases/12 Rights of Third Parties/§12.44 a. Good Faith Transferees Not Subject to Judgment

§12.44 a. Good Faith Transferees Not Subject to Judgment

To the extent that the transfer is voidable, the creditor may obtain a judgment against (CC §3439.08(b)):

- The first transferee of the asset or the person for whose benefit the transfer was made; or
- Any subsequent transferee other than a good faith transferee who took for value or from any subsequent transferee.

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§12.45 b. Amount of Judgment Limited

Judgment for a voidable transfer may be recovered in the lesser of (1) the amount necessary to satisfy the claim, or (2) the value of the transferred asset at the time of the transfer, subject to adjustment as the equities may require. CC §3439.08(b)-(c).

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§12.46 c. Other Rights Retained in Judgment

Notwithstanding the voidability of a transfer, to the extent of value given the debtor, a good faith transferee or obligee is entitled to (CC §3439.08(d)):

- A lien on or a right to retain any interest in the transferred asset;
- Enforcement of any obligation incurred; and
- A reduction in the amount of liability on the judgment.

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§12.47 D. Insolvent Seller

A buyer of goods from a seller who becomes insolvent may have a claim to the goods that is superior to the seller's creditors. Under Com C §2402(1), a buyer who can recover the goods under the strict requirements of Com C §2502 (see §§17.75-17.78), or obtain them by specific performance or replevin under Com C §2716 (see §§18.46-18.47), should prevail over the seller's unsecured creditors unless the seller's retention of the goods can be attacked as fraudulent or void (Com C §2402(2)) or the sale is voidable as a fraudulent transfer (Com C §2402(3)(b)). For discussion of fraudulent retention, see §§12.29-12.36. On fraudulent transfers, see §§12.37-12.46.

The seller's secured creditors have greater rights under Division 9. See §12.48. On the rights of the seller's creditors and the buyer in bankruptcy, see §§12.49-12.51.

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§12.48 1. Secured Creditors

The rights of a creditor under Division 9, dealing with secured transactions, are not impaired by any provisions of Division 2. Com C §2402(3)(a).

- Unperfected security interests are subject to the rights of a good faith purchaser to the extent that the purchaser pays for the goods and takes delivery. Com C §9317(b); Official Comment 6 to UCC §9-317.

- Perfected security interests created by the seller are subject only to the rights of buyers in ordinary course of business. Com C §9320(a). See *Kwikset Div. of Emhart Indus., Inc. v Mohawk Indus. Design Enters., Inc. (In re Pennsylvania Conveyor Co.)* (Bankr WD Pa 1982) 31 BR 680.

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§12.49 2. Trustee in Bankruptcy

When a seller seeks relief in bankruptcy, the Bankruptcy Code determines the rights of the seller's creditors and the buyer. In a Chapter 7 bankruptcy proceeding, the trustee in bankruptcy has the power to avoid preferential transfers made by the debtor. Not every transfer within the preference period is preferential. See §§12.50-12.51.

NOTE: A debtor-in-possession or Chapter 11 trustee has the same power of avoidance, but the power is seldom exercised when a reorganization is contemplated. However, if a debtor-in-possession fails to exercise the power in circumstances in which the creditors believe that the power should be exercised, the creditors may seek appointment of a Chapter 11 trustee.

The buyer's right to recover goods from the trustee after the seller files a petition in bankruptcy may depend on whether the buyer has made partial or full payment of the contract price. See §§17.75-17.79.

For a more extended discussion of preferential transfers, see Secured Transactions in California Commercial Law Practice §§6.78-6.96 (2d ed Cal CEB 2001).

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§12.50 a. Avoidable Preferences

The elements of an avoidable preference are (11 USC §547(b)):

- A transfer of the debtor's property (including the giving of a security interest);
- To or for the benefit of a creditor;
- For or on account of an antecedent debt;
- Made while the debtor is insolvent;
- Made within 90 days (or, if the transferee is an "insider," within one year) of the filing of the bankruptcy petition; and
- That enables the creditor to receive more than he or she would have received in a Chapter 7 liquidation had the transfer not been made; thus, payments to a secured creditor on a fully secured debt are not avoidable preferences.

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§12.51 b. Nonpreferential Transfers

The following are examples of nonpreferential transfers:

- A contemporaneous exchange for new value, *e.g.,* the taking of a security interest in exchange for an advance of money. 11 USC §547(c)(1).
- The payment of a debt that was incurred in the ordinary course of business and paid in the ordinary course of business and according to ordinary business terms. 11 USC §547(c)(2).
- The granting of a security interest to secure "new money" financing (as opposed to securing existing debt). 11 USC §547(c)(3).
- Transfers for which the creditor later extends new value. 11 USC §547(c)(4).
- A security interest in inventory and receivables, or proceeds of that collateral, except to the extent that the secured creditor improves its position at the expense of unsecured creditors during the preference period. 11 USC §547(c)(5).

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IV. RIGHTS OF BUYER'S CREDITORS

§12.52 A. Creditors' Rights Against Sellers

After the sale of goods, the seller may retain rights superior to the rights of the buyer's creditors if the transaction is a "sale on approval" or "sale and return" transaction. Com C §2326(1). See §§12.53-12.55. Consignors also have a security interest in consigned goods that may be superior to the rights of the consignee's creditors. Com C §9319. See §§12.56-12.66. In certain circumstances, the seller may reclaim goods sold to an insolvent buyer. Com C §2702. See §12.67.

The buyer's creditors may include secured and unsecured creditors, lien creditors, and a trustee in bankruptcy. Com C §1201(b)(13).

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§12.53 B. Sale on Approval and Sale or Return Contracts

When a buyer may return goods even though they conform to the contract, the transaction is classified as either a "sale on approval" or a "sale or return." Each type of sale has different ramifications for creditors' rights.

- A "sale on approval" involves goods delivered primarily for the buyer's use. Com C §2326(1)(a). See §12.54.
- A "sale or return" involves goods delivered primarily for resale. Com C §2326(1)(b). See §12.55.

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§12.54 1. Sale on Approval

The buyer's creditors have no rights in goods sold on approval under Com C §2326(1)(a) until the buyer accepts them. Com C §2326(2). Therefore, the buyer's creditors will want to establish that the buyer accepted the goods in one of the following ways (Com C §2327):

- Expressly;
- By using them inconsistently with the purpose of trial;
- By failing to notify the seller seasonably of its election to return the goods;
- By accepting any part of the goods; or
- In any other way that the parties agreed would constitute acceptance.

PRACTICE TIP: If a seller of goods on approval expects trouble collecting from the buyer, it may take steps to protect itself against the buyer's creditors by contractually providing for the time that acceptance occurs. On acceptance generally, see §§10.19-10.31, 17.61.

The buyer in a sale on approval transaction is typically the ultimate consumer of the goods, who wants to decide whether to accept them. See, *e.g., Exchange Bank & Trust Co. v Glenn's Marine, Inc.* (Ark 1979) 579 SW2d 358, in which the court considered a transaction to be a sale on approval because the buyer was given a weekend trial period to test a speedboat motor before purchase.

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§12.55 2. Sale or Return

Goods sold on a sale or return basis under Com C §2326(1)(b) are subject to claims of the buyer's creditors while they are in the buyer's possession. Com C §2326(2). See *Escrow Connection v Haas* (1987) 189 CA3d 1640, 235 CR 200 (judgment creditor could levy on consigned goods treated as held by debtor on sale or return under former Com C §2326(3)). Therefore, a seller who allows a buyer to obtain sale or return goods on credit risks losing them to the buyer's creditors until they are returned. To avoid this risk, the seller could insist on payment for the goods at the time of delivery and give the buyer credit or reimbursement if and when the goods are returned.

NOTE: Consignments that were generally treated as sale or return transactions under former Com C §2326(3) are now specifically governed by Division 9, with similar legal consequences. Com C §9109(a)(4); Official Comment 6 to UCC §9-109. See §12.56.

A sale or return is essentially a financing and merchandising arrangement in which a buyer who intends to resell goods is given title and possession with the option to return the goods if it cannot sell them. Between the seller and buyer, the sale or return is treated as a normal sale, except that the buyer has an option to return the goods and receive its money back.

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§12.56 C. Consignment Contracts

Division 9 applies to all consignments meeting the definitional requirements of Com C §9102(20). Com C §9109(a)(4). See §§12.57-12.60. For purposes of determining the rights of creditors of a consignee, while goods are in the possession of the consignee, the consignee is deemed to have the rights that the consignor had or had power to transfer. Com C §9319. Therefore, the rights of the consignor are determined by the regular priority rules of Division 9. Official Comment 2 to UCC §9-319.

To protect its interest in the goods, the consignor generally must file a financing statement and notify existing creditors of the consignee. See §§12.61-12.63. The consignor's rights in a consignee's bankruptcy are discussed in §12.64.

EXAMPLE: In *Minor v Stevenson* (1991) 227 CA3d 1613, 278 CR 558 (decided under former Com C §2623(3)) the court held that a judgment creditor could attach an automobile in the possession of dealer *A,* who had obtained it from dealer *B* and was attempting to sell it. Dealer *B* claimed that the car was rightfully his, because dealer *A* had stopped payment on the check used to pay for the automobile and had never received documents of title. The court concluded that as long as (1) the automobile was delivered to dealer *A* for sale, (2) dealer *A* was a person who maintained a place of business at which automobiles were sold, and (3) dealer *A* conducted its business under a name other than dealer *B*'s, the automobile would be subject to the claims of dealer *A*'s creditors.

EXAMPLE: In *South Beverly Wilshire Jewelry & Loan v Superior Court* (2004) 121 CA4th 74, 16 CR3d 710, the consignor relinquished possession of diamonds, other gems, and jewelry to the consignee for inspection and prospective sale. The consignee then pledged a portion of the goods to its creditors. The consignor brought an action for conversion and recovery of goods. The trial court granted the consignor's motion for summary adjudication. The creditors filed a writ of mandate with the court of appeal. The court directed the trial court to vacate its order. It stated that the consignor and the creditors were both innocent victims of the consignee's embezzlement. However, the consignor did not avail himself of the Commercial Code's protections. See §§12.61-12.63. Those provisions would have given the consignor priority over the consignee's creditors who later came into possession of the goods for value and without notice. Thus, under the directive of CC §3543, as it applies to the consignor and the creditors, the consignor had to be the "sufferer." The consignor could avoid that outcome only if he could establish that the consignee was generally known by the creditors to be substantially engaged in the sale of goods belonging to others. See §12.59.

EXAMPLE: In *Irving Nelkin & Co. v South Beverly Hills Wilshire Jewelry & Loan* (2005) 129 CA4th 692, 28 CR3d 815, a case involving essentially the same parties as those in *South Beverly Wilshire Jewelry & Loan v Superior Court*, different relief was granted because the consignor took the precaution of filing a financing statement when it consigned its diamonds and other gems with the embezzling consignee. Because of the filing of the financing statement, the goods consigned to the retailer were not transferred to him on a "sale or return" basis under former Com C §2326; title did not pass, and the retailer's pawning of the goods with South Beverly Hills Wilshire Jewelry & Loan (in violation of the consignment memorandum) constituted a conversion. In cases where the property changes possession more than once, a plaintiff has a cause of action for conversion if the defendant who is sued for conversion took the property from another converter, with actual or constructive notice that the prior conversion took place. The financing statement provided the pawnshop with constructive notice that the pledged jewelry belonged to the plaintiff. The plaintiff was able to recover the jewelry with a writ of possession, and then subsequently won a summary adjudication of its right to possession. The court of appeal determined that the plaintiff was entitled to prejudgment interest for the period of time beginning with the conversion and ending not when it recovered the jewelry under the writ, but on entry of the trial court's summary adjudication order.

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§12.57 1. Definition of Consignment

Commercial Code §9102(a)(20) defines a consignment as a transaction, regardless of its form, in which a person, the consignor (§9102(a)(21)), delivers goods to a merchant, the consignee (§9102(a)(19)), for the purpose of sale (see §12.58). The transaction must meet the following requirements:

- The merchant (1) deals in goods of that kind under a name other than the name of the person making delivery, (2) is not an auctioneer, and (3) is not generally known by its creditors to be substantially engaged in selling the goods of others. Com C §9102(a)(20)(A). See §12.59.
- The aggregate value of the goods is $1000 or more at the time of each delivery. Com C §9102(a)(20)(B).
- The goods are not consumer goods immediately before delivery. Com C §9102(a)(20)(C). See §12.60.
- The transaction does not create a security interest that secures an obligation. Com C §9102(a)(20)(D). Consignments intended as security are generally covered by Division 9. Com C §§1201(b)(35), 9109(a)(1), (4); Official Comment 6 to UCC §9-109.

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§12.58 a. Goods Must Be Delivered for Sale

Delivery of goods must be for the purpose of sale to be treated as a consignment. Com C §9102(a)(20). See, *e.g., Walter E. Heller & Co. v Riviana Foods* (5th Cir 1981) 648 F2d 1059 (creditor's security interest did not attach to goods when debtor acted only as warehouse and had no authority to sell merchandise); *Robbins v Comerica Bank-Detroit (In re Zwagerman)* (Bankr WD Mich 1991) 125 BR 486 (bankruptcy trustee had no interest in cattle or proceeds of their sale because cattle's owner had contracted with debtor only to fatten cattle, not to sell them); *In re Key Book Serv.* (Bankr D Conn 1989) 103 BR 39 (debtor was merely entrusted with supply of books for limited purposes of warehousing, shipping, and billing; creditor with security interest in debtor's inventory had no claim to books).

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§12.59 b. Delivery of Goods Not Consignment If Merchant Not Generally Known to Sell Goods of Others

The delivery of goods to a merchant for sale is not a consignment if the merchant is "not generally known by its creditors to be substantially engaged in selling the goods of others." Com C §9102(a)(20)(A). A person delivering goods to a merchant for sale may be assuming a considerable risk, however, if it intends to rely on the merchant's reputation as a seller of the goods of others to avoid the security interests of the merchant's creditors. The terms "generally known" and "substantially engaged" make this exception unpredictable in its application.

EXAMPLE: In *Bank of Cal. v Thornton-Blue Pac., Inc.* (1997) 53 CA4th 841, 62 CR2d 90 (decided under former Com C §2326(3)(b)), a flower grower who consigned flowers to the defendant flower wholesaler argued that the exception should apply because it and several other consignors who were creditors knew that the defendant was engaged in selling the goods of others. The court refused to apply the exception, however, because the evidence did not show that the defendant's *general class* of creditors knew it was a consignee. Consequently, the plaintiff bank's security interest in the defendant's inventory of flowers was superior to that of the consignor grower.

"Substantially engaged" has been held to mean "primarily" engaged in the business of selling the goods of others. See *Heller Fin., Inc. v Samuel Schick, Inc. (In re Wedlo Holdings, Inc.)* (Bankr ND Ill 2000) 248 BR 336, 342; *Multibank Nat'l v State Street Auto Sales, Inc. (In re State Street Auto Sales, Inc.)* (Bankr D Mass 1988) 81 BR 215 (consignments accounting for 15-20 percent of total inventory not sufficient).

PRACTICE TIP: Individual creditors of the consignee are not required to prove detrimental reliance in extending credit to prevail over the consignor (*Escrow Connection v Haas* (1987) 189 CA3d 1640, 235 CR 200); the burden is on the consignor to prove the creditors' knowledge regarding the consignee's business. This may be difficult because the creditors' and consignor's interests are in direct opposition.

The consignor might still prevail if it can demonstrate that the creditor had actual knowledge of the consignment. See *GBS Meat Indus. Pty. Ltd. v Kress-Dobkin Co.* (WD Pa 1979) 474 F Supp 1357, aff'd without published opinion (3d Cir 1980) 622 F2d 578; *First Nat'l Bank v Olsen* (Minn App 1987) 403 NW2d 661. But see *Multibank Nat'l v State Street Auto Sales, Inc. (In re State Street Auto Sales, Inc.)* (Bankr D Mass 1988) 81 BR 215, 218 (secured lender aware that debtor was dealing in consigned automobiles; consignor still required to give lender notice to prevail).

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§12.60 c. Consumer Goods Excluded

The definition of "consignment" in Com C §9102(a)(20) excludes consumer goods. Consumer goods are defined as goods used or bought for use primarily for personal, family, or household purposes. Com C §9102(a)(13). The definition of consignment also requires that, with respect to each delivery, the aggregate value of the goods must exceed $1000. Com C §9102(a)(20).

NOTE: If the consignor delivers goods originally used or bought by the consignor for personal, family, or household purposes, proceeds from the sale of such goods are exempt from the claims of the consignee's creditors, except those amounts that the consignor expressly agreed to pay to the consignee as a fee, commission, or the like. Com C §2326(4).

Because the definition of consignment excludes goods that were consumer goods before delivery, and also excludes goods that are valued at less than $1000, consumers will generally be shielded from the claims of the creditors of a consignee. The common law rule that creditors of a bailee are unable to reach the bailor's interest should prevail with respect to consumer consignors. Official Comment 6 to UCC §9-109. See Benfield, Jr., *Consumer Provisions in Revised Article 9*, *74* Chi-Kent L Rev 1255, 1307 (1999).

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§12.61 2. Protecting Consignor's Interest in Consigned Goods By Filing and Sending Notification

For purposes of Division 9, the interest of a "consignor" is a purchase money security interest in inventory. Com C §9103(d). Therefore, Com C §9324 applies to consignments. Official Comment 6 to UCC §9-103; Official Comment 7 to UCC §9-324. To protect its interest in the consigned goods against the consignee's future secured creditors or a trustee in bankruptcy (see §12.64), the consignor should file a financing statement before the goods are delivered. Com C §9324(b)(1), (c)(1). See §12.62.

If the consignor merely files a financing statement, however, its interest will be junior to those of the consignee's existing secured creditors whose security interests are perfected. Com C §9319; Official Comment 2 to UCC §9-319. To be fully protected under Division 9, the consignor must also send an authenticated notification of its interest in the goods to the consignee's secured creditors before the goods are delivered to the consignee. Com C §9324(b)(2). See §12.63.

PRACTICE TIP: The consignor must send an authenticated notification only if the holder of the conflicting security interest has filed a financing statement before the date of the consignor's filing, or before the beginning of the 20-day temporary perfection period under Com C §9312(f) if the creditor relies on temporary perfection. Com C §9324(c)(2).

For discussion of priorities among secured creditors, see Secured Transactions in California Commercial Law Practice, chap 4 (2d ed Cal CEB 2001).

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§12.62 a. Effect of Financing Statement

A consignor may file a financing statement using the terms "consignor" and "consignee" rather than "secured party" and "debtor." Com C §9505(a). Its interest will be protected in this manner under Com C §9324(b)(1), but the filing itself will not be a factor in determining whether the transaction creates a security interest that secures an obligation and therefore is not a consignment. Com C §9505(b); Official Comment 4 to UCC §9-505. See §12.57.

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§12.63 b. Requirements for Authenticated Notification

The following requirements apply to the sending of authenticated notification under Com C §9324(b)(2):

- The holder of the prior conflicting interest must receive the notification within five years before the consignee receives possession of the consigned goods. Com C §9324(b)(3).
- The notification must state that the consignor has an interest in the consigned goods and describe the goods by item or type. Com C §9324(b)(4).

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§12.64 3. Consignor's Rights in Consignee's Bankruptcy

When a consignee files for relief in bankruptcy, the consignor's right to the consigned goods depends on whether it has taken the steps required for protecting its interest in the goods by filing a financing statement and giving notice (see §§12.61-12.63) or it can demonstrate that the goods were not delivered for sale (see §12.58) or the consignee is generally known by its creditors to be substantially engaged in selling the goods of others (see §12.59). The consignor's right to the goods also may depend on whether they were consumer goods. Com C §9102(a)(20). See §12.60.

- If the consignor has protected its interest in the goods, they are not part of the bankruptcy estate and may be recovered by the consignor. See *Emerson Quiet Kool Corp. v Marta Group, Inc. (In re Marta Group, Inc.)* (Bankr ED Pa 1983) 33 BR 634 (goods covered by consignor's filing were not part of bankruptcy estate).

- If the consignor has not protected its claim to the goods, or cannot otherwise show facts under Com C §9102(a)(20) entitling it to protection, the consignor has the rights of a creditor with an unperfected security interest. Such an interest is subordinate to the rights of a lien creditor, which includes a trustee in bankruptcy under Com C §9102(a)(52)(C). See *Gennet v Oriental Rug Agency, Inc. (In re Florida Consumer's Furniture Warehouse, Inc.)* (Bankr SD Fla 1981) 9 BR 7 (trustee's interest in consigned oriental rugs was superior to consignor's). The consignor's interest is also subordinate to creditors of the consignee whose security interests are perfected. Com C §§9103(d), 9324(b).

The consignor's rights also may be affected by the automatic stay and the trustee's right to avoid preferential transfers. See §§12.65-12.66.

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§12.65 a. Effect of Automatic Stay

Even though the bankrupt consignee may have no interest in the consigned goods (see §12.64), the automatic stay bars the consignor from reclaiming them (see §12.67) without leave of the bankruptcy court, because the goods are in the debtor's possession. See 11 USC §362(a)(3); *Emerson Quiet Kool Corp. v Marta Group, Inc. (In re Marta Group, Inc.)* (Bankr ED Pa 1983) 33 BR 634, 639. The consignor must either obtain a stipulation from the trustee for relief from the automatic stay, along with bankruptcy court approval of the stipulation, or move for relief from the automatic stay in the consignee's bankruptcy case. The automatic stay also prevents the consignor from protecting its interest in the goods by filing after the bankruptcy proceeding has commenced. 33 BR at 641.

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§12.66 b. Avoidance of Consignor's Interest

If the consignor has not protected its claim to the goods and reclaims the goods within the 90-day period preceding the filing of the petition in bankruptcy, the trustee may avoid the reclamation of the goods as a preference if the other requirements of an avoidable preference are met. See 11 USC §547; *In re Gross Mfg. & Importing Co*. (D NJ 1971) 328 F Supp 905; *Independence Nissan, Inc. v Vogue Coach Co. (In re Vogue Coach Co.)* (Bankr ND Okla 1991) 132 BR 454; *Loeb v G.A. Gertmenian & Sons (In re A.J. Nichols, Ltd.)* (Bankr ND Ga 1982) 21 BR 612.

The filing of a financing statement by a consignor within the 90 days preceding the bankruptcy also may be considered a preference under 11 USC §547. See *In re Gross Mfg. & Importing Co., supra*.

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§12.67 D. Seller's Right to Reclaim Goods From Insolvent Buyer

In the rather confined circumstances described in Com C §2702, a seller may reclaim goods sold to an insolvent buyer. Demand for the goods must be made within 10 days after the buyer's receipt. If the buyer is in bankruptcy, the reclamation period is extended to 45 days, or 20 days after the petition for bankruptcy is filed, if bankruptcy commences during the 45-day period. 11 USC §546(c)(1). See §§17.24-17.31 for complete discussion of this remedy.

However, a secured creditor with a perfected security interest in the insolvent buyer's inventory may have priority over a seller attempting to exercise a right of reclamation. The right of the seller to reclaim goods depends on whether the competing creditor of the insolvent buyer is considered to be a good faith purchaser for value under Com C §2403. See *Stowers v Mahon (In re Samuels & Co.)* (5th Cir 1976) 526 F2d 1238 (secured creditor was "good faith purchaser for value" who could obtain goods free of seller's interest). See also *Collingwood Grain, Inc. v Coast Trading Co. (In re Coast Trading Co.)* (9th Cir 1984) 744 F2d 686.

A creditor asserting its interest in the goods through the involuntary processes of attachment or execution probably will not qualify as such a purchaser, because "purchaser" as defined by Com C §1201(b)(29)-(30) contemplates a *voluntary* transaction creating an interest in the goods. See *Citizens Bank v Taggart* (1983) 143 CA3d 318, 191 CR 729 (judgment creditor was not a good faith purchaser for value; seller's right to reclaim upheld). See §§12.16-12.19 for further discussion of good faith purchaser.

The seller's right of reclamation cannot be impugned by the trustee in bankruptcy. See 11 USC §546; *Alfred M. Lewis, Inc. v Holzman (In re Telemart Enters., Inc.)* (9th Cir 1975) 524 F2d 761. As part of its holding in that case, the court determined that (1) the insolvent buyer acquires only voidable title to the goods and (2) reclamation is analogous to rescission.

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V. RIGHTS OF FINANCING AGENCY OR PERSON IN POSITION OF SELLER

§12.68 A. Financing Agency

If an entity or person fits the definition of a financing agency (see §12.69), it has certain rights. These rights may be classified for analysis as:

- Rights with respect to the goods. See §12.70.
- Rights in the seller's contract claim against the buyer. See §12.71.

For further discussion of these rights, see chap 17.

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§12.69 1. Definition of "Financing Agency"

"Financing agency" means a bank, finance company, or other entity or person who in the ordinary course of business makes advances against goods or documents of title or who, by arrangement with either the seller or the buyer, intervenes in ordinary course to make payment or collect payment due under the contract. Com C §2104(2).

The entity assumes this role by purchasing or paying the seller's draft, making advances against it, or merely taking it for collection whether or not documents of title accompany or are associated with the draft. Com C §2104(2).

A financing agency also includes a bank or other entity or person who similarly intervenes between persons in the position of the seller or buyer with respect to the goods. Com C §2104(2). See Official Comment 1 to UCC §2-506.

The rights of a financing agency are discussed in §§12.70-12.71.

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§12.70 2. Rights With Respect to Goods

The financing agency's rights with respect to the goods are in effect the seller's remedies, with all the infirmities that attach.

- In addition to whatever rights might be provided in the draft itself or any document of title securing it, the financing agency is specifically given any rights of the shipper in the goods, including the right to stop delivery (subject to the limitation in Com C §2705(3)(c)-(d) that the carrier need not obey a stop order from a stranger to the contract, unless the goods are being sent under a negotiable document of title and the document is presented). Com C §2506(1).

- The financing agency also has the rights of a person in the position of a seller. Com C §2707(2). See §12.72.

The rights of the shipper arise even though the financing agency does not have possession of the goods or a bill of lading. See Official Comment 3 to UCC §2-506. The financing agency is subject to the rights of the buyer, just as the seller is. For example, the buyer can require delivery of the goods on tender of payment. See Official Comment 4 to UCC §2-506.

NOTE: It does not appear that the financing agency may exercise the seller's right to reclaim the goods from an insolvent buyer. Com C §2702. See §12.67. Although the right is arguably included in "any rights of the shipper in the goods" (Com C §2506(1)), courts have held that, because the reclamation right is based on the seller's reliance on the buyer's misrepresentation, the right is personal to the seller (unless the financing agency also relied on the misrepresentation). See *Shapiro v Union Bank & Sav. Co. (In re Hardin)* (7th Cir 1972) 458 F2d 938.

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§12.71 3. Contractual Rights

In addition to its rights with respect to the goods (see §12.70), the financing agency has the same contractual right as the seller to have a draft for a shipment of goods paid by the buyer. Com C §2506(1); Official Comment 2 to UCC §2-506.

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§12.72 B. Person in Position of Seller

A "person in the position of a seller" includes financing agencies (see §§12.68-12.71), but it also includes agents who have paid or become liable for the price (see CC §§2026-2030) and other parties who hold a security interest or other right in the goods similar to that of the seller. Com C §2707(1). Such a person may withhold the goods or stop their delivery (Com C §2705), resell them (Com C §2706), and recover incidental damages (Com C §2710). Com C §2707(2). On any resale of the goods, however, a person in the position of a seller must relinquish to the seller any excess over its security interest. Com C §2706(6); Official Comment 11 to UCC §2-706 (Official Comment 10 to UCC §2-706 (2003)).

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13

Letters of Credit

Neil B. Martin

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I. USES OF LETTERS OF CREDIT GENERALLY

§13.1 A. Introduction

The letter of credit is a financial undertaking usually issued to assure the payment of money. Letters of credit evolved through merchant custom and practice and the law respecting them is codified in Division 5 of the California Commercial Code. Letters of credit became necessary when trade could no longer be conducted based on the parties' personal knowledge of one another. Originally, a letter of credit was, as the name implies, a letter addressed by the buyer's bank to the seller's bank stating that the buyer's bank knew the buyer and would pay the seller in case of the buyer's default.

Today, reduced to simple terms, a letter of credit is a record (either a writing or electronically retrievable perceivable form) by which its issuer (usually a bank) substitutes the issuer's credit worthiness for the credit worthiness of the party requesting issuance. The obligation of the issuer under the letter of credit to the party named as its beneficiary is independent of any obligation that the party requesting its issuance might have to the beneficiary. Accordingly, a letter of credit is not a guaranty, by which one party answers for the debts of another, but is an independent obligation of the issuer created by statute. It involves at least three separate and independent transactions:

(1) the undertaking from the issuer of the letter of credit to the beneficiary;

(2) the agreement between the issuer and the credit applicant; and

(3) the underlying contract between the applicant and the beneficiary.

See *Morgan Creek Residential v Kemp* (2007) 153 CA4th 675, 63 CR3d 232 (liabilities of letter of credit applicant different from those of guarantors); *San Diego Gas & Elec. Co. v Bank Leumi* (1996) 42 CA4th 928, 50 CR2d 20.

An excellent short history and description of the function of letters of credit is found in *Voest-Alpine Int'l Corp. v Chase Manhattan Bank* (2d Cir 1983) 707 F2d 680, 682. See also *3Com Corp. v Banco de Brasil S.A.* (2d Cir 1999) 171 F3d 739.

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§13.2 B. General Characteristics and Requirements

Because of the greater security for payment that they provide, letters of credit are generally used to facilitate foreign and domestic trade. A letter of credit transaction used to facilitate foreign trade, for example, begins when a domestic buyer of foreign goods approaches its bank for credit to pay for the goods. The buyer (applicant) completes an application for a letter of credit, which usually states the terms under which the letter of credit is to be issued and a commitment by the applicant to repay the bank in the event of a draw on the letter of credit by the seller (beneficiary).

Appropriate credit arrangements or collateral will usually be required from the applicant. Based on the application, the bank issues the letter of credit identifying the foreign seller as the beneficiary, *i.e.,* the person or entity entitled to draw under the credit if the terms set in the letter of credit are met. The issuer notifies the seller directly or through a confirming bank that a letter of credit has been issued. In reliance on the letter of credit, the seller ships the goods and draws a draft under the terms of the letter of credit, attaches the necessary documents to it, and forwards it to the issuer for payment, also called "honor."

The draft is honored by the issuer if the terms of the letter of credit are met. The documents are delivered to the buyer when the buyer pays the issuer the amount the issuer advanced to pay the draft or otherwise arranges to satisfy the obligation of the issuer when it honored the draft. The buyer can then take the documents and claim the shipped goods.

Under Com C §5108(g), if an undertaking is a letter of credit, the issuer is required to disregard any nondocumentary conditions and treat them as if they had not been stated. The Official Comment 9 to UCC §5-108 sets out examples of nondocumentary conditions, such as a requirement that shipment be made only on a vessel no more than 15 years old.

Letters of credit are also used widely instead of bid bonds, performance bonds, advance payment guaranties, or other transactions in which the payment of money needs to be assured. See, *e.g.,* Ins C §§922.4-922.5 (use in the reinsurance business). Letters of credit are also used as additional collateral to enhance credit. See *Western Sec. Bank v Superior Court* (1997) 15 C4th 232, 62 CR2d 243.

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§13.3 C. Terminology

The term "documentary" letter of credit is generally used in a transaction involving the sale of tangible goods and delivery of their documents of title; hence the term. The issuer expects to pay under a documentary letter of credit. A "back to back" credit involves two separate letters of credit. This type of credit usually occurs when a letter of credit is issued to a buyer for the benefit of the seller. The buyer's letter of credit is then used as security by the seller for its letter of credit issued for the benefit of the party that supplied the goods to the seller.

The term "standby" or "guaranty" letter of credit is generally used in a transaction involving no documents of title and applies to a transaction to secure the customer's performance of an obligation owed to the beneficiary, such as a loan. The issuer might not expect to pay under a standby letter of credit.

The term "direct pay" letter of credit is also used in a transaction involving no documents of title and applies to a transaction in which the letter of credit is drawn by one or more beneficiaries (for, *e.g.*, the payment of bond interest) and the issuer is expected to pay them.

NOTE: To avoid being a guaranty, which can be an ultra vires act when a bank has no interest in the transaction, the letter of credit typically is tightly drawn to strictly and clearly limit the issuer's responsibility. Whether a letter of credit will be enforced is determined by the terms of the agreement. An instrument labeled a letter of credit that required the issuer to deal not only in documents, but also in facts relating to the performance of a separate contract, may be held to be an ordinary guaranty of that contract and not a letter of credit. If so, the issuer may become obligated as a guarantor for the liquidated damages up to the amount of the guaranty. See *Andy Marine, Inc. v Zidell* (9th Cir 1987) 812 F2d 534; *Wichita Eagle & Beacon Publishing Co. v Pacific Nat'l Bank* (9th Cir 1974) 493 F2d 1285.

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II. APPLICABLE LAW

§13.4 A. Uniform Customs

Before the adoption of the Uniform Commercial Code, letters of credit were devices developed by custom, practice, and contract largely among bankers for the purpose of financing foreign and domestic trade.

Article 5 of the Uniform Commercial Code (UCC) was the first enactment of a uniform statutory structure governing letters of credit. Previously, the law on letters of credit was developed largely through court decisions. The concern about devising a statutory structure among letter of credit practitioners was, and remains, that a statutory structure may impede the vitality of this commercial device. Thus, the goals of Article 5 are (1) to establish a substantive theoretical framework that describes the function and legal nature of letters of credit, and (2) to preserve procedural flexibility. Official Comment to UCC §5-101.

Revised UCC Article 5, which is included in the California Commercial Code as Division 5, reflects refinement in terms and clarification of intent but continues the original goal to preserve flexibility through variation by agreement. See Official Comment to UCC §5-101. The purpose is to respond to and accommodate developments in custom and usage that are not inconsistent with the essential definition and substantive mandates of the statute.

The evolution of the letter of credit as a vehicle to facilitate trade and finance and the flexibility preserved by Division 5 continues through the efforts of the International Chamber of Commerce to compile the customs and practices of practitioners in the field of letters of credit, usually bankers. The Uniform Customs and Practice for Documentary Credits 2007 Revision (UCP 600) and the International Standby Practices (ISP 98), both published by the International Chamber of Commerce, are the latest iterations of this continuing compilation. The incorporation of these publications, or portions of them, into the terms of a letter of credit is an example of variation by agreement.

Except for those provisions that cannot be varied, in the event of conflict between the rules of custom and practice incorporated in a letter of credit and the provision of Division 5 governing the letter of credit, the rules of custom and practice govern. Com C §5116(c).

NOTE: In addition to the Uniform Commercial Code, UCP 600, and ISP 98, national banks are subject to 12 CFR §7.1016, the interpretive ruling issued by the Comptroller of the Currency that deals with letters of credit.

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B. Commercial Code

§13.5 1. Scope

Division 5 of the California Commercial Code provides definitions of the terms, fixes the responsibilities of parties, imposes warranties on those transferring or presenting drafts drawn under a letter of credit, provides for indemnities by banks, sets the time within which a bank must act on a draft, describes the conditions under which a bank may or must honor drafts, and provides for the transfer and assignment of proceeds of a letter of credit for letters of credit issued under California law. It is the statutory foundation on which letter of credit law is based. However, because code provisions may be varied by agreement, except as otherwise provided under Com C §5103(c), the parties to a letter of credit may choose to incorporate certain terms and conditions by referring to Uniform Customs and Practice for Documentary Credits 2007 Revision (UCP 600), International Standby Practices (ISP 98), or other standards.

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§13.6 2. Role of Custom and Practice

The Commercial Code does not attempt complete statutory coverage. The existence of custom and practice is recognized. See Com C §§5103(b), 5104 (authentication requirements), 5108 (presentation requirements and issuer requirements).

Custom and practice is a matter of interpretation by the court based on evidence offered by the parties. Com C §5108(e). The liability of an issuer, nominated person, or adviser on a letter of credit, confirmation, or other undertaking is governed by rules of custom or practice, such as Uniform Customs and Practice for Documentary Credits 2007 Revision (UCP 600) or International Standby Practices (ISP 98), to which it is expressly made subject. Com C §5116(c).

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§13.7 3. Variance by Agreement

The code provisions may be varied by agreement or by a provision stated or incorporated by reference into the undertaking except as otherwise stated in Com C §5103(c).

Exceptions noted in Com C §5103(c) include (see §13.8 for defined terms):

- Rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or that underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary (Com C §5103(d));
- "Issuer" for these purposes does not include an individual who makes an engagement for personal, family, or household purposes (Com C §5102(a)(9));
- "Letter of credit" for these purposes means a definite undertaking that satisfies the requirements of Com C §5104 by an issuer to a beneficiary at the request or for the account of an applicant or, in the case of a financial institution, to itself or for its own account, to honor a documentary presentation by payment or delivery of an item of value (Com C §5102(a)(10));
- A letter of credit that states that it is perpetual expires 5 years after its stated date of issuance, or, if none is stated, after the date on which it is issued (Com C §5106(d));
- An issuer or nominated person has no obligation to give or withhold its consent to an assignment of proceeds of a letter of credit, but consent may not be unreasonably withheld if the assignee possesses and exhibits the letter of credit and presentation of the letter of credit is a condition to honor (Com C §5114(d));
- The obligations of good faith, diligence, reasonableness, and care may not be disclaimed by agreement, but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if those standards are not manifestly unreasonable (Com C §1302(b));
- The issuer's and applicant's subrogation rights under Com C §5117(a)-(b) do not arise until the issuer honors the letter of credit or otherwise pays and the nominated person's subrogation rights under Com C §5117(c) do not arise until the nominated person pays or otherwise gives value. Until then, the issuer, nominated person, and the applicant do not have any present or prospective rights under Com C §5117(d) forming the basis of a claim, defense, or excuse (Com C §5117(d)); and
- A term in an agreement or undertaking generally excusing liability or generally limiting remedies for failure to perform obligations is not sufficient to vary obligations prescribed by Division 5 (Com C §5103(c)).

Terms from Uniform Customs and Practice for Documentary Credits 2007 Revision (UCP 600) or International Standby Practices (ISP 98) within letters of credit will be deemed to override Division 5 provisions except where the code does not permit variance of obligations (see Com C §5103(c)).

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Source: Business Law/California UCC Sales and Leases/13 Letters of Credit/§13.8 4. Key Definitions

§13.8 4. Key Definitions

Some of the key terms used in Division 5 are defined as follows:

- *Adviser* means a person who, at the request of the issuer, a confirmer, or another adviser, notifies or requests another adviser to notify the beneficiary that a letter of credit has been issued, confirmed, or amended. Com C §5102(a)(1).
- *Applicant* means a person at whose request or for whose account a letter of credit is issued. Com C §5102(a)(2). The term includes a person who requests an issuer to issue a letter of credit on behalf of another if the person making the request undertakes an obligation to reimburse the issuer. An applicant, in practice, is sometimes called an "account party," a "customer," an "accredited buyer" or the "account."
- *Beneficiary* means a person who under the terms of a letter of credit is entitled to have its complying presentation honored. The term includes a person to whom drawing rights have been transferred under a transferable letter of credit. Com C §5102(a)(3). The beneficiary may also be known, in practice, as the "accreditee."
- *Confirmer* means a nominated person who undertakes, at the request or with the consent of the issuer, to honor a presentation under a letter of credit issued by another. Com C §5102(a)(4).
- *Document* means a draft or other demand, document of title, investment security, certificate, invoice, or other record, statement, or representation of fact, law, right, or opinion (1) that is presented in a written or other medium permitted by the letter of credit or, unless prohibited, by the standard practice referred to in Com C §5108(e), and (2) that is capable of being examined for compliance with the terms and conditions of the letter of credit. A document may not be oral. Com C §5102(a)(6).
- *Good faith* means honesty in fact in the conduct or transaction concerned. Com C §5102(a)(7).
- *Honor* means performance of the issuer's undertaking in the letter of credit to pay or deliver an item of value. Unless the letter of credit provides otherwise, "honor" occurs (1) on payment, (2) if the letter of credit provides for acceptance, on acceptance of a draft and, at maturity, its payment, or (3) if the letter of credit provides for incurring a deferred obligation, on incurring the obligation and, at maturity, its performance. Com C §5102(a)(8).
- *Issuer* means a bank or other person that issues a letter of credit, but does not include an individual who makes an engagement for personal, family, or household purposes. Com C §5102(a)(9).
- *Letter of credit* means a definite undertaking that satisfies the requirements of Com C §5104 by an issuer to a beneficiary at the request or for the account of an applicant or, in the case of a financial institution, to itself or for its own account, to honor a documentary presentation by payment or delivery of an item of value. Com C §5102(a)(10).
- *Nominated person* means a person whom the issuer (1) designates or authorizes to pay, accept, negotiate, or otherwise give value under a letter of credit, and (2) undertakes by agreement or custom and practice to reimburse. Com C §5102(a)(11).
- *Presentation* means delivery of a document to an issuer or nominated person for honor or giving of value under a letter of credit. Com C §5102(a)(12).
- *Record* means information that is inscribed on a tangible medium, or that is stored in an electronic or other medium and is retrievable in perceivable form. Com C §5102(a)(14).

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§13.9 C. Other Sources of Law

Other laws may apply to letters of credit. Federal bankruptcy law applies to applicants and beneficiaries that are in bankruptcy. In addition, there are antiboycott and other similar laws that may affect the issuance and performance of letters of credit. See, *e.g.,* Bus & P C §16721.5 (unlawful to use letter of credit that requires discriminatory conduct) and the federal Export Administration Act (50 USC App §§2401-2420).

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III. CREATION OF LETTER OF CREDIT

§13.10 A. Parties to Letter of Credit Transaction

The buyer (documentary letter of credit) or the debtor (standby letter of credit) on whose behalf the letter of credit is issued is generally the applicant. The seller (documentary letter of credit) or the creditor (standby letter of credit) is the beneficiary.

The applicant seeks a letter of credit from the issuer, usually the applicant's bank, to finance a trade or enhance collateral for borrowing.

Another party who may be included in the transaction is the confirmer, which is usually a bank accessible to the beneficiary, and which engages to honor the letter of credit as issued by the issuing bank. The confirmer thereby takes on the obligation of an issuing bank. Com C §5107(a). Another party also involved is the adviser, which informs the beneficiary that the letter of credit has been issued, confirmed, or amended. Com C §5102(a)(1). An advisor who is not also the confirmer does not assume liability to honor the letter of credit. Instead, the adviser assumes an obligation to the issuer and the beneficiary for the accuracy of its advice. Com C §5107(c).

The nominated person is a person whom the issuer designates or authorizes to honor the issuer obligations on presentation under the letter of credit. However, the nominated person who is not also a confirmer is not obligated to honor a presentation. Com C §5107(b).

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§13.11 B. Application for Letter of Credit

The application for a letter of credit need not take a particular form. The basic information will include the applicant's name and account number against which draws are to be charged, the beneficiary's name, the requirements for a draw, and the length of time the letter of credit will be outstanding, or an expiration date and the governing law.

To obtain a documentary letter of credit, the applicant describes to the issuing bank in detail the transaction to be financed. The information is recorded on an application for a letter of credit, which is the agreement between the applicant and the bank covering the transaction. The application also includes the applicant's instructions on what documents must accompany drafts drawn under the letter of credit before the draft should be honored.

The applicant seeking to finance a letter of credit used in international trade may want:

- A document of title to the goods shipped by the seller (*e.g.,* a clean bill of lading in which the applicant is the consignee);
- Customs clearances showing that import requirements have been observed;
- The seller's invoice showing precisely what has been shipped; and
- The certificate of an independent inspector that the shipped goods conform to the buyer's order.

The applicant for a standby letter of credit is less likely to describe the details of the transaction being financed but will describe in detail the document or documents that must accompany a draw under the letter of credit (*e.g.,* a Default Certificate signed by two officers of the beneficiary, stating that the borrower is in default under a loan agreement).

The application will usually include a clause reciting that the applicant agrees to reimburse the bank for drafts honored by it or to supply the bank with sufficient money to cover the draft. The bank in turn agrees to issue the letter of credit, to honor drafts drawn under it when accompanied by the necessary documentation, and to charge the applicant's account with the drafts or to comply with any other agreed financing arrangement. The application generally contains an indemnity agreement reciting that the customer will indemnify the bank for honoring proper drafts despite any instructions received by the bank from the customer.

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§13.12 C. Consideration and Issuance

Consideration is not required to issue, amend, transfer, or cancel a letter of credit. Com C §5105. Because a beneficiary will have no way of knowing if consideration was given for a letter of credit, and it is not expected that a letter of credit would be issued without consideration of some type, consideration is irrelevant to the enforceability of the letter of credit obligation.

There is no particular prescribed form for a letter of credit. It may be issued in any form as long as it is a record (see §13.13) and is authenticated by a signature or in accordance with the parties' agreement or the standard practice of financial institutions that regularly issue letters of credit. Com C §5104.

The letter of credit is treated as established as soon as it is sent to the person requested to advise its issuance or is sent to the beneficiary. Com C §5106(a).

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§13.13 D. Advice of Credit and Confirmation

The advice of credit, like the letter of credit, may assume any intelligible form. It is often transmitted to the beneficiary through an advising bank or, if the beneficiary requires local credit, through a confirming bank.

With regard to a confirmation of a letter of credit, in the absence of language in the confirmation specifying how presentment is to occur and when the obligation expires, a beneficiary need not present the required documents to the confirming bank in addition to the issuing bank to bind the confirming bank to honor the letter of credit. *Northern Trust Co. v Community Bank* (9th Cir 1989) 873 F2d 227.

In *Northern Trust,* the written confirmation only specified "[w]e confirm this letter of credit." 873 F 2d at 228. The court held that the confirming bank was bound to honor drafts drawn under the letter of credit even though presentment was first made before expiration to the issuing bank, the issuing bank was in receivership and could not honor the obligation, and a claim was made on the confirming bank after expiration. 873 F2d at 229. The confirming bank may have avoided the problem by including the following term in its confirmation contract: "We hereby confirm the letter of credit and undertake to honor any drafts presented to us on or before expiration date of the letter of credit."

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§13.14 E. Duration of Credit

If there is no stated expiration date or other provision in the letter of credit that determines its duration, it will expire 1 year after its stated date of issuance or, if no date is stated, then 1 year after the date on which it was issued. Com C §5106(c). If the letter of credit states that it is "perpetual," it expires 5 years after its stated date of issuance or, if none is stated, then 5 years after the date on which it was issued. Com C §5106(d); *Golden W. Refining Co. v SunTrust Bank* (9th Cir 2008) 538 F3d 1233 (letter of credit whose terms provided for expiration 1 year from date of issuance unless beneficiary timely notified issuer not to renew it was not perpetual). The *Golden West* court, after examining the terms of the letter of credit and Com C §5106(d), held that a letter of credit must state that it is perpetual to qualify as such. The court declined to take into account Official Comment 4 to UCC §5-106, which implies that letters of credit providing for revocation or termination only at the discretion of the beneficiary are perpetual. Instead, the court noted that Article 5's drafters (538 F3d at 1239):

> [c]ould have included Official Comment 4 specifically [in the statutory text] to protect a particular type of letter of credit—evergreen credits—and not to indicate that all other letters of credit that contain renewal clauses terminated at the discretion of the beneficiary are perpetual.

The court's decision discounted the drafters' intent and rested on a strict reading of the statutory section, which the court found unambiguous. Many authorities have criticized the Ninth Circuit's decision in this case. See Barnes & Byrne, *Letters of Credit,* 62 Bus Law 1607, 1608 (Aug. 2007).

NOTE: One way that the issuer could have avoided this problem is by retaining the evergreen clause but providing that the credit was renewable at the issuer's discretion and that it would provide notice if it was not going to renew the credit.

The failure to specify an expiration date does not invalidate the letter of credit under Division 5. Article 6 of Uniform Customs and Practice for Documentary Credits 2007 Revision (UCP 600) requires that all letters of credit issued subject to it state an expiration date (which practitioners call the "expiry"). Rule 9.01 of International Standby Practices (ISP 98) requires that a standby letter of credit contain an expiration date or permit the issuer to terminate the standby on reasonable prior notice or payment.

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Source: Business Law/California UCC Sales and Leases/13 Letters of Credit/§13.15 F. Modification and Revocation of Credit

§13.15 F. Modification and Revocation of Credit

Under both Com C §5106 and Article 6 of Uniform Customs and Practice for Documentary Credits 2007 Revision (UCP 600), a letter of credit may be either revocable or irrevocable. Commercial Code §5106(a) states that a letter of credit is revocable only if it so provides. Article 3 of UCP 600 states that a letter of credit is irrevocable even if there is no indication to that effect. International Standby Practices (ISP 98) states that a standby letter of credit is irrevocable.

After a letter of credit is established, the rights and obligations of a beneficiary, applicant, confirmer, and issuer cannot be changed without the consent of each affected party unless the letter of credit provides that it may be revoked or that the issuer may amend or cancel it without consent. Com C §5106(b). There is no statutory requirement that notice of a permitted change be given to any party. Article 10 of UCP 600 states that except as may otherwise be provided in Article 38 (which addresses transferable credits), a credit may not be amended or canceled by the issuer without prior notice to the beneficiary and confirming bank, if any.

PRACTICE TIP: If provision for revocation, amendment, or cancellation is included in a letter of credit (a provision that is very rare), consider also including a provision for notice to the affected beneficiary, applicant, confirmer, and issuer.

A nominated person who has honored, accepted, or undertaken a deferred obligation before receiving notice of an amendment or cancellation is entitled to reimbursement from the issuer. See Official Comment 3 to UCC §5-106.

Also, under Rule 2.06 of ISP 98, a standby letter of credit may contain an express statement that it is subject to automatic amendment by an increase or decrease in the available amount, an extension of the expiration date, or the like, without notice or consent except as otherwise provided in the terms of the credit. If there is no provision for automatic amendment, the beneficiary must consent before an amendment is binding. Partial consent rejects the entire amendment.

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§13.16 G. Form: Sample Letter of Credit

To download **Word** version, right click and choose *Save Target As*

To download **WordPerfect** version, right click and choose *Save Target As*

13.16-1 Sample letter of credit

LARGE NATIONAL BANK
INTERNATIONAL DEPARTMENT
100 NORTH STREET, SUITE 200
LARGETOWN, OTHERSTATE, USA 56473
SWIFT ADDRESS: LARGUS7L TLX NO. 123987
TEL NO. (123) 456-7890
FAX NO. (123) 098-7654

ISSUE DATE: 10/23/07

IRREVOCABLE STANDBY LETTER OF CREDIT NUMBER: 00-1234-LA

BENEFICIARY: ABC TRADING CORP.
1234 MAIN STREET
ANYTOWN, ANYSTATE, USA 12345
ATTN: JOHN DOE

ACCOUNT PARTY: XYZ BUYING COMPANY, INC.
54321 SOUTH STREET
OTHERTOWN, OTHERSTATE, USA 98765
ATTN: MARY SMITH

STATED AMOUNT: USA $750,000

EXPIRY DATE AND PLACE: 12/31/07 AT ISSUING BANK'S INT'L DEPT.

LADIES OR GENTLEMEN:

WE HEREBY ESTABLISH OUR IRREVOCABLE STANDBY LETTER OF CREDIT IN YOUR FAVOR AVAILABLE FOR PAYMENT BY YOUR DRAFT(S) AT SIGHT DRAWN ON LARGE INTERNATIONAL BANK, INTERNATIONAL DEPARTMENT, LARGETOWN, OTHERSTATE, AND ACCOMPANIED BY DOCUMENTS AS SPECIFIED BELOW:

1. THIS ORIGINAL STANDBY LETTER OF CREDIT AND AMENDMENTS, IF ANY;

2. BENEFICIARY'S SIGNED AND DATED STATEMENT WORDED AS FOLLOWS:

"I, _ _[*name of signer*]**_ _, AN AUTHORIZED REPRESENTATIVE OF ABC TRADING CORPORATION, CERTIFY THAT THE ORIGINAL COMMERCIAL INVOICE(S), COPIES ATTACHED HEREWITH, WERE RENDERED TO XYZ BUYING COMPANY, INC., AN OTHERSTATE CORPORATION, FOR PAYMENT AND THAT XYZ BUYING COMPANY, INC., AN OTHERSTATE CORPORATION, HAS FAILED TO COMPLY WITH THE TERMS OF SAID INVOICE(S) AS CONTRACTUALLY AGREED. THEREFORE, ABC TRADING CORPORATION IS DRAWING THE AMOUNT OF USD (AMOUNT OWING) UNDER LARGE NATIONAL BANK STANDBY LETTER OF CREDIT NO. 00-1234-LA TO COVER PAYMENT OF THE UNPAID INVOICES(S)."**

3. COPY(IES) OF COMMERCIAL INVOICE(S) MENTIONED IN DOCUMENTARY REQUIREMENT NO. 2 ABOVE.

SPECIAL CONDITIONS:

1. PARTIAL DRAWINGS PERMITTED.

2. MULTIPLE DRAWINGS PERMITTED.

EACH DRAFT MUST STATE "DRAWN UNDER CREDIT NO. 00-1234-LA OF LARGE NATIONAL BANK, LARGETOWN, OTHERSTATE."

WE HEREBY ENGAGE WITH YOU THAT ALL DRAFTS DRAWN UNDER AND IN COMPLIANCE WITH THE TERMS AND CONDITIONS OF THIS CREDIT SHALL BE DULY HONORED IF PRESENTED FOR PAYMENT AT THE OFFICE OF LARGE NATIONAL BANK, INTERNATIONAL DEPARTMENT, 100 NORTH STREET, SUITE 200, LARGETOWN, OTHERSTATE, USA 56473, ON OR BEFORE THE EXPIRATION DATE OF THIS CREDIT.

EXCEPT SO FAR AS OTHERWISE EXPRESSLY STATED, THIS CREDIT IS ISSUED SUBJECT TO THE INTERNATIONAL STANDBY PRACTICES ("ISP 98"), INTERNATIONAL CHAMBER OF COMMERCE PUBLICATION NO. 590.

AUTHORIZED SIGNATURE	**AUTHORIZED SIGNATURE**
LARGE BANK	**LARGE BANK**

Comment: There is no particular format for a letter of credit provided that the required elements of the credit are clearly spelled out.

PRACTICE TIP: A beneficiary may want to consider negotiating for the removal of the obligation to submit the original letter of credit along with its draw request. There is no statutory or other mandate requiring an issuer to replace a letter of credit if the original is lost or destroyed. If the beneficiary is not able to produce the original when it makes a draw, the issuer may dishonor the presentation for not complying with the terms and conditions of the letter of credit.

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IV. OPERATION OF LETTER OF CREDIT

A. Issuing Bank's Obligations

§13.17 1. Duty to Honor Presentation Independent of Transaction

When the letter of credit is issued, the obligation of the issuing bank to honor drafts drawn or presented under it is independent of the transaction in which the draft was drawn. The issuing bank is not a party to that underlying transaction and has no responsibility for the performance of the parties. Com C §5108(f)(1).

An issuer must honor a presentation that appears on its face, as determined by standard practice, strictly to comply with the terms and conditions of the letter of credit. The standard applied to the issuer is the standard practice of financial institutions that regularly issue letters of credit, and whether the issuer has complied is determined by the court. Com C §5108(a), (e).

NOTE: By requiring that a "presentation" appear strictly to comply, the issuer must look not only at the documents to determine that they appear on examination to be regular on their face but also that the other terms of the letter of credit comply, such as the time and place of presentation. The strict compliance standard is not a "substantial compliance" standard but it is also not intended to impose "slavish conformity" on the examination. Applying the standard practice of financial institutions when interpreting strict compliance allows for some variance, such as the obvious misspelling of a name. The requirement that the court must determine if the issuer complied, rather than relying on a jury's interpretation, is intended to provide reasonable consistency.

Under Article 16 of Uniform Customs and Practice for Documentary Credits 2007 Revision (UCP 600), if the issuing bank refuses to honor or negotiate, it is required to provide notice of the same to the presenter. The notice must state that the bank is refusing to honor or negotiate and list each defect for which the bank is refusing to honor or negotiate the credit. The notice must also state that the bank is:

- Holding the documents pending further instructions from the presenter;
- Holding the documents until it receives a waiver from the applicant and agrees to accept it, or receives further instructions from the presenter prior to agreeing to accept a waiver;
- Returning the documents; or
- Acting in accordance with instructions previously received from the presenter.

Article 16(f) of UCP 600 specifies that failure to act in accordance with Article 14 precludes the issuing bank or the confirming bank from claiming that documents are not in compliance with the terms and conditions of the credit. See *Voest-Alpine Trading USA Corp. v Bank of China* (2d Cir 2002) 288 F3d 262 (issuing bank waived right to reject letter of credit by failing to give notice of refusal to beneficiary by close of seventh banking day following presentment; dealing with provision of UCP 500 substantially similar to Article 16 in UCP 600). See also *Paramount Export Co. v Asia Trust Bank Ltd.* (1987) 193 CA3d 1474, 238 CR 920 (dealing with provision of UCP 500 substantially similar to Article 16 in UCP 600).

If the documents presented comply with the terms of the credit, the issuer must honor the draft regardless of whether the goods or documents conform to the underlying contract. The issuer is not responsible for the performance or nonperformance of the underlying contract, arrangement, or transaction; the act or omission of others; or the observation or knowledge of a particular trade. Com C §5108(f).

Even though a required document is forged or fraudulent, or there is fraud in the underlying transaction, the issuer must honor the draft if the documents accompanying the draft appear to comply with its terms when honor is demanded by any of the following (Com C §5109(a)):

- A nominated person who has given value in good faith and without notice of forgery or material fraud;
- A confirmer who has honored its confirmation in good faith;
- A holder in due course of a draft drawn under a letter of credit which was taken after acceptance by the issuer

or nominated person; or
- An assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person.

If no innocent third party is concerned, the issuer is not under a duty to honor, but, acting in good faith, has the right to honor or dishonor the credit despite notification from the customer of fraud, forgery, or other defect not apparent on the face of the documents, and is entitled to reimbursement from the applicant if the credit is honored. Com C §§5108(i)(1), 5109(a)(2).

An issuer to which a presentation is made has a reasonable time—but not beyond the end of the issuer's seventh business day after the day of receipt of the documents—to (Com C §5108(b)):

- Honor the presentation;
- Accept the draft or incur a deferred obligation, if the letter of credit allows for honor to be completed more than 7 days after presentation; or
- Give notice to the presenter of discrepancies in the presentation.

This provision allows time for the issuer to examine the documents. Official Comment 2 to UCC §5-108. Failure to honor or otherwise act as provided in Com C §5108(b) within the time permitted constitutes dishonor. If the issuer fails to give timely notice of a specific documentary discrepancy, the issuer is precluded from asserting that discrepancy thereafter. Note that under Article 14(b) of UCP 600, nominated, confirming, and issuing banks have a maximum of 5 (not 7) banking days to determine whether a presentation is complying.

In *DBJJJ Inc. v National City Bank* (2004) 123 CA4th 530, 19 CR3d 904, the court held that 7 banking days, the maximum time permitted, is not automatically reasonable when a bank seeks a waiver from an applicant. The 7-day period is not a safe harbor. The time within which the issuing bank must give notice is the lesser of a reasonable time or 7 business days. When there are few documents, the reasonable time would be less than 7 days. See Comment to Com C §5108. When a bank fails to timely examine documents and provide notice, it is precluded from arguing that the documentary presentation is nonconforming. The phrase, "reasonable time, not to exceed seven banking days," was reflected in Article 13(b) of UCP 500 (which may be incorporated by reference in a letter of credit). Although UCP 600 does not provide for the "reasonable time" concept in designating the length of time that nominated, confirming, and issuing banks have to determine a complying presentation, some authorities suggest that such a concept is implied.

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§13.18 2. Remedies for Wrongful Dishonor

The remedies for a wrongful dishonor to which the beneficiary is entitled under Com C §5111 are the amount of the dishonor or, if the issuer's obligation is not payment of money, specific performance. The claimant may also recover incidental damages but is precluded from recovering consequential damages. The applicant may also recover damages from the issuer for a wrongful dishonor, not including consequential damages. Com C §5111(b). Interest may be recovered on the amount owed from the date of the dishonor.

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§13.19 3. Choice of Law

The law governing a letter of credit is the law of the place of performance in the absence of an agreed jurisdiction. See, *e.g., Chuidian v Philippine Nat'l Bank* (CD Cal 1990) 734 F Supp 415.

The liability of an issuer, nominated person, or adviser for acts or omissions is governed by the law chosen by the parties' agreement. Com C §5116. The law of the jurisdiction chosen need not bear any relation to the transaction. If the parties do not choose a governing law, then liability is governed by the law of the jurisdiction in which the issuer, nominated person, or adviser is located. Except as otherwise provided, the liability of the parties is governed by the custom or practice to which the letter of credit, confirmation, or other undertaking is expressly made subject.

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Source: Business Law/California UCC Sales and Leases/13 Letters of Credit/§13.20 B. Issuer's Rights and Duties in Honoring Drafts

§13.20 B. Issuer's Rights and Duties in Honoring Drafts

On payment of a draft or one of a series of drafts contemplated by a letter of credit, the issuer is entitled to immediate reimbursement by the customer. Com C §5108(i).

Although the code provides that an issuer that pays a draft improperly (*e.g.,* when there are nonconforming documents) is not entitled to reimbursement, the applicant's reimbursement obligation may be varied by agreement. Reimbursement agreements between the applicant and the issuer customarily provide that the applicant must reimburse the issuer for any payments made under the letter of credit, if the documents substantially comply, unless the issuer acted with gross negligence or willful misconduct. It does not appear that the customer can recover consequential damages for improper payment. If the issuer wrongfully dishonors a draft, it will be liable to the beneficiary for both the amount of the draft and incidental damages under Com C §2710. Com C §5111(b).

NOTE: Because the issuer will act carefully before honoring a draft drawn under a letter of credit and will confer with the customer before doing so, the problem of improper payment of a letter of credit is more academic than real.

If a presentation is made that appears on its face to strictly comply with the letter of credit even if a required document is forged or there is material fraud, the issuer must honor presentation by a nominated person who gave value in good faith without notice of the forgery or material fraud or a confirmer who honored its confirmation in good faith or certain others. In any other presentation, the issuer, acting in good faith, may honor or dishonor the presentation. Com C §5109(a)(2).

However, Com C §5109(b) provides that if an applicant claims a required document is a forgery or is materially fraudulent, or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court may enjoin the issuer from honoring the presentation if the court finds:

- The relief sought is not prohibited under the law applicable to accepted drafts or deferred obligations incurred by the issuer;
- A beneficiary, issuer, or nominated person who may be adversely affected is adequately protected from loss (including legal fees) by bond or otherwise if relief is granted;
- All conditions under the law entitling the applicant to relief have been met; and
- Based on the submissions, it is more likely than not that the applicant will succeed under its claim of forgery or material fraud and the person demanding honor is not protected under Com C §5109(a).

The Official Comments to UCC §5-109 make clear that the fraud on which the injunction is based may be in the documents or in the underlying transaction and the fraud must be "material" or significant to the particular transaction, so that the beneficiary has no colorable right to draw under the letter of credit. In such instances, to allow the issuer to honor a draw would be unjust.

NOTE: Neither the International Standby Practices (ISP 98) nor the Uniform Customs and Practice for Documentary Credits 2007 Revision (UCP 600) address or otherwise provide defenses to honor based on fraud, abuse, or similar matters. This means that matters of this nature are governed by Division 5.

The issuer of an irrevocable letter of credit is exempted from any responsibility to ascertain the reciprocal rights and liabilities of the applicant for the letter of credit and the beneficiary. See *Lumbermans Acceptance Co. v Security Pac. Nat'l Bank* (1978) 86 CA3d 175, 150 CR 69. In *San Diego Gas & Elec. Co. v Bank Leumi* (1996) 42 CA4th 928, 939, 50 CR2d 20, the court stated that

> the issuer of a standby letter of credit does not have the right to inquire into the contractual dispute between its customer and the beneficiary, including the issue of the beneficiary's damages, in considering whether to honor the beneficiary's demand for payment under the letter.

An issuer who wrongfully dishonors or repudiates its obligation is liable to the beneficiary or any successor or nominated person for the amount of the letter or, if no amount is required, for specific performance or an amount

representing the value of specific performance. Com C §5111(a). The claimant may also recover incidental damages but may not recover consequential damages. The claimant is not obligated to mitigate the damages but, if the claimant does mitigate, the amount of recovery is reduced by the amount of the mitigation, with the issuer carrying the burden of proof.

An issuer who wrongfully dishonors a presentation or honors a presentation in breach of its obligation under the letter of credit is liable to the applicant for damages resulting from the breach, including incidental damages and interest but not consequential damages. Com C §5111(b).

If an advisor or nominated person breaches an obligation under Division 5 or an issuer breaches an obligation not covered by other sections of Com C §5111, the person damaged may recover damages resulting from the breach, including incidental and interest but not consequential damages. Com C §5111(c).

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§13.21 C. Beneficiary's Rights and Obligations: Warranties on Transfer or Presentment

The beneficiary draws a draft on the customer under the letter of credit. If the draw is under a documentary letter of credit, the beneficiary attaches to the draft the documents called for in the letter and sends the draft with documents on for presentment. The beneficiary may also negotiate the draft to the beneficiary's bank, and that bank would become the negotiating bank. The negotiating bank then presents the draft and documents for honor.

When the presentation is honored, the beneficiary warrants (1) to the issuer, any other person to whom presentation is made, and to the applicant that there is no fraud or forgery of the kind described in Com C §5109, and (2) to the applicant only that the drawing does not violate any agreement between the applicant and the beneficiary or any other agreement intended by them to be augmented by the letter of credit. The warranties in Com C §5110(a) continue to be in addition to the warranties given under Divisions 3, 4, 7, and 8 to the extent that a presentation or transfer is covered by one of those divisions. See Com C §5110(b) and the Official Comments to UCC §5-110. Persons moving the documents from the beneficiary to the applicant (*e.g.*, negotiating or confirming banks), being of purely intermediary character, make no such warranty.

These warranties are given when the presentation is honored. Accordingly, no claim of breach of warranty can be a defense to dishonor by the issuer. Instead, the issuer must defend under Com C §5108 or §5109.

NOTE: The relationship between the issuer and the beneficiary is statutory, and a beneficiary under a standby letter of credit does not owe the issuer a duty to mitigate damages. Nor will actual mitigation reduce a beneficiary's recovery under a letter of credit. *San Diego Gas & Elec. Co. v Bank Leumi* (1996) 42 CA4th 928, 50 CR2d 20.

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D. Jurisdiction

§13.21A 1. Jurisdiction Over Foreign Issuer

Several courts have found that a beneficiary's status as a resident of a forum state is not sufficient to establish personal jurisdiction over the banks involved in issuing or confirming the letter of credit for the benefit of the beneficiary. See, *e.g., RZV Holdings, AVV v Commerzbank, AG* (ED Va 2003) 279 F Supp 2d 716. In that case, Commerzbank, a German bank with its principal place of business in Germany, acted as the confirming bank for a letter of credit issued by a Venezuelan bank at the request of a Venezuelan state oil company for the benefit of a Virginia partnership with its principal place of business in Virginia. The court reasoned that jurisdiction over an issuer (or confirming bank) does not arise from the issuance of a letter of credit because the credit is not a contract between a beneficiary and an issuer but instead is a contract between the applicant and issuer independent of the underlying contract between the applicant and beneficiary. Applying a similar analysis, the court determined that a confirming bank also does not have a contractual relationship with a beneficiary and is likewise insulated from the contract between the applicant and issuer. The court followed the majority approach, noting that it was more reflective of the minimum contacts test as set forth by the United States Supreme Court. By merely confirming a letter of credit issued by a foreign bank in a foreign nation for the benefit of a resident of a particular state, the confirming bank does not purposefully avail itself of the laws, privileges, and protections of that state. 279 F Supp 2d at 722.

The court noted the contrary position taken by the Alaska and Colorado state supreme courts. Those courts ruled that when issuing or confirming a letter of credit, the issuing or confirming bank is almost always aware of the beneficiary's location and purpose for the funds. The courts reasoned that because the banks are aware that the impact of their decisions to issue or honor letters of credit will be felt in the state in which the beneficiary resides, those banks purposely avail themselves of the laws and privileges of the beneficiary's state. 279 F Supp 2d at 721.

The *RZV Holdings* case, while not decided by a California court, is still useful for understanding the majority approach on jurisdiction over a foreign issuer.

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Source: Business Law/California UCC Sales and Leases/13 Letters of Credit/§13.22 2. Jurisdiction Over Foreign Beneficiary

§13.22 2. Jurisdiction Over Foreign Beneficiary

Factors to consider when attempting to establish jurisdiction over a foreign beneficiary for purposes of enjoining a draw under a letter of credit include:

- The beneficiary does some act or consummates some transaction within the forum or performs some act to purposefully benefit from the privilege of conducting activities in the forum;
- The claim arises or results from the forum-related activities of the beneficiary; and
- The exercise of jurisdiction is reasonable.

See *Data Disc, Inc. v Systems Technol. Assocs.* (9th Cir 1977) 557 F2d 1280.

NOTE: The fact that a foreign bank was a beneficiary under a letter of credit issued by a California bank and maintained an account with the California bank to receive payment under the letter of credit and perform other international banking transactions did not provide sufficient contacts to permit the California court to exercise jurisdiction over it. *Thomas J. Palmer, Inc. v Turkiye Is Bankasi A.S.* (1980) 105 CA3d 135, 164 CR 181.

It should be noted that, in *Wyle v Bank Melli* (ND Cal 1983) 577 F Supp 1148, the district court found jurisdiction on facts similar to those in *Thomas J. Palmer, Inc. v Turkiye Is Bankasi, A.S., supra.* Later court decisions, however, have refused to follow *Wyle,* finding it to be a product of the strained relations between the United States and Iran and not supported by authority. See *Paccar Int'l, Inc. v Commercial Bank of Kuwait* (9th Cir 1985) 757 F2d 1058; *New Tech Devs. v Bank of Nova Scotia* (1987) 191 CA3d 1065, 236 CR 746.

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§13.23 E. Duties of Advising Bank

An advising bank under a letter of credit ordinarily has no duty to investigate the factual basis for a beneficiary statement unless the letter of credit so instructs. In fact, an advising bank, usually a correspondent of the issuing bank, has no duties at all except to accurately advise the beneficiary of the fact of the issuance of the letter of credit (hence the name) and to check the apparent authenticity of the request to advise. Com C §5107(c). If an advising bank is also the assignee of the proceeds of the letter of credit, it has a direct interest that requires it to investigate the factual basis of the draw. *Pubali Bank v City Nat'l Bank* (9th Cir 1985) 777 F2d 1340.

In *Pubali Bank,* the Ninth Circuit upheld its previous decision that a customer may sue for breach of the warranties made by beneficiaries who drew down on a letter of credit for an obligation not specified in the letter. Other amounts owing did not justify drawing down on a letter that was a standby guaranty for a particular debt that had been honored fully. The beneficiaries could have avoided the issue through specificity in drafting the terms of the letter.

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§13.24 F. Standard Practices Followed

Division 5 seeks to minimize unnecessary restrictions on letters of credit. The emphasis is on the standard practices of financial institutions issuing letters of credit. Com C §5108(e). This is exemplified in Uniform Customs and Practice for Documentary Credits 2007 Revision (UCP 600) and International Standby Practices (ISP 98), to the extent that the letter of credit is issued subject to one or the other of these compilations.

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Source: Business Law/California UCC Sales and Leases/13 Letters of Credit/§13.25 G. Transfer and Assignment of Credit; Security Interests in the Credit

§13.25 G. Transfer and Assignment of Credit; Security Interests in the Credit

Unless a letter of credit specifically provides that it is transferable, the beneficiary may not transfer the right to draw or otherwise demand performance under the credit. Com C §5112(a). The intent is to protect the applicant and permit control over the persons who may draw under the credit. Provisions for partial transfer may be permitted if the letter of credit incorporates references to Uniform Customs and Practice for Documentary Credits 2007 Revision (UCP 600) provisions that permit such transfers. Similarly, provisions for transfer are contained in International Standby Practices (ISP 98), if the letter of credit so states.

The issuer, however, need not recognize a transfer by the beneficiary if (Com C §5112(b)(1)):

- The transfer violates applicable law; or
- Either the transferor or transferee fails to comply with any requirement of the letter of credit, applicable standard industry practice, or other reasonable requirement of the issuer.

The issuer may impose requirements that do not conform to standard industry practice. The issuance of a transferable letter of credit permits the beneficiary to transfer the drawing rights and permits the nominated person to deal with the transferee without notice to the issuer or the applicant. To protect against multiple presentations, it is common practice for the nominated person to take possession of the original letter of credit.

With regard to the rights of a successor to a beneficiary (see Com C §5102(a)(15)), an issuer is required to recognize a successor to a beneficiary if the successor has met the requirements for transfer of the drawing rights by operation of law, under the standard practices set out in Com C §5108(e) or, absent such practices, complied with procedures sufficient to protect the issuer. Com C §5113.

The Official Comment to UCC §5-113 gives examples of transfers by operation of law arising by reason of merger or bankruptcy. Thus, evidence of the transfer could include a certificate of merger or an order from a court of appropriate jurisdiction. The FDIC, as a corporate entity, was entitled to the transfer of the rights of a beneficiary bank under a letter of credit by the FDIC in its capacity as receiver on the failure of the beneficiary bank. *FDIC v Bank of Boulder* (10th Cir 1990) 911 F2d 1466.

NOTE: "Transfer" must be distinguished from "assignment of proceeds." The former is comparable to a novation or a substitution of beneficiaries. Performance by the transferee is contemplated. "Assignment of the proceeds" requires performance by the beneficiary and a presentation of a draft and invoice signed by the beneficiary. See Official Comments to UCC §5-112.

The right of the beneficiary to assign all or part of the proceeds of a letter of credit is governed by Com C §5114. A beneficiary may assign the proceeds of a letter of credit. An issuer or nominated person need not recognize an assignment without its consent (see Com C §5114(c)), but that consent may not be unreasonably withheld if the assignee presents the letter of credit and the presentation is a requirement to honor it (Com C §5114(d)).

NOTE: "Proceeds of a letter of credit" is defined to include the cash, check, accepted draft, or other value paid or delivered when the letter of credit is honored, but does not include the beneficiary's drawing rights or the documents that must be presented by the beneficiary. Com C §5114(a).

Proceeds of a letter of credit may be assigned before performance of the conditions of the letter, but honor remains contingent on the beneficiary's compliance with the terms and conditions of the letter of credit. The rights of a transferee are superior to those of an assignee. Com C §5114(e).

To the extent that the letter of credit is drawn down by draft, the beneficiary may draw a draft under the credit and endorse it to a third party, such as a supplier. If the supplier takes the draft in payment and negotiates it through a collecting bank to the issuer for payment, the issuer must pay the endorsee if the terms and conditions of the credit are otherwise met. If the draft is a documentary draft, the collecting bank has a perfected security interest in the documents to the extent the bank credit is given for the draft. Com C §4210.

PRACTICE TIP: Primarily to protect against fraudulent endorsements and, in part, to limit endorsements without knowledge of the issuer, issuers will generally prohibit a beneficiary from drawing a draft and endorsing it to a third party. Instead, the issuer will require the beneficiary to execute an assignment-of-proceeds form with certain limitations or prohibitions on additional endorsements and indemnification provisions.

The issuer or nominated person has a security interest in the documents presented under a letter of credit to the extent that the issuer or nominated person honors or gives value for the presentation. Com C §5118.

The local law of the issuer's jurisdiction or the nominated person's jurisdiction will govern the perfection of a security interest, and priority of a security interest, in letter of credit rights. Com C §9306. Under California law, a security interest in letter of credit rights is perfected by control. Com C §9314. Control of letter of credit rights to payment or performance exists to the extent that the issuer or nominated person has consented to an assignment of the proceeds of the letter of credit under Com C §5114(c) or other applicable law or practice. Com C §9107.

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Source: Business Law/California UCC Sales and Leases/13 Letters of Credit/§13.26 H. Remedies of Beneficiary or Other Claimant

§13.26 H. Remedies of Beneficiary or Other Claimant

A beneficiary, successor, or nominated person may recover from the issuer who wrongfully dishonors or repudiates its obligation to pay money in the amount of the dishonor or repudiation. If no money is to be paid, the claimant may require specific performance or, at the claimant's election, an amount equal to the value of specific performance. Although a claimant is not obligated to avoid damages that might arise under anticipatory breach by the issuer, if the claimant does take action to avoid damage, the recovery from the issuer must be reduced as well. Com C §5111(a).

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§13.27 V. EXPANSION OF LETTER OF CREDIT DEVICE

The use of the letter of credit as a financing tool has grown from its traditional roots as a means of financing trade through the documentary letter of credit. International Standby Practices (ISP 98) recognizes that there are significant differences in the scope and practice between standby letters of credit and commercial or documentary letters of credit covered by Uniform Customs and Practice for Documentary Credits 2007 Revision (UCP 600). Important extensions and new applications of the letter of credit device have been and are being conceived. Secondary or "back-to-back" credits, in which the beneficiary assures a supplier payment by initiating a secondary credit in favor of the supplier with the bank issuing or confirming the original credit, are common. "Revolving credits" permit a customer to have a line of credit that may be reused as the customer reduces his or her obligation to the issuer, *i.e.,* as he or she reimburses the bank for drafts previously honored by it.

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14

Bulk Sales

Bryan D. Hull

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§14.1 I. CALIFORNIA BULK SALES LEGISLATION

The original objective of state bulk sales laws was to protect creditors against dishonest merchants who, with disturbing frequency, sold all or the bulk of their inventories or equipment, and then either absconded with or dissipated the proceeds without paying their bills. The purpose of California's bulk sales law is to warn the seller's creditors of the impending sale of all, or substantially all, of its assets by requiring recordation and publication. Creditors can then can take steps to obtain payment of their claims, or otherwise protect their rights, before the assets are sold.

The bulk sales law is in Division 6 of the California Commercial Code. The current version is based to a great extent on Article 6 of the 1988 Official Text of the Uniform Commercial Code. California's version, however, contains many changes that conform the uniform code to local practice.

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§14.2 II. TRANSACTIONS SUBJECT TO LAW

Commercial Code Division 6 does not attempt to cover all kinds of businesses or transactions; the coverage is limited both by original definition (see §§14.3-14.6) and by a series of exemptions (see §§14.7-14.23). The threshold question is whether California's Division 6 applies to the transaction.

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§14.3 A. Location of Seller

Commercial Code Division 6 applies only if the seller is located in California. Com C §6103(a)(2). The location of the seller is considered to be at its place of business or, if the seller has more than one place of business, at its chief executive office. Com C §6103(b). If the seller is located outside the United States (including United States territories and possessions or Puerto Rico; Com C §6102(a)(14)), California law applies if the seller's major executive office in the United States is in California. Com C §6103(a)(2).

Because California law specifies that Commercial Code Division 6 applies only if the seller (and not the assets) is located in California, in a situation in which assets are located in more than one jurisdiction, creditors will most likely look for notice in the state in which the seller is located.

A gap in coverage may exist until all states adopt the choice-of-law rule found in the 1988 Official Text of UCC Article 6. For example, if a seller (whose principal executive office is outside of California) conducts a bulk sale of assets located in California, and the seller's jurisdiction has not adopted the new UCC Article 6 and applies a law in which the seller's state has jurisdiction if the goods are located there, then neither California's bulk sales law nor the bulk sales law of the seller's state may apply. California's law will not apply because the seller is not located in California; the law of the seller's jurisdiction will not apply because the goods are not located there.

In addition, if the seller is located in California and the assets being sold are located in a jurisdiction that has not adopted the new choice-of-law rule, it will be necessary to comply with both California law and the law of the jurisdiction in which the assets are located. Thus, in any transaction with multijurisdictional aspects, practitioners will need to keep track of the states that have adopted the choice-of-law rule of the 1988 UCC text. As of August 2009, only California, the District of Columbia, and Virginia have adopted the 1988 Official Text of UCC §6-103. Forty-seven jurisdictions, including Puerto Rico and the U.S. Virgin Islands, have repealed Article 6 altogether. For a current listing of these states, see the website of the National Conference of Commissioners on Uniform State Laws: http://www.nccusl.org. Only Georgia, Maryland, and Wisconsin continue to use former Article 6.

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§14.4 B. Type of Business

A seller is subject to the bulk sales law if (1) the seller is a restaurant owner or (2) the seller's principal business is the sale of inventory from stock, including those sellers who manufacture what they sell. Com C §6103(a)(1). In some cases, it may be difficult to determine the nature of the seller's principal business. For example, assume that a corporation has a carpet cleaning division, which is its principal business, and a retail outlet that sells carpeting. If the corporation sells all the inventory of the retail outlet, is the sale covered by Commercial Code Division 6?

At least one court has held that a retail outlet owned by a larger business must be considered a separate enterprise for the purpose of determining whether the bulk sales law applies. See *National Bank of Royal Oak v Frydlewicz* (Mich Ct App 1976) 241 NW2d 471. The better analysis, however, would seem to be a cumulative approach, in which the seller's principal business is determined on the basis of the corporation as a whole. Nevertheless, buyers and sellers in bulk and their attorneys should be aware that some courts may define "seller" to be a smaller part of a larger organization.

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Source: Business Law/California UCC Sales and Leases/14 Bulk Sales/§14.5 C. Type and Amount of Transfer

§14.5 C. Type and Amount of Transfer

If the seller is governed by Division 6, the bulk sales law applies when:

- The sale of a seller's inventory or equipment is not in the ordinary course of the seller's business (Com C §6102(a)(3)(i)-(ii)); and
- The value of inventory or equipment being sold is worth more than half of the seller's total inventory or equipment, as measured by their fair market value on the effective date of the bulk sales agreement (Com C §6102(a)(3)(i)-(ii), (a)(8)(ii)).

The bulk sales law also applies to comparable sales that are not in the ordinary course of business, and which are conducted by auction or by a liquidator on the seller's behalf. Com C §6102(a)(3)(i). In that case, the date for determining fair market value of the inventory and/or equipment being sold is the date on which the seller engages the liquidator or auctioneer. Com C §6102(a)(8)(i).

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§14.6 D. Type of Property

The bulk sales law governs sales of "equipment" and "inventory." Com C §6102(a)(3). The bulk sales law incorporates the definitions of these terms in Com C §9102(a), which provides in part that:

> (33) "Equipment" means goods other than inventory, farm products, or consumer goods.
> …
> (48) "Inventory" means goods, other than farm products, which are any of the following:
> (A) Leased by a person as lessor.
> (B) Held by a person for sale or lease or to be furnished under a contract of service.
> (C) Furnished by a person under a contract of service.
> (D) Consist of raw materials, work in process, or materials used or consumed in a business.

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III. EXEMPTED SALES

§14.7 A. Value of Assets Test

Transactions in which the value of the assets sold is more than $5 million or less than $10,000, net of liens and security interests, are exempted from application of the bulk sales law. Com C §6103(c)(12).

"Assets" include the seller's inventory and equipment and any tangible or intangible business personal property sold in connection with the inventory and equipment. Com C §6102(a)(1). The definition of "assets" does not include (Com C §6102(a)(1)):

- Fixtures other than readily removable factory and office machines;
- The lessee's interest in a lease of real property; or
- Any property that is exempt from creditor process, such as enforcement of judgment, under nonbankruptcy law.

The value of the assets in a sale not held by an auctioneer or liquidator is presumed to be the price that the buyer agrees to pay for the assets. In a sale held by an auctioneer or liquidator, the value is presumed to be the amount that the auctioneer or liquidator reasonably anticipates the assets will bring at auction or on liquidation. Com C §6103(f).

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§14.8 B. Creation of Security Interests

Transfers made to secure payment or performance of an obligation are exempted from application of the bulk sales law. Com C §6103(c)(1).

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Source: Business Law/California UCC Sales and Leases/14 Bulk Sales/§14.9 C. Assignment for Benefit of Creditors

§14.9 C. Assignment for Benefit of Creditors

General assignments for the benefit of creditors or to a subsequent transfer by the assignee are exempted from application of the bulk sales law. Com C §6103(c)(6).

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Source: Business Law/California UCC Sales and Leases/14 Bulk Sales/§14.10 D. Settlement of Lien or Security Interest

§14.10 D. Settlement of Lien or Security Interest

A secured party's taking possession of the pledged collateral after default (Com C §9609) is not a bulk sale. Com C §6103(c)(2). In addition, a secured party's sale of collateral (Com C §9610) or retention of collateral in satisfaction of the obligation (Com C §§9620) is exempted from application of the bulk sales law. Com C §6103(c)(3)-(4).

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Source: Business Law/California UCC Sales and Leases/14 Bulk Sales/§14.11 E. Sale of Encumbered Asset

§14.11 E. Sale of Encumbered Asset

A sale of an asset encumbered by a security interest or lien is exempted from application of the bulk sales law if (Com C §6103(c)(5)):

- All the proceeds of the sale are applied in partial or total satisfaction of the debt secured by the security interest or lien; or
- The security interest or lien is enforceable against the asset after it has been sold to the buyer, and the net contract price is zero.

"Net contract price" is defined as the new consideration that the buyer is obligated to pay for the assets, less any security interests or liens enforceable against the assets before and after the sale and any proceeds applied to partially or totally discharge any lien or security interest enforceable against an asset. See Com C §6102(a)(11) for the full definition.

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Source: Business Law/California UCC Sales and Leases/14 Bulk Sales/§14.12 F. Sale by Court-Appointed and Public Officers

§14.12 F. Sale by Court-Appointed and Public Officers

Sales by an executor, administrator, receiver, trustee in bankruptcy, debtor in possession, or any public officer under judicial process are exempted from application of the bulk sales law. Com C §6103(c)(7).

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§14.13 G. Sales in Corporate Dissolution and Reorganization Proceedings

Sales made in the course of judicial or administrative proceedings for the dissolution or reorganization of an organization are exempted from application of the bulk sales law. Com C §6103(c)(8).

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§14.14 H. Transfers of Goods in Warehouse

Transfers of goods in a warehouse are exempted from application of the bulk sales law if a warehouse receipt has been issued by a warehouse (a person or business engaged in the business of storing goods for hire (Com C §7102(a)(13))), and a copy of the receipt is kept at the warehouse's principal place of business and at the warehouse where the goods are stored. Com C §6103(c)(16).

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§14.15 I. Sale and Leaseback

A transfer of personal property, if the personal property is leased back to the transferor immediately following the transfer, is exempted from application of the bulk sales law if either there has been compliance with the filing and notice requirements of CC §3440.1(h) (see §§14.24-14.41) or the transfer is exempt under CC §3440.1(k) (property purchased for value and in good faith). Com C §6103(c)(14).

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§14.16 J. Transfer of Alcoholic Beverage License

A limited exemption from application of the bulk sales laws is provided for transfers that are subject to and comply with Bus & P C §§24070-24082 (alcoholic beverage licenses). Com C §6102(c)(15). The transferee must record and publish notice of the transfer, containing the information listed in Com C §6105(a)(1)-(4), at least 12 business days before the transfer is to be consummated. Com C §6103(c)(15). See §§14.25-14.27.

In alcoholic beverage license transfers, the Business and Professions Code provides an escrow mechanism for the protection of creditors. For discussion of requirements for license transfers, see Carmichael, *Transferring Retail Liquor Licenses in California*, 15 CEB Cal Bus L Prac 67 (Summer 2000).

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§14.17 K. Sale of Business in Which Buyer Agrees to Pay Seller's Debts

Commercial Code Division 6 contains three exemptions of sales in which the buyer assumes the seller's obligations: one in which the buyer obtains the names of the known claimants and assumes those debts (see §§14.17-14.19); one in which the buyer assumes all the seller's business debts (see §§14.20-14.21); and one for newly formed entities organized to continue the seller's business (see §14.22).

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1. Buyer Assumes Debts to Known Claimants

§14.18 a. Requirements

A sale is exempted from application of the bulk sales law if the buyer discovers the known claimants against the seller and assumes in full the debts owed to them. Com C §6103(c)(9)(ii). The buyer may make this discovery either by obtaining a verified list from the seller within 21 days before the sale, listing the claimants of whom the seller has notice 3 days before it sends or delivers the list to the buyer, or by reasonable inquiry. Com C §6103(c)(9)(i). "Claimant" is defined in Com C §6102(a)(5).

The buyer must have its principal place of business in the United States and must be solvent after the assumption. It must record and publish notice of the assumption within 30 days after the assumption in the same manner as a bulk sale notice (Com C §6105). Com C §6103(c)(9). The contents of the notice are spelled out in Com C §6103(d) (see form 14.19-1):

- That a sale that may constitute a bulk sale has been or will be made;
- The date or prospective date of the bulk sale;
- The individual, partnership, or corporate names and the addresses of the seller and buyer;
- The address to which inquiries about the sale may be made, if different from the seller's address; and
- That the buyer has assumed or will assume in full the debts owed to claimants of whom the buyer has knowledge on the date the buyer receives the list of claimants from the seller or completes a reasonable inquiry to discover the claimants.

NOTE: As noted, the exemption is effective only if the buyer assumes those known debts owed to claimants following a reasonable period of discovery or if the seller provides a list of claimants. A buyer who takes a verified list from the seller is held to have knowledge of the claimants on the list and is entitled to rely in good faith on the list without making further inquiry. See Official Comment 6 to UCC §6-103.

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Source: Business Law/California UCC Sales and Leases/14 Bulk Sales/§14.19 b. Form: Notice for Exemption When Buyer Assumes Debts to Known Claimants

§14.19 b. Form: Notice for Exemption When Buyer Assumes Debts to Known Claimants

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14.19-1 Notice for exemption when buyer assumes debts to known claimants

PLEASE TAKE NOTICE that what may constitute a bulk sale _ _[*has been/is about to be*]_ _ **made. This bulk sale** _ _[*will be consummated on or after/was consummated at*]_ _ _ _[*specify either anticipated date of bulk sale or actual date*]_ _**. The sale** _ _[*will be/was*]_ _ **made by** _ _[*name of individual, partnership, or corporate seller*]_ _**, whose business address is** _ _[*business address of seller*]_ _**. The sale** _ _[*will be/was*]_ _ **made to** _ _[*name of individual, partnership, or corporate buyer*]_ _**, whose business address is** _ _[*business address of buyer*]_ _**.**

[*Add if appropriate*]

The address to which inquiries about the sale may be made, if different from the seller's address, is _ _[*address to which inquiries may be directed*]_ _**.**

[*Continue*]

The buyer has assumed or will assume, in full, the debts owed to claimants of whom the buyer has knowledge on the date the buyer receives the list of claimants from the seller or completes a reasonable inquiry to discover the claimants.

Date: _ _ _ _ _ _ __[*Signature of buyer*]__
_ _[*Typed name*]_ _

Copies: One original for each county in which the notice is recorded; one copy for each newspaper in which the notice is published; one copy for each county tax collector to which the notice must be sent; one office copy.

Comment: See §14.18 for requirements for exemption. The method of recordation and publication is set forth in Com C §6105(b).

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2. Buyer Assumes All Debts

§14.20 a. Requirements

A sale is exempt if it is made to a buyer that assumes in full the debts that were incurred in the seller's business before the date of the bulk sale. The buyer must have its principal place of business in the United States and must be solvent after the assumption. It must record and publish notice of the assumption within 30 days after the date of the bulk sale in the same manner as a bulk sale notice (Com C §6105). Com C §6103(c)(10). The contents of the notice are prescribed by Com C §6103(e) (see form 14.21-1):

- That a sale that may constitute a bulk sale has been or will be made;
- The date or prospective date of the bulk sale;
- The individual, partnership, or corporate names and the addresses of the seller and buyer;
- The address to which inquiries about the sale may be made, if different from the seller's address; and
- That the buyer has assumed or will assume the debts that were incurred in the seller's business before the date of the bulk sale.

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Source: Business Law/California UCC Sales and Leases/14 Bulk Sales/§14.21 b. Form: Notice for Exemption When Buyer Assumes All Debts

§14.21 b. Form: Notice for Exemption When Buyer Assumes All Debts

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14.21-1 Notice for exemption when buyer assumes all debts

PLEASE TAKE NOTICE that what may constitute a bulk sale _ _[*is about to be/has been*]_ _ **made. This bulk sale** _ _[*will be consummated/was consummated*]_ _ **on** _ _[*or after*]_ _ _ _[*specify either anticipated date of bulk sale or actual date*]_ _**. The sale will be made by** _ _[*name of individual, partnership, or corporate seller*]_ _**, whose business address is** _ _[*business address of seller*]_ _**. The sale will be made to** _ _[*name of individual, partnership, or corporate buyer*]_ _**, whose business address is** _ _[*business address of buyer*]_ _**.**

[*Add if appropriate*]

The address to which inquiries about the sale may be made, if different from the seller's address, is _ _[*address to which inquiries may be directed*]_ _**.**

[*Continue*]

The above buyer has assumed or will assume the debts that were incurred in the seller's business before the date of the bulk sale.

Date: _ _ _ _ _ _ __[*Signature of buyer*]__
_ _[*Typed name*]_ _

Copies: One original for each county in which the notice is recorded; one copy for each newspaper in which the notice is published; one copy for each county tax collector to which the notice must be sent; one office copy.

Comment: The requirements of this notice are identical for both Com C §6103(c)(10) (buyer assumes all seller's debts) and Com C §6103(c)(11) (new organization takes over business). They are similar to the other notice forms (see, *e.g.,* form 14.19-1), but have the additional information that the buyer has or will assume all of the seller's debts before the sale. The method of recordation and publication is set forth in Com C §6105(b).

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§14.22 3. Sale to Newly Formed Organization That Will Continue Business

A sale is exempt if it is made to a new organization that is organized to take over and continue the seller's business. This exemption applies only if each of the following conditions is satisfied (Com C §6103(c)(11)):

- The buyer's principal place of business is in the United States;
- The buyer assumes in full all debts of the seller's business before the date of the bulk sale;
- The seller obtains nothing from the sale except an interest in the new organization that is subordinate to claims against the organization arising from the assumption; and
- The buyer records and publishes notice of the assumption within 30 days after the date of the bulk sale in the same manner as a bulk sale notice (Com C §6105).

The contents of the notice are the same as a notice when a buyer assumes all the seller's business debts (Com C §6103(e); see form 14.21-1).

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Source: Business Law/California UCC Sales and Leases/14 Bulk Sales/§14.23 L. Sales Pursuant to Statute

§14.23 L. Sales Pursuant to Statute

Sales made pursuant to statute are exempt from application of the bulk sales law. Com C §6103(c)(13). Official Comment 8 to UCC §6-103(3)(m) gives as examples statutes requiring sales on termination of a franchise or termination of a contract between a dealer and supplier, such as termination of a franchise or a contract between a dealer and a supplier. Creditors are presumed to know the risk of such sales.

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IV. MANNER OF COMPLIANCE

§14.24 A. Buyer's Obligations

If the transaction is subject to Commercial Code Division 6, the buyer must give notice of the bulk sale. Com C §§6104-6105. See §14.26. If (1) the consideration is $2 million or less and paid in cash, or (2) the buyer is obligated to pay cash in the future, or (3) the transaction involves a combination of the first two situations, the buyer must also comply with the statutory rules for application of the proceeds. Com C §§6106.2-6107. See §§14.28-14.31. The requirements for auction and liquidation sales are somewhat different. See §§14.32-14.34.

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B. Transfers Not by Auction Sale

1. Notice Requirements

§14.25 a. Recordation and Publication of Notice

A buyer subject to the bulk sales requirements must do all of the following (Com C §6105(b)):

- At least 12 business days before the date of the bulk sale, record a notice in the recorder's office in each county in California where the tangible assets are located and, if the seller is not located in one of these counties, in the county in which the seller is located (Com C §6103(a)(2)). The date on which the bulk sale takes place is the later of the date on which more than 10 percent of the assets is transferred or 10 percent of the net contract price (defined in Com C §6102(a)(11)) is paid (Com C §6102(a)(7)).
- Publish the notice at least once in a newspaper of general circulation that is published in the judicial district in which the tangible assets are located. If the assets are located in more than one judicial district, the notice is published in the district in which the greater portion of assets is located. If the seller is located in a different judicial district, the notice must also be published in that judicial district.
- Deliver or send the notice by registered or certified mail to the county tax collector in the California county or counties in which the tangible assets are located. If delivered between January 1 and May 7, inclusive, the notice must be accompanied by a completed business property statement (Rev & T C §§441, 2192).

PRACTICE TIP: The statutory 12-day notice period must be strictly observed. In *Gifford v J & A Holdings* (1997) 54 CA4th 996, 63 CR2d 253, the bulk sale was to occur on October 15. The buyer published a timely notice of sale on September 28, but did not record the notice until October 4, less than 12 business days before the sale date. To attempt to remedy the notice problem, the parties delayed the closing of escrow until 12 business days after the October 4 date of recording. Nevertheless, the court held the notice defective. The court reasoned that the purpose of the statutory scheme is to protect creditors by giving them notice in time to take action before the transfer takes place. The statute requires payment only if a claim is timely filed. If the notice is not recorded 12 business days before the anticipated date of the bulk sale as designated in the notice, creditors do not have sufficient time to file a timely claim. The court did not consider the parties' act of holding escrow open to be a good faith and commercially reasonable effort to comply with the statutory notice requirements.

The requirement of publication and recordation in the seller's jurisdiction follows from the choice-of-law rule of Com C §6103(a)(2), which applies the bulk sales law to sellers located in California. Local recordation and publication are also required when the seller is located in California but the assets are located in another state.

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Source: Business Law/California UCC Sales and Leases/14 Bulk Sales/§14.26 b. Contents of Notice

§14.26 b. Contents of Notice

The notice must state (Com C §6105(a)(1)):

- That a bulk sale is about to be made;
- The seller's name and business address, other business names and addresses used by the seller within three years before the date on which the list is given to the buyer (Com C §6104(a)), and the buyer's name and business address;
- The location and general description of the assets;
- The place and anticipated date of the bulk sale; and
- Whether or not the bulk sale is subject to Com C §6106.2.

If the sale is subject to Com C §6106.2, the notice should also contain the name and address of persons with whom claims may be filed and the last date to file claims (the business day before the date of the bulk sale). Com C §6106.2(f). A sale is subject to Com C §6106.2 if the consideration is $2 million or less and is substantially all cash, paid at closing, or constitutes an obligation to pay cash in the future.

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Source: Business Law/California UCC Sales and Leases/14 Bulk Sales/§14.27 c. Form: Notice for Transfers Not by Auction or Liquidation Sale

§14.27 c. Form: Notice for Transfers Not by Auction or Liquidation Sale

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14.27-1 Notice for transfers not by auction or liquidation sale

PLEASE TAKE NOTICE that a bulk sale is about to be made by _ _[*name of seller*]_ _, whose business address is _ _[*business address of seller*]_ _. Other business names and addresses used by the seller within the last three years are as follows: _ _[*none/specify names and addresses*]_ _. The sale will be made to _ _[*name of buyer*]_ _, whose business address is _ _[*business address of buyer*]_ _. The assets to be sold are located at _ _[*address of location of assets*]_ _ and consist of _ _[*general description of assets*]_ _. The anticipated date of the bulk sale is _ _[*date*]_ _ at _ _[*place where bulk sale will take place*]_ _. This bulk sale _ _[*is/is not*]_ _ subject to California Commercial Code §6106.2.

[*Add if sale is subject to Com C §6106.2*]

The name and address of the person with whom claims may be filed is _ _[*name and address of person receiving claims*]_ _.

[*Continue*]

The last date to file claims is _ _[*business day before date of bulk sale*]_ _.

Date: _ _ _ _ _ _ __[*Signature of buyer*]__
_ _[*Typed name*]_ _

Copies: One original for each county in which the notice is recorded; one copy for each newspaper in which the notice is published; one copy for each county tax collector to which the notice must be sent; one office copy. See Com C §6105(b).

Comment: The Commercial Code does not require that the notice be acknowledged to be eligible for recordation in the county recorder's office. The buyer is required to obtain a list of all business names and addresses used by the seller within three years before the date on which the list is sent or delivered to the buyer. Com C §6104(a). The sale is subject to Com C §6106.2 if the consideration is $2 million or less and is substantially all cash paid at closing or an obligation to pay cash in the future.

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§14.28 2. Payment of Transferor's Creditors' Claims

In transactions in which the consideration is $2 million or less and is substantially all cash paid at closing or an obligation of the buyer to pay cash in the future, the buyer or escrow agent must apply the sale proceeds to payment of claims filed as of the date designated in the notice of sale. Com C §§6106.2, 6106.4.

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§14.29 3. Disputed Claims Procedure

If the seller disputes whether a claim is due and payable on the date of the bulk sale or the amount of any claim, the buyer or escrow agent shall withhold from distribution 125 percent of the first $7500 of the claim and an amount equal to that portion of the claim in excess of the first $7500, or, if applicable, the prorata amount to which the claimant would be entitled under Com C §6106.4(b). Com C §6106.2(c). See also §14.31. The buyer or escrow agent must notify the claimant of the withholding. The claimant must attach the funds, through the appropriate procedure, within 25 days after the notice is mailed to prevent their payment to the seller. Com C §6106.2(c).

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§14.30 4. Insufficient Funds to Pay All Claims Filed With Escrow Agent

Often, when payment of the seller's creditors' claims are to be made from the proceeds of a bulk sale, the parties prefer to make payment through an escrow agent. In all cases governed by Com C §6106.2 in which claims are to be filed with an escrow agent, the buyer must deposit the full amount of the purchase price with the escrow agent. If the amount of cash deposited is insufficient to pay in full all the claims filed with the escrow agent, the agent must delay all distributions for no less than 25 and no more than 30 days. See Com C §6106.4. Within 5 business days from the time that the bulk sale would otherwise have been consummated, the agent must send a notice to each claimant, reciting in full all claims filed against the escrow, the amount of each, the amount proposed to be paid to each, and the new date proposed for the passing of title. If no written objection to the new order of distribution is received before the new date specified for the passing of title, the escrow agent is not liable for any good faith error that may have been made in allocating and distributing the consideration.

Note that, if the sale is subject to Com C §6106.2 and no escrow is established, the buyer is required to follow these procedures (set forth in Com C §6106.4(a)-(c)) when the cash consideration is not sufficient to pay all claims.

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Source: Business Law/California UCC Sales and Leases/14 Bulk Sales/§14.31 5. Order of Priorities for Distribution of Consideration

§14.31 5. Order of Priorities for Distribution of Consideration

If the consideration is not sufficient to pay all claims in full, it must be distributed in the following order (Com C §6106.4):

- All obligations owed to the United States, to the extent that federal law gives priority;
- Secured claims, including statutory and judicial liens, under the guidelines provided;
- Escrow and professional charges and brokers' fees directly attributable to the sale;
- Wage claims given priority by CCP §1205;
- All other tax claims; and
- All other unsecured claims pro rata, including any partially secured creditors' claims.

Trade creditors have found the mandatory distribution/optional escrow provisions of Commercial Code Division 6 to be a relatively inexpensive means to secure payment of unsecured debts. These provisions put some teeth in the California bulk sales law, because creditors will actually receive payment of their claims, in addition to mere notice of the transaction.

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C. Auction Sales and Sales by Liquidator

§14.32 1. Notice Requirements

If a sale is by auction or conducted by a liquidator on the seller's behalf, the auctioneer or liquidator must give notice in the manner prescribed for the buyer in other sales. Com C §6108(a)(1), (3). The purchaser at such a sale has no duty to give notice and is not liable for the auctioneer's or liquidator's failure to do so. Com C §6108(c).

The notice in sales by auction or by a liquidator on the seller's behalf must set forth certain information in addition to that required for ordinary bulk sales. The notice must additionally state that the sale is to be by auction or by liquidation, the name of the auctioneer or liquidator, and the time and place of the auction or the time and place on or after which the liquidator will begin to sell assets on the seller's behalf. Com C §6108(a)(3).

Note that Com C §§6106.2 and 6106.4, relating to mandatory payment of claims, do not apply to sales by auction or by a liquidator.

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§14.33 2. Form: Notice of Intended Bulk Sale by Public Auction

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14.33-1 Notice of intended bulk sale by public auction

PLEASE TAKE NOTICE that a bulk sale is about to be made by auction at _ _[*time and place of auction*]_ _**. The auctioneer is** _ _[*name of auctioneer*]_ _**. The business address of the auctioneer is** _ _[*business address of auctioneer*]_ _**. The seller of assets is** _ _[*name of seller*]_ _**, whose business address is** _ _[*business address of seller*]_ _**. Other business names and addresses used by the seller within the last 3 years are as follows:** _ _[*none/specify names and addresses provided by seller*]_ _**. The assets being sold are located at** _ _[*address*]_ _ **and consist of** _ _[*general description of assets*]_ _**. This bulk sale is not subject to California Commercial Code §6106.2, because it is a sale by auction.**

Date: _ _ _ _ _ _ __[*Signature of auctioneer*]__
_ _[*Typed name*]_ _

Copies: One original for each county in which the notice is recorded; one copy for each newspaper in which the notice is published; one copy for each county tax collector to which the notice must be sent; one office copy. See Com C §6105(b).

Comment: The auctioneer is responsible for giving the notice if the sale is by auction. Com C §6108. The form of notice prescribed is the information in the nonauction form (see §14.34) plus the statement that the sale is to be by auction, the name of the auctioneer, and the time and place of the auction. Com C §6108(a)(3).

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§14.34 3. Form: Notice of Intended Bulk Transfer by Liquidator on Seller's Behalf

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14.34-1 Notice of intended bulk transfer by liquidator on seller's behalf

PLEASE TAKE NOTICE that a bulk sale is about to be made by a liquidator on the seller's behalf on or after _ _[*date on which liquidation is expected to commence*]_ _ **at** _ _[*place of liquidation*]_ _**. The liquidator is** _ _[*name of liquidator*]_ _**. The business address of the liquidator is** _ _[*business address of liquidator*]_ _**. The seller of assets is** _ _[*name of seller*]_ _**, whose business address is** _ _[*business address of seller*]_ _**. Other business names and addresses used by the seller within the last 3 years are as follows:** _ _[*none/specify names and addresses provided by seller*]_ _**. The assets being sold are located at** _ _[*address*]_ _ **and consist of** _ _[*general description of assets*]_ _**. This bulk sale is not subject to California Commercial Code §6106.2, because it is a sale by a liquidator on the seller's behalf.**

Date: _ _ _ _ _ _ __[*Signature of liquidator*]__
_ _[*Typed name*]_ _

Copies: One original for each county in which the notice is recorded; one copy for each newspaper in which the notice is published; one copy for each county tax collector to which the notice must be sent; one office copy. See Com C §6105(b).

Comment: The liquidator is responsible for giving the notice if the sale is by liquidation. The form of notice is the information in the nonauction form (see §§14.26-14.27) plus the statement that the sale is to be by liquidation, the name of the liquidator, and the time and place on or after which the liquidator will begin to sell assets on the seller's behalf. Com C §6108.

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§14.35 D. Rights of Creditors in Event of Compliance

Generally speaking, when a buyer of goods meets its obligation to pay the seller, the buyer is not concerned with the seller's disposition of the proceeds or with claims the seller's creditors may have to those proceeds. See *Eastern Aviation Group, Inc. v Airborne Express, Inc.* (1992) 6 CA4th 1448, 8 CR2d 355. When the bulk sale is concluded in compliance with Com C Division 6, the seller's creditors have no rights against the buyer personally, and the buyer's interest in the transferred assets is unassailable unless the transaction violates some other applicable law, *e.g.,* the Uniform Fraudulent Transfer Act (CC §§3439-3439.12). See §14.41. Similarly, when an auction sale complies with Division 6, the seller's creditors have no rights against the auctioneer. Because the sale and the purchasers' title at an auction are valid even when there is noncompliance, it follows that they are valid when there is compliance. The notice of the proposed transfer is intended to warn the seller's creditors to protect themselves before consummation occurs.

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E. Effect of Noncompliance

§14.36 1. Liability for Failure to Comply

Noncompliance with Commercial Code Division 6 neither renders the sale ineffective nor otherwise affects the buyer's rights in or title to the assets. The remedy is that of damages. Commercial Code §6107(h) provides specifically that a buyer's failure to comply with the requirements of Com C §6104 (buyer's duties) does not do any of the following:

- Impair the buyer's rights in or title to the assets;
- Render the sale ineffective, void, or voidable;
- Entitle a creditor to more than a single satisfaction of its claim; or
- Create liability other than as provided in Division 6.

Liability for noncompliance is imposed on a buyer in a bulk sale only when failure to comply has actually injured a creditor and then only to the extent of the injury. A noncomplying buyer is liable to a claimant for damages in the amount of the claim, reduced by any amount that the claimant would not have realized if the buyer had complied. Com C §6107(a). Only a claimant with a noncontingent, liquidated claim may bring an action against a noncomplying buyer. Com C §6107(g). The claimant has the burden of establishing the validity of the claim, whereas the buyer has the burden of establishing the amount that the claimant would not have realized if the buyer had complied with the statute. Com C §6107(b).

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§14.37 2. Buyer's Good Faith Defense

The buyer's compliance duty is limited to making a good faith and commercially reasonable effort. A buyer that makes a good faith and commercially reasonable effort to comply with Com C §6104 or to exempt the transaction from the coverage of the bulk sales law is not liable to creditors for failure to comply. The buyer has the burden of establishing the good faith and commercial reasonableness of the effort. Com C §6107(c). This provision might, for example, protect a buyer that erroneously, but in a commercially reasonable and good faith manner, published the bulk sale notice in a newspaper of general circulation in the wrong judicial district.

PRACTICE TIP: The practitioner should take note, however, of *Gifford v J & A Holdings* (1997) 54 CA4th 996, 63 CR2d 253. In that case, the buyer published a timely notice of sale but did not record the notice until less than 12 business days before the sale date. To attempt to remedy the notice problem, the parties delayed the closing of escrow until 12 business days after the date the notice was recorded. Nevertheless, the court held the notice defective. The court did not consider the parties' act of holding escrow open to be a good faith and commercially reasonable effort to comply with the statutory notice requirements.

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§14.38 3. Limitation on Cumulative Liability

Commercial Code §6107 limits the aggregate liability of the noncomplying buyer for any one sale (which includes a series of sales by a liquidator). The purpose of the liability limitations is to make certain that the noncomplying buyer does not pay more than twice for the goods.

If the assets consist only of inventory and equipment, the maximum cumulative liability is an amount equal to twice the net contract price of the inventory and equipment, less the amount of any portion of that net contract price paid to or applied for the benefit of the seller or a creditor of the seller. Com C §6107(d)(1). See Com C §6102(a)(11) for the definition of "net contract price."

A more complicated formula is provided for determining a noncomplying buyer's liability when the property sold includes other assets in addition to the inventory and equipment. The noncomplying buyer's liability is limited to twice the net value of the inventory and equipment, less any portion of any part of the net contract price paid to or applied for the benefit of the seller that is allocable to the inventory and equipment. Com C §6107(d)(2). The overall goal is to limit the buyer's liability to the harm actually suffered by unsecured creditors as a result of noncompliance. The unsecured creditors would be able to reach only the value in excess of security interests and liens even if there were no bulk sale.

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§14.39 4. Remedies Available to Trustee in Bankruptcy

More often than not, the question of violation of the bulk sales law arises in a bankruptcy context. Because the remedy under the law prior to the 1988 Official Text of the Uniform Commercial Code and Commercial Code Division 6 was avoidance of the transfer, a bankruptcy trustee could avoid in its entirety a defective bulk transfer as long as one creditor was adversely affected by noncompliance. 11 USC §544(b); *Moore v Bay* (1931) 284 US 4, 76 L Ed 133, 52 S Ct 3; *Verco Indus. v Spartan Plastics (In re Verco Indus.)* (BAP 9th Cir 1981) 10 BR 347, rev'd in part (9th Cir 1983) 704 F2d 1134.

The 1988 Official Text of the Uniform Commercial Code and Commercial Code Division 6 seek to eliminate the bankruptcy trustee's power to avoid noncomplying bulk sales by limiting recovery to money damages by claimants who have actually been harmed by noncompliance. See Official Comment 2 to UCC §6-107. It is unclear whether this objective has been accomplished. Because a trustee's avoidance power is derived from federal bankruptcy law and not from state law, the trustee may be able to argue that he or she can still assert a bulk sale claim because the state law remedy is the functional equivalent of avoidance. However, because 11 USC §544(b) gives the trustee the power to avoid transfers that can be avoided by creditors under state law, the bankruptcy courts should give effect to the intent of the drafters and not permit the trustee to assert claims under Division 6. Whether the drafters were successful in limiting the power of the trustee to assert a bulk sale claim will ultimately be determined in the bankruptcy courts.

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§14.40 5. Statute of Limitations and Levies

The statute of limitations applicable to buyers, auctioneers, or liquidators is one year after the date of the bulk sale. Com C §6110(a). If the buyer, auctioneer, or liquidator conceals the fact that the sale has occurred, the limitation is tolled and an action may be commenced within the earlier of (1) 1 year after the plaintiff discovers or should have discovered that the sale has occurred, or (2) 2 years after the date of the bulk sale. Failure to comply with the requirements of the bulk sales law does not constitute concealment. Com C §6110(b)(2).

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§14.41 F. Compliance With Other Laws Not Excused

Compliance with Commercial Code Division 6 does not excuse compliance with other laws. For example, a strong nexus exists between bulk sales and fraudulent transfers. Therefore, sellers and buyers in a bulk sale must still be concerned whether the transfer is considered fraudulent under the Uniform Fraudulent Transfer Act (CC §§3439-3439.12). See *Monastra v Konica Bus. Machs. Corp.* (1996) 43 CA4th 1628, 51 CR2d 528.

Furthermore, compliance with Division 6 does not excuse compliance with the so-called special bulk sales laws when they apply. For example, in the transfer of a license to sell alcoholic beverages, the provisions of the Alcoholic Beverage Control Act (see Bus & P C §§24070-24082) must be observed. Com C §6103(c)(15). Certain tax statutes and ordinances may also have to be taken into account. See *Schnyder v State Bd. of Equalization* (2002) 101 CA4th 538, 124 CR2d 571 (buyer of grocery business liable for seller's sales tax obligation).

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§14.42 V. SOME ASPECTS OF CALIFORNIA LAW COMPARED WITH 1988 UCC OFFICIAL TEXT

California's bulk sales law is based to a great extent on the 1988 Official Text of the Uniform Commercial Code but with some significant differences. California practitioners need to be aware of these differences when advising out-of-state buyers or sellers or when a transaction involves assets located out of state. Sections 14.43-14.47 discuss some of the significant differences between California's Division 6 and the 1988 Official Text. This discussion is not exhaustive, however.

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§14.43 A. Scope of Coverage

Unlike Commercial Code Division 6, the 1988 Official Text of the Uniform Commercial Code limits the application of the bulk sales law to sales of inventory and does not include sales of equipment within the definition of "bulk sale." UCC §6-102(1)(c). The 1988 Official Text does not include restaurant owners and those who manufacture what they sell within its coverage. UCC §6-103(1)(a). The Official Text is also limited to cases in which the buyer, auctioneer, or liquidator has notice, or, after reasonable inquiry, would have had notice, that the seller will not continue to operate the same or a similar kind of business after the sale. UCC §6-102(1)(c). The "going out of business" requirement was not included in California because of trade creditor concerns regarding the difficulty of measuring when a seller has gone out of business and in determining whether a buyer had notice of the seller's intentions.

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§14.44 B. Exemptions

California law has nonuniform exemptions covering sales and leasebacks, transfers of liquor licenses, and transfers of goods covered by warehouse receipts. See Com C §6103(c)(14)-(16). These exemptions are based on California practice, such as special California rules set forth in Bus & P C §§24070-24082 regarding the transfer of licenses to sell alcoholic beverages.

The most significant difference between the exemptions of California law and those of the 1988 Official Text of the Uniform Commercial Code is the coverage ceiling of $25 million under the uniform law but only $5 million in California. UCC §6-103(3)(*l*)(ii); Com C §6103(c)(12)(ii). The uniform ceiling seems far in excess of an amount reasonably necessary to protect trade creditors.

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§14.45 C. Schedule of Distribution

Commercial Code Division 6 and the 1988 Official Text of Uniform Commercial Code Article 6 differ most significantly in their compliance procedures. California law does not require a schedule of distribution, but Article 6 requires the buyer and the seller to prepare a "schedule of distribution" of the proceeds of the bulk sale (UCC §6-104(1)(c)). The schedule may provide that the proceeds will all be distributed to the seller or that some or all of the proceeds will be distributed to creditors. See UCC §6-106. If the buyer undertakes in the schedule of distribution to distribute proceeds to creditors, the buyer may be liable if it fails to abide by the undertaking. UCC §6-107(1)(a).

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§14.46 D. Notice to Claimants

The 1988 Official Text of the Uniform Commercial Code requires that, at least 45 days before the date of the bulk sale, the buyer must send notice of the sale (including the schedule of distribution) to each of the claimants listed by the seller. If, however, the number of claimants is 200 or more (excluding those holding secured or matured claims for employment compensation and benefits), the buyer may give notice by filing the notice of sale in a designated office, perhaps that of the jurisdiction's Secretary of State. UCC §6-105(2). Division 6 of the California Commercial Code does not incorporate these requirements.

The UCC compliance requirements are more burdensome than California's to the extent that they require a schedule of distribution and direct notification of claimants. In addition, the notice must be given much further in advance of the bulk sale (45 days versus California's 12 business days). California's compliance rules, however, are more burdensome in cash transactions of $2 million or less, because the buyer must follow the mandatory distribution scheme set forth in Com C §§6106.2-6106.4 (see §14.31).

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§14.47 E. Good Faith Belief

The 1988 Official Text of the Uniform Commercial Code provides an exemption from liability for a buyer that holds a commercially reasonable and good faith belief that the particular sale is not subject to Article 6. UCC §6-107(3)(b). This exemption was excluded from Commercial Code Division 6 in California because of trade creditor concerns that it would provide too great a loophole for a noncomplying buyer, even though the buyer would have the burden of proof in showing that the belief was commercially reasonable and in good faith. California does follow the uniform law in excusing a buyer's good faith, reasonable effort to comply with the bulk sales law for a covered transaction or to exempt the transaction from compliance. Com C §6107(c).

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15

Documents of Title

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I. INTRODUCTION

§15.1 A. Commercial Use of Documents of Title

The term "documents of title" refers to both negotiable and nonnegotiable written or electronic documents developed to facilitate trade by substituting entitlement to goods under such documents for actual possession of the goods. The document can then be transferred between a buyer and a seller, or between a borrower and a lender, rather than having to physically transfer the goods described on the document. By possessing the document, the holder or transferor possesses rights to the goods represented by the document. By transferring the document, the right to possess the goods is transferred from one person to another. The issuer of the document, usually the bailee, is obligated to deliver the goods described on the document to the person in possession of the document on surrender of the document.

Division 7 of the California Uniform Commercial Code (Com C §§7101-7603) governs documents of title and the rights and obligations of the persons issuing and transferring the documents to the extent that federal law does not apply. Whether a document of title is adequate to fulfill the obligations of a contract of sale or the conditions of a credit is governed by Division 2, "Sales," and Division 5, "Letters of Credit." Security interests in documents of title are governed by Division 9, "Secured Transactions." Division 7 of the Commercial Code includes the basic law on the transportation and storage of goods in California. The greater portion of Division 7 is directed to determining the specific commercial risk one undertakes when accepting a document of title.

A "document of title" includes a warehouse receipt, a bill of lading, a delivery order, a dock warrant, a dock receipt, a gin ticket, a compress receipt, and any other document that, in the regular course of business or finance, is treated as adequately evidencing that the person entitled under the document has the right to receive, hold, and dispose not only of the document but also the goods it represents. Com C §1201(b)(16). It must purport to be issued by a bailee and to cover goods in the bailee's possession that are either identified or are a fungible portion of an identified mass. A "person entitled under the document" includes a holder of a negotiable document or the person to whom delivery is to be made pursuant to the instructions of a nonnegotiable document. Com C §7102(a)(9).

In 2003, the National Commissioners on Uniform State Laws propounded the first revisions in 52 years of Article 7 of the Uniform Commercial Code, "Warehouse Receipts, Bills of Lading and Other Documents of Title." In 2006, those revisions were adopted in California, effective January 1, 2007. The revisions provide a legal structure and rules for use of electronic documents of title and update sections to reflect current commercial practice and gender neutrality. The revisions expand the present requirement that a document of title must be a writing to create an "electronic document of title" evidenced by a record (see Division 5) of information stored in an electronic medium. Electronic documents of title anticipate the eventual end to the paper-based system currently in use.

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B. Organization and Terminology of Division 7

§15.2 1. Organization

Division 7 is divided into six chapters. The first, fourth, fifth, and sixth contain provisions applicable to both warehouse receipts and bills of lading as well as other documents of title. Chapter 2 contains special provisions applicable to warehouse receipts and Chapter 3 contains special provisions applicable to bills of lading.

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Source: Business Law/California UCC Sales and Leases/15 Documents of Title/§15.3 2. Terminology

§15.3 2. Terminology

The terms used in Division 7 are defined or indexed in Com C §7102. They include:

- *Bailee*: the person who, by a warehouse receipt, bill of lading, or other document of title, acknowledges possession of the goods and contracts to deliver them. Com C §7102(a)(1).
- *Carrier*: the person who issues a bill of lading. Com C §7102(a)(2).
- *Consignee*: the person named in a bill of lading to whom or to whose order the bill promises delivery. Com C §7102(a)(3).
- *Consignor*: the person named in a bill of lading as the person from whom the goods have been received for shipment. Com C §7102(a)(4).
- *Delivery order*: a record (see below) that contains an order to deliver goods directed to a warehouse, carrier, or other person that in the ordinary course of business issues warehouse receipts or bills of lading. Com C §7102(a)(5).
- *Document*: a document of title as defined in Com C §1201(b)(16).
- *Goods*: all things that are treated as movable for the purposes of a storage or transportation contract. Com C §7102(a)(7).
- *Issuer*: a bailee that issues a document of title or, in the case of an unaccepted delivery order, the person that orders the possessor of goods to deliver. This term includes a person for whom an agent or employee purports to act if the agent or employee has real or apparent authority to do so even if no goods were received or if the goods were misdescribed or the document was issued in violation of instructions. Com C §7102(a)(8).
- *Person entitled under the document*: the holder in the case of a negotiable document or the person to whom delivery is to be made by the terms of or pursuant to written instructions under a nonnegotiable document. Com C §7102(a)(9).
- *Record*: information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form. Com C §7102(a)(10).
- *Sign*: means, with present intent to authenticate or adopt a record: (A) to execute or adopt a tangible symbol; or (B) to attach to or logically associate with the record an electronic sound, symbol, or process. Com C §7102(a)(11).
- *Shipper*: a person that enters into a contract of transportation with a carrier. Com C §7102(a)(12).
- *Warehouse*: a person engaged in the business of storing goods for hire. Com C §7102(a)(13).

Terms common to all code provisions are defined in Com C §1201. They include:

- *Delivery*: with respect to documents of title, means the voluntary transfer of possession. Com C §1201(b)(15).
- *Good faith*: honesty in fact and the observance of reasonable commercial standards. Com C §1201(b)(20).
- *Person*: an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, government, governmental subdivision, agency, or instrumentality, public corporation, or any other legal or commercial entity. Com C §1201(b)(27).
- *Purchase*: includes taking by sale, lease, discount, negotiation, mortgage, pledge, lien, security interest, issue or reissue, gift, or any other voluntary transaction creating an interest in property. Com C §1201(b)(29).
- *Written* or *writing*: includes printing, typewriting, or any other intentional reduction to tangible form. Com C §1201(b)(43).

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§15.4 C. Subordination of Division 7 to Federal and State Laws and Regulations

Division 7 is subject to any treaty or statute of the United States or regulatory statute of California to the extent the treaty, statute, or regulatory statute is applicable. Com C §7103(a).

Division 7 does not modify or repeal any law prescribing the form or content of a document of title or the services or facilities to be afforded by a bailee, or otherwise regulating a bailee's business in respects not specifically treated in Division 7. However, violation of such a law does not affect the status of a document of title that otherwise is within the definition of a document of title. Com C §7103(b).

Division 7 does modify, limit, and supersede the federal Electronic Signatures in Global and National Commerce Act (ESIGN) (15 USC §§7001-7031), but does not modify, limit, or supersede 15 USC §7001(c) or authorize electronic delivery of any of the notices described in 15 USC §7003(b). Com C §7103(b).

To the extent there is a conflict between Division 7 and the Uniform Electronic Transactions Act (CC §§1633.1-1633.17), Division 7 governs. Com C §7103(c).

Federal law dealing with transportation and storage of goods is extensive. It is beyond the scope of this chapter to provide an analysis of the federal law on documents of title. It is important to emphasize, however, that Division 7 may be irrelevant if the transaction is controlled by federal law. For example, the Interstate Commerce Act, "Bills of Lading" (49 USC §§80101-80116), the Hague Convention (51 Stat 233 (1937)), the Warsaw Convention (49 Stat 3000 (1929)), and the Carriage of Goods by Sea Act (46 USC App §§1300-1315), may govern bills of lading used in interstate or international commerce. The scope of federal law governing bills of lading in interstate commerce is summarized at 49 USC §80102:

> This chapter applies to a bill of lading when the bill is issued by a common carrier for the transportation of goods—
> (1) between a place in the District of Columbia and another place in the District of Columbia;
> (2) between a place in a territory or possession of the United States and another place in the same territory or possession;
> (3) between a place in a State and a place in another State;
> (4) between a place in a State and a place in the same State through another State or a foreign country; or
> (5) from a place in a State to a place in a foreign country.

The Carmack Amendment to the Interstate Commerce Act (49 USC §14706) provides a uniform system of liability for interstate transportation carriers. It provides certainty to both the interstate carrier and shipper by enabling the carrier to better assess its risk and predict its potential liability for damages, including loss or damage arising from storage or other service provided by that carrier. Courts consistently hold that this amendment preempts all state and common law claims and provides the sole and exclusive remedy to shippers for loss or damage in interstate transit. See *Hughes Aircraft v North Am. Van Lines* (9th Cir 1992) 970 F2d 609. The preemption applies to claims of loss or damage arising from storage or other services provided by interstate carriers. It also extends to a claim for intentional infliction of emotional distress, to the extent that it arises from the same conduct as claims for delay, loss, or damage to shipped property. *White v Mayflower Transit, LLC* (9th Cir 2008) 543 F3d 581 (plaintiff's claim for intentional infliction of emotional distress preempted because it was based solely on same conduct giving rise to claims for property damage). An excellent discussion of the Carmack Amendment is found in *Dictor v David & Simon, Inc.* (2003) 106 CA4th 238, 130 CR2d 588.

When considering claims arising under Division 7, counsel must carefully consider if the claim is preempted by federal law.

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II. CREATION OF DOCUMENTS OF TITLE

§15.5 A. Issuer

Commercial carriers of goods issue bills of lading. Com C §7102(a)(2). Any warehouse may issue a warehouse receipt. Com C §7201(a). A warehouse receipt also may be issued by an owner of goods who is not a warehouse if the goods include distilled spirits or agricultural commodities, and are stored under a statute that requires a bond against withdrawal or a license for issuance of receipts in the nature of warehouse receipts. Com C §7201(b). Persons dealing with the warehouse receipt may look to the bond, or to the owner's license, in the event of difficulty recovering the goods.

The issuer is bound on the document notwithstanding issuance in violation of the issuer's instructions. See Com C §7102(a)(8). Under some interpretations of regulatory statutes together with the old uniform acts, the issuer was able to defeat these obligations wholly or in part by showing that the document was unlawfully issued. This problem was resolved by Com C §7401. That section invalidates the following defenses that would deny the obligations imposed on the issuer:

- The business was unlawfully conducted;
- The issuer was not in fact a warehouse;
- The goods covered by the document were the issuer's own property and hence the receipt was not a warehouse receipt; or
- The receipt was improper in form, content, or issuance.

The Commercial Code regulates persons who have undertaken to perform only a portion of the service necessary for transportation of the goods. Com C §7302. An example is the freight forwarder who collects goods from a number of persons to make up a carload, and consolidates them for transportation under the forwarder's own name. The freight forwarder saves the person with less than a full carload of goods the higher charges of less-than-carload rates. The forwarder makes its profit by pricing between carload and less-than-carload rates.

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§15.6 B. Terms of Document

In addition to representing the title to the goods and the fact of receipt of the goods, the document of title also serves as a contract between the bailor and the bailee. Provisions requiring or permitting certain contract terms, and making others void, are scattered through the Commercial Code.

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§15.7 1. Required Terms

Generally, a warehouse receipt need not be in a particular form. Com C §7202(a). Also, a warehouse may insert in its receipt any other terms that are not contrary to the Commercial Code and do not impair the obligation of delivery under Com C §7403 or the duty of care under Com C §7204. Com C §7202(3). Any contrary provisions are ineffective.

Certain terms of the warehouse receipt are essential. The warehouse cannot complain of omission of one of these essential terms. On the other hand, the warehouse is liable for damages caused by such an omission to a person injured by it. Com C §7202(b).

Normally, a warehouse receipt must include rate of storage and handling charges. A nonnegotiable receipt governing a field-warehousing arrangement, however, need not include provisions on the rate of storage and handling charges. Com C §7202(b)(5). This is because field warehousing is not ordinary storage bailment for hire.

NOTE: The field-warehousing arrangement was created to meet the need for a secure method of financing the inventory of a borrower. The warehouse is often a simple enclosure on the borrower's premises in which the field warehouse maintains actual, open, and exclusive possession of the goods.

Warehouse receipt is defined in Com C §1201(b)(42). It means a document evidencing the receipt of goods for storage issued by a warehouse, and which, by its terms, evidences the intention of the issuer that the person entitled under the document has the right to receive, hold, and dispose of the document and the goods it covers. See also Com C §7102(a)(9). Designation of a document by the issuer as a "warehouse receipt" is conclusive evidence of such intention.

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§15.8 2. Permitted Terms

The Commercial Code permits the warehouse and the carrier to restrict the time and manner of presenting claims and instituting actions based on the bailment, provided the restrictions are reasonable. See Com C §§7204(c), 7309(c).

The bailee is allowed to include in the document of title contractual provisions limiting the bailee's liability in case of loss or damage to the goods. Com C §§7204(b), 7309(b). The provisions for limitation of liability have their principal value in a through bill of lading, which provides the bailor with one party responsible for the transportation of the goods, although a number of separate carriers may transport them. To encourage the use of a through bill, the Commercial Code allows its issuer the right to all defenses available to the issuer as if the issuer were performing the other steps in the transportation service. The issuer also has a right of indemnity against the performing carrier in possession of the goods when the breach creating the issuer's liability occurs. The issuer may also recover the expense incurred in defending an action brought by anyone entitled to recover on the document. Com C §7302(c).

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§15.9 3. Void Terms; Conversion by Bailee

If the bailee converts the goods to the bailee's own use, a term of a document limiting the value of the goods in the event of a breach of the bailment contract is ineffective. Com C §§7204(b), 7309(b).

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§15.10 4. Provisions on Description of Goods

Commercial Code §7301 imposes certain duties of inspection (weighing, loading, and counting) on the person issuing a bill of lading. The words "shipper's weight, load, and count," "contents or condition of contents of package unknown," "said to contain," and like phrases in the document of title are considered void under certain circumstances, depending on the nature of the carrier and the facilities available. Such disclaimers are valid only if the issuer has no knowledge of misdescription. Com C §7203.

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§15.11 5. Negotiability

If the terms of the document of title provide for the delivery of goods to the order of a named person or to the bearer of the document, it is negotiable. Com C §7104(a). Otherwise, it is nonnegotiable. A document of title also is nonnegotiable if, at the time it is issued, the document has a conspicuous legend, however expressed, that it is nonnegotiable. Com C §7104(c).

A bill of lading that states that the goods are consigned to a named person is not made negotiable by a provision that the goods are to be delivered only against an order in a record signed by the same or another named person. Com C §7104(b).

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Source: Business Law/California UCC Sales and Leases/15 Documents of Title/§15.11A 6. Electronic Documents of Title

§15.11A 6. Electronic Documents of Title

To accommodate the increasingly commonplace use of electronic communications in business, in modernizing UCC Article 7, the drafters broadened the definition of documents of title (Com C §1201(a)(16)):

> "Document of title" includes a bill of lading, dock warrant, dock receipt, warehouse receipt, or order for the delivery of goods, and also any other document which in the regular course of business or financing is treated as adequately evidencing that the person in possession of it is entitled to receive, hold, and dispose of the document and the goods it covers.

The concept of an electronic document of title allows for commercial practice to determine what records issued by bailees are "in the regular course of business or financing" and are "treated as adequately evidencing that the person in possession of it is entitled to receive, hold, and dispose of the document and the goods it covers." Such records in electronic form are electronic documents of title and in tangible form are tangible documents of title.

A person has control of an electronic document of title if a system employed for evidencing the transfer of interests in the electronic document reliably establishes that person as the person to which the electronic document was issued or transferred. Com C §7106(a).

A system satisfies Com C §7106(a), and a person is deemed to have control of an electronic document of title, if the document is created, stored, and assigned in such a manner that (Com C §7106(b)(1)-(6)):

- A single authoritative copy of the document exists that is unique, identifiable, and unalterable;
- The authoritative copy identifies the person asserting control as:
- The person to which the document was issued; or
- If the authoritative copy indicates that the document has been transferred, the person to which the document was most recently transferred;
- The authoritative copy is communicated to and maintained by the person asserting control or its designated custodian;
- Copies or amendments that add or change an identified assignee of the authoritative copy can be made only with the consent of the person asserting control;
- Each copy of the authoritative copy and any copy of a copy is readily identifiable as a copy that is not the authoritative copy; and
- Any amendment of the authoritative copy is readily identifiable as authorized or unauthorized.

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Source: Business Law/California UCC Sales and Leases/15 Documents of Title/§15.11B 7. Substitution of Tangible and Electronic Documents of Title

§15.11B 7. Substitution of Tangible and Electronic Documents of Title

On request of a person entitled under an electronic document of title, the issuer of the electronic document may issue a tangible document of title as a substitute for the electronic document if (Com C §7105(a)):

- The person entitled under the electronic document surrenders control of the document to the issuer; and
- The tangible document when issued contains a statement that it is issued in substitution for the electronic document.

On issuance of a tangible document of title in substitution for an electronic document of title, the electronic document ceases to have any effect or validity, and the person that procured issuance of the tangible document warrants to all subsequent persons entitled under the tangible document that the warrantor was a person entitled under the electronic document when the warrantor surrendered control of the electronic document to the issuer. Com C §7105(b)(1)-(2).

On request of a person entitled under a tangible document of title, the issuer of the tangible document may issue an electronic document of title as a substitute for the tangible document if (Com C §7105(c)):

- The person entitled under the tangible document surrenders possession of the document to the issuer; and
- The electronic document when issued contains a statement that it is issued in substitution for the tangible document.

On issuance of an electronic document of title in substitution for a tangible document of title, the tangible document ceases to have any effect or validity, and the person that procured issuance of the electronic document warrants to all subsequent persons entitled under the electronic document that the warrantor was a person entitled under the tangible document when the warrantor surrendered possession of the tangible document to the issuer. Com C §7105(d)(1)-(2).

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C. Multiple Documents

§15.12 1. In General

The sections on multiple issuance of documents affect the rights of the person entitled under the document. The provisions are helpful in reducing the risk in documents of title and making the documents more commercially acceptable.

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§15.13 2. Duplication of Documents

Although the issuer may not confer rights in goods already covered by an original document by issuing a duplicate, the issuer may be liable for damages caused by overissue or failing to identify a document as a duplicate. Com C §7402. Once an issuer has conferred rights in the goods, the issuer is without further power to affect the title to the goods.

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§15.14 3. Bills in a Set

Bills in a set are generally used in international shipping. If relevant, the Hague Convention (51 Stat 233 (1937)), the Warsaw Convention (49 Stat 3000 (1929)), and the Carriage of Goods by Sea Act (46 USC App §§1300-1315) should be consulted.

A set of bills of lading is issued in two or more parts, each part numbered and marked as a duplicate original. The bills usually provide the following: "One being accomplished, the others to stand void." The Commercial Code allows a bill to be issued in a set in overseas transportation, although prohibiting such issuance in general. Com C §7304(a). Parties dealing in them have rights to be considered. When bills in a set are lawful, the carrier's undertaking is to deliver against the first part presented. If the carrier does so when permitted, and in good faith, the carrier is not liable to persons holding subsequent parts. Com C §7304(e).

Negotiation of the first part carries with it the title to the whole set and to the goods. Parties who negotiate or transfer a single part of a bill of lading are liable to persons holding a subsequent part of the bill. Com C §7304(d).

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§15.15 4. Overissue of Documents for Fungible Goods

Because of the substantial economic benefit to be gained by the storage of fungible goods in mass rather than in separate units, Division 7 makes special exemptions in Com C §§7205, 7207, 7402, and 7502 for overissuance of documents of title governing fungible goods. The holder of a document of title to fungible goods is given a prorata interest in the diminished mass. These sections are an exception to the rule of Com C §7402 that, once the goods have been covered by a document of title, title to the goods cannot be defeated by issuance of a subsequent document of title. Fungible goods are excepted because a large portion of the saving to the bailee by storing in mass may be passed on to those bailors who are willing to deal in fungible goods, while the comparative risk of overissuance is minor.

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§15.16 5. Lost, Stolen, or Destroyed Documents

If a document of title is lost, stolen, or destroyed, a court may order delivery of the goods or issuance of a substitute document and the bailee may, without liability to any person, comply with the order. If the document was negotiable, a court may not order delivery of the goods or issuance of a substitute document without the claimant's posting security, unless it finds that any person that may suffer loss as a result of nonsurrender of possession or control of the document is adequately protected against the loss. If the document was nonnegotiable, the court may in its discretion require security. The court may also order payment of the bailee's reasonable costs and attorney fees. Com C §7601(a).

A bailee that, without a court order, delivers goods to a person claiming under a missing negotiable document of title is liable to any person injured thereby. If the delivery is not in good faith, the bailee is liable for conversion. Delivery in good faith is not conversion if the claimant posts security with the bailee in an amount at least double the value of the goods at the time of posting to indemnify any person injured by the delivery who files a notice of claim within one year after the delivery. Com C §7601(b).

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Source: Business Law/California UCC Sales and Leases/15 Documents of Title/§15.17 D. Alteration of Documents

§15.17 D. Alteration of Documents

Any subsequent alteration of a bill of lading leaves the bill enforceable according to its original tenor. Com C §7306. However, if a warehouse leaves a blank in the negotiable receipt and that blank has been filled in without authority, a purchaser for value without notice of the lack of authority may treat the insertion as authorized. Any other unauthorized alteration leaves any tangible or electronic warehouse receipt enforceable against the issuer according to its original tenor. See Com C §7208.

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§15.18 E. Reducing Risk to Clients

In considering a prospective bailee, it is important that the bailee be in sound financial condition, because most of the bailor's remedies under the Commercial Code are against the bailee. Surety bonds by the bailee and insurance covering the bailed goods may also be obtained.

When the bailor is inexperienced in transportation, the bailor should use a through bill of lading. The shipper-bailor can then rely on the local issuer of the through bill rather than proceeding against a remote carrier.

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Source: Business Law/California UCC Sales and Leases/15 Documents of Title/§15.19 F. Checklist of Possible Problems on Issuance of Document of Title

§15.19 F. Checklist of Possible Problems on Issuance of Document of Title

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- Is the person issuing the document authorized to issue that type of document under the laws of the state of California?
- Did that person or that person's employee issue or purport to issue a document of title?
- Are there any problems with the terms of the document?
- Does the document lack an essential or required term? If so, did plaintiff suffer any damage because of the lack of this required or essential term?
- Is there a question of whether a particular term can be permitted?
- Is an adequate period of time allowed for filing a claim or instituting an action?
- Is the term relating to limitation of liability within the permissible scope?
- Did bailee issue a through bill of lading or agree to act as shipper's agent for the completion of the transportation service?
- Is there a provision in federal and state regulations that would make the particular term void?
- Did bailee convert the goods to his or her own use?
- Is there a problem relating to inspection or description of the goods?
- Was the document negotiable or nonnegotiable?
- Was the document marked "nonnegotiable"?
- Did the document provide for delivery to the order of a named person or bearer of the document?
- Will the loss suffered by the person entitled under the document be greater or less if the duties relating to the issuance of a negotiable document are imposed on the bailee?
- Were the goods subject to the document of title also subject to a previously issued document of title?
- Is the document in the same form and style as when it was issued?

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III. FORMS OF DOCUMENTS OF TITLE; TRANSFER AND NEGOTIATION

§15.20 A. Types and Forms

The Commercial Code recognizes two types of documents of title: negotiable and nonnegotiable. A document of title is negotiable if by its terms, the goods are to be delivered to the bearer or to the order of a named person. All other documents of title are nonnegotiable. A bill of lading that states that the goods are consigned to a named person is not made negotiable by a provision that the goods are to be delivered only against an order in a record signed by the same or another named person. Com C §7104(a)-(b). A document of title is also nonnegotiable if, at the time it is issued, it has a conspicuous legend, however expressed, that it is nonnegotiable. Com C §7104(c).

The document takes the character it will have throughout the transaction from its form at the time of issuance, and nothing can be done subsequently to change its character. Indorsement of a nonnegotiable document will not make the document negotiable. Com C §7501(c).

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B. Transfer of Interest in Goods Subject to Negotiable Document of Title

§15.21 1. Due Negotiation

The transfer of the interest in a negotiable document of title is accomplished by the due negotiation of the document as specified in Com C §7501. A negotiable document of title may be negotiated by delivery alone when it runs to the bearer. Com C §7501(a)(2). Once a negotiable document of title running to the order of the named person is negotiated by an indorsement in blank or to bearer, it can also be negotiated by delivery alone. Com C §7501(a)(1). When a document runs to the order of a named person, the delivery to him or her alone will have the same effect as if the document had been negotiated. Com C §7501(a)(3). Negotiation of a negotiable document after it has been indorsed to a specific person will require his or her indorsement as well as delivery. Com C §7501(a)(4).

In order for a negotiable document of title be treated as duly negotiated, it must have been negotiated in the manner required under Com C §7501, and the transferee must be a holder who purchases the document in good faith and for value, without notice of any defense against or claim to it on the part of any person, unless it is established that the negotiation is not in the regular course of business or financing or involves receiving the document in settlement or payment of a monetary obligation. Com C §7501(a)(5).

With respect to electronic documents of title, the following rules apply (Com C §7501(b)):

- If the document's original terms run to the order of a named person or to bearer, the document is negotiated by delivery of the document to another person. Indorsement by the named person is not required to negotiate the document.
- If the document's original terms run to the order of a named person and the named person has control of the document, the effect is the same as if the document had been negotiated.
- As with tangible documents of title, an electronic document of title is duly negotiated if it is negotiated to a holder that purchases it in good faith, without notice of any defense against or claim to it on the part of any person, and for value, unless it is established that the negotiation is not in the regular course of business or financing or involves taking delivery of the document in settlement or payment of a monetary obligation.

Generally, a person gives "value" for rights if he or she acquires them (Com C §1204):

- In return for a binding commitment to extend credit or for the extension of immediately available credit, whether or not drawn upon and whether or not a chargeback is provided for in the event of difficulties in collection;
- As security for or in total or partial satisfaction of a preexisting claim;
- By accepting delivery pursuant to a preexisting contract for purchase; or
- Generally, in return for any consideration sufficient to support a simple contract.

The "good faith" required for "due negotiation" (Com C §7501(a)(5)) means "honesty in fact and the observance of reasonable commercial standards of fair dealing." Com C §1201(b)(20).

Notice is discussed in Com C §1202. Notice is effective for a particular transaction from the time when it is brought to the attention of the individual conducting the transaction, or generally from the time when it would have been brought to the attention of the individual if the organization had exercised due diligence. Com C §1202(e)-(f).

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§15.22 2. Rights of Transferee in Duly Negotiated Document

The transferee of a negotiable document of title that has been duly negotiated obtains title to the document and the goods, and any rights accruing by agency or estoppel, including rights to goods delivered to the bailee after the document was issued. Com C §7502(a)(1)-(3).

The transferee acquires the obligation of the issuer to hold or deliver the goods covered by the document according to the terms of the document, free of any defense or claim by the issuer except those arising under the terms of the document or under Division 7. In the case of a delivery order, the bailee's obligation accrues only on the bailee's acceptance of the delivery order, and the obligation acquired by the holder is that the issuer and any indorser will procure the bailee's acceptance. Com C §7502(a)(4).

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§15.23 3. Limitation on Transferee of Duly Negotiated Document

The transferee's title to bailed goods is subject to the following limitations:

- A buyer of fungible goods from a warehouse who deals in such goods takes free of any claim under a warehouse receipt. Com C §7205.
- A person who had a prior legal or perfected security interest in goods, and who does not acquiesce in the procurement by the bailor or the bailor's nominee of any document of title, may defeat a transferee's title to bailed goods. Com C §7503(a)(2).
- Delivery by a carrier in accordance with Com C §§7401-7404 and pursuant to its own bill of lading discharges the carrier's obligation to deliver, even though the goods may be subject to a duly negotiated bill of lading issued by a freight forwarder. Com C §7503(b)-(c)).

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§15.24 C. Transfer of Document Not Qualifying as Due Negotiation

The transferee of a document acquires the title and rights that his or her transferor had or had actual authority to convey. Com C §7504(a). The transferee of a negotiable tangible document of title, however, has a specifically enforceable right to have the transferor supply the necessary indorsement. Com C §7506. Because the transfer becomes a negotiation only at the time the indorsement is supplied (Com C §7506), the bailee may be acting at the bailee's own risk if it delivers the goods without the necessary indorsement. See Comment 1 to UCC §7-506.

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§15.25 D. Transfer of Interest in Goods Subject to Nonnegotiable Document of Title

The transferee of a nonnegotiable document not duly negotiated but delivered also acquires the title and rights that his or her transferor had or had actual authority to convey. Com C §7504(a). These rights may be defeated until the bailee receives notification of the transfer by (1) creditors of the transferor who could treat the sale as void under Com C §2402, (2) a buyer from the transferor in the ordinary course of business if the bailee has delivered the goods to the buyer, (3) a lessee from the transferor in the ordinary course of business if the bailee has delivered the goods to the lessee or received notification of the lessee's rights, or (4) as against the bailee, by good faith dealings of the bailee with the transferor. Com C §7504(b)(1)-(4).

The transferee's rights to the goods may also be defeated by (1) a change in shipping instructions by the consignor resulting in nondelivery of the goods to the consignee, provided the goods were delivered to a buyer in the ordinary course of business (Com C §7504(c)), and (2) a stoppage by the seller under Com C §2705, subject to due notification. Com C §7504(d).

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E. Warranties of Transferor, Intermediary, and Indorser

§15.26 1. Transferor's Warranties

The person negotiating or transferring a document of title for value (other than as an intermediary) warrants to the immediate purchaser only that (1) the document is genuine, (2) he or she has no knowledge of any fact that would impair its validity or worth, and (3) his or her negotiation or delivery is rightful and fully effective with respect to title to the document and the goods it represents. Com C §7507.

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§15.27 2. Intermediary's Warranties

A collecting bank or other intermediary entrusted with documents warrants only good faith and authority to act. The transferee must have known of the entrustment at the time of delivery. This rule on the intermediary's warranty applies even if the intermediary has purchased or made advances against the claim or draft to be collected. Com C §7508.

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§15.28 3. Indorser's Warranties

Indorsement of a document of title does not make the indorser liable for any default by the bailee or previous indorsers. Com C §7505. This rule is intended to avoid any reluctance on the part of the transferor about indorsing the document.

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§15.29 IV. DOCUMENTS USED AS SECURITY DEVICES

The document of title may be used to create a secured interest in goods in two ways. First, the owner of the goods may wish to borrow money, using as security the owner's interest in the goods. The lender, in order to protect the security during the loan period, may require that the owner transfer the security to the lender or to a bailee. In these cases, it is not necessary for the lender to make a filing as required for other types of security devices. The lender's security, however, is subject to any security interest that may have been filed prior to the lender's perfection. Persons dealing with the borrower are bound to inquire about possession of the security if they have notice that the borrower does not have possession.

Second, the seller of goods may transfer the goods to a bailee and use the document of title to withhold possession from the buyer until payment of the purchase price.

EXAMPLE: Delivery of a boat to a field warehouse on the premises of a boat dealer did not constitute delivery to the dealer or give the dealer possession of the boat. The dealer sold the boat under a conditional sales contract and retained a security interest in the boat. The boat was never delivered, the conditional sales contract was sold, and the dealer's business failed. The manufacturer took possession of the boat, and the bank that purchased the conditional sales agreement attempted to assert its security interest. The manufacturer prevailed, in part because the boat dealer never received delivery or possession of the boat and could not pass title. *Chartered Bank v Chrysler Corp.* (1981) 115 CA3d 755, 171 CR 748.

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§15.30 A. Security Interest Created to Borrow Money

When the owner of goods seeks to borrow money on the goods, the owner may deposit them in a warehouse and utilize the warehouse receipt as collateral. The owner may also obtain financing from the warehouse. The Commercial Code provides the warehouse with the security interest necessary to enable the warehouse to act as the financier. See Com C §§7202, 7209. The warehouse's security interest for charges other than those for storage as stated in Com C §7209(a) is governed by Division 9. The carrier's lien for charges is a part of the shipping contract (see Com C §7307), but is not a "general lien" under the Commercial Code. *Expeditors Int'l, Inc. v Official Creditors Comm. of CFLC, Inc. (In re CFLC, Inc.)* (9th Cir 1999) 166 F3d 1012; see §15.39A.

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§15.31 B. Seller Retains a Secured Interest

When the seller uses a bailment and document of title to reserve a security interest, the seller may have the document issued to:

- The seller's own order;
- The order of the financing agency;
- The order of the buyer;
- The seller itself;
- A nominee; or
- The buyer.

The first three may be negotiable documents; the remaining three cannot be negotiable, because none is payable to order or bearer. Usually, the bailment is with a carrier, and for that reason bills of lading are used in the following discussion.

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§15.32 1. Bill of Lading to Seller's Order

The shipper's order bill is used for collection of the price of the goods through banks. The seller-shipper may negotiate the bill of lading to the bank with its indorsement. Normally this will provide the bank with the protection afforded the bona fide holder of a negotiable document of title. The bank is protected in this transaction by the limitations on the bank's warranties to those of good faith and authority.

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§15.33 2. Bill of Lading to Financing Agency's Order

Since delivery of a negotiable bill to the person named in the bill effects a due negotiation of the bill (Com C §7501(b)(2)), a bill drawn to the financing agency's order accomplishes the same result as the shipper's order bill, but eliminates the necessity of obtaining the shipper's signature.

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§15.34 3. Bill of Lading to Buyer's Order

Like the other two order bills, the buyer's order bill protects the seller because the goods will not be released by the carrier (except at the carrier's own risk) without the surrender of the negotiable document and payment of the amount due for the goods and carriage.

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§15.35 4. Bill of Lading to Seller (Straight Bill)

When the seller of goods reserves possession of the goods as security by having the bill issued to itself, the seller may, on the buyer's default, stop delivery of the goods. See Com C §§2505(1)(b), 2703, 2705-2706. A bill issued to the seller (straight bill) is generally issued with instructions to the carrier to deliver on the seller's written instructions without surrender of the bill. The rights of a bank to which such a straight bill has been transferred to secure a loan may be defeated by the acts of the seller-transferor until the bailee receives notification of the transfer. For that reason, the straight bill is not often used in bank financing.

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§15.36 5. Straight Bill of Lading to Seller's Nominee

The seller's nominee is usually a bank. The seller's possession of the goods may then be transferred to the bank as security for the bank's loan to the seller. A notice to the carrier of the transfer to the nominee is unnecessary because the bank would be the "person" entitled to the goods under the document and the one to which the carrier was bound to deliver. The bank is exposed, however, to changes in shipping instructions. See Com C §7504(c).

Liability for transportation costs may not be imposed on a secured creditor who did not agree to liability, did not act as an owner of the goods shipped under a straight bill of lading (even though named in the bill of lading), and aggressively monitored its collateral and did not mislead the carrier by its actions. *A/S Dampskibsselskabet Torm v Beaumont Oil Ltd.* (2d Cir 1991) 927 F2d 713.

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§15.37 6. Bill of Lading to Buyer

The security retained under a bill issued to the buyer is fragile. The seller has only the right to a timely, rightful, and effective stoppage of delivery in transit. Com C §2505; Official Comment 4 to UCC §2-505. The bill issued to the buyer is simple in operation and reduces the risk of loss of goods to third parties because the bill is nonnegotiable.

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V. RIGHTS OF BAILEE

§15.38 A. Collection of Charges; Bailee's Lien

The warehouse and carrier are both entitled to liens to ensure the collection of unpaid charges. See Com C §§7209, 7307. Enforcement of the lien is a cumulative remedy for the bailee. Both Com C §§7210(g) and 7308(f) provide, "the rights provided by this section are in addition to all other rights allowed by law to a creditor against a debtor." Civil Code provisions that were not repealed by the Commercial Code provide for the division of responsibility between the consignee and the consignor for the purpose of paying the freight on a particular shipment of goods.

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1. Extent of Bailee's Lien

§15.39 a. Warehouse's Lien

Commercial Code §7209(a) provides that "[a] warehouse has a lien against the bailor on the goods covered by a warehouse receipt or storage agreement or on the proceeds thereof in its possession for charges for storage or transportation, including demurrage and terminal charges, insurance, labor, or other charges, present or future, in relation to the goods."

The lien includes the expenses necessary for preservation of the goods and reasonably incurred in the sale of the goods under law. "If the person on whose account the goods are held is liable for similar charges or expenses in relation to other goods whenever deposited, and it is stated in the warehouse receipt or storage agreement that a lien is claimed for charges and expenses in relation to the other goods," the warehouse's lien will include those charges and expenses incurred "whether or not the other goods have been delivered." Com C §7209(a). A warehouse may also reserve a security interest against the bailor for the maximum amount specified on the receipt for other charges, such as money advanced and the interest on it. The security interest is governed by Division 9. Com C §7209(b).

For a discussion of the operation of a general or "spreading" warehouse's lien, see, *e.g.*, *Western Cotton Serv. Corp. v Marlow* (*In Re Julien Co.)* (Bankr WD Tenn 1991) 136 BR 743, 751. In *Western Cotton Serv. Corp.,* a warehouse was entitled to a general lien on other goods on proof of the form of the warehouse receipt, proof that other goods to which the lien was to spread were in the possession of the warehouse, and proof of the charges giving rise to the lien.

The effectiveness of the warehouse's lien against third parties is covered in Com C §7209(c)-(d), which provides:

> (c) A warehouse's lien for charges and expenses under subdivision (a) or a security interest under subdivision (b) is also effective against any person that so entrusted the bailor with possession of the goods that a pledge of them by the bailor to a good faith purchaser for value would have been valid. However, the lien or security interest is not effective against a person that before issuance of a document of title had a legal interest or a perfected security interest in the goods and that did not:
>
> (1) deliver or entrust the goods or any document of title covering the goods to the bailor or the bailor's nominee with:
>
> (A) actual or apparent authority to ship, store, or sell;
>
> (B) power to obtain delivery under [Com C §7403]; or
>
> (C) power of disposition under [Com C §§2403, 9320, 9321(c), 10304(b), 10305(b)] or other statute or rule of law; or
>
> (2) acquiesce in the procurement by the bailor or its nominee of any document.
>
> (d) A warehouse's lien on household goods for charges and expenses in relation to the goods under [Com C §7209(a)] is also effective against all persons if the depositor was the legal possessor of the goods at the time of deposit. In this subdivision, "household goods" means furniture, furnishings, or personal effects used by the depositor in a dwelling.

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§15.39A 2. Carrier's Lien

The carrier's lien is less extensive than the warehouse's. It applies only to the specific goods covered by a bill of lading, and then only for charges after the date of receipt of the goods. It includes all charges for storage and transportation after that date (including demurrage and terminal charges), expenses incurred to preserve the goods, and expenses incurred in the sale of the goods under law. Com C §7307. See also *Robert B. Olsen v Santa Barbara's Gracious Living, Inc.* (2002) 103 CA4th 1377, 127 CR2d 744. In that case, a moving and storage company sought to recover its transport and storage fees, claiming a lien on certain personal property. The owner of the property had sold its business but before completion of the sale had allowed the buyer to take possession of the business. The buyer contracted with the moving company to remove some of the personal property but did not pay the transport and storage charges. The buyer then failed to complete the purchase of the business and the seller sought to recover its property. In a case of first impression interpreting Com C §7307, the court confirmed that the lien is valid against anyone who permitted the bailor to have possession of the personal property even if the bailor had no authority to incur the charges. The lien is defeated only if the carrier had actual knowledge or reason to know of the bailor's lack of authority. Although the seller was not obligated to prevent the transportation and storage, the seller did have some responsibility for allowing the moving and storage company to incur costs based on the unauthorized actions of the buyer.

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§15.40 2. Operation of Lien

Due negotiation of a warehouse receipt limits the warehouse's lien to charges specified on the document. In the absence of such specification, the warehouse's lien is limited "to a reasonable charge for storage of the specific goods covered by the receipt subsequent to the date of the receipt." Com C §7209(a).

Against a purchaser for value of a negotiable bill of lading, the carrier's lien is limited to the charges specified in the bill of lading or the applicable tariffs (or, if no charges are stated, a reasonable charge). Com C §7307(a).

The effectiveness of the carrier's lien depends on whether the carrier is required by law to receive the goods for transportation. If the carrier is so required, the lien is effective unless the carrier had notice that the consignor lacked authority to subject the goods to such charges and expenses. Com C §7307(b). If the carrier is not required by law to transport the goods, the lien is effective only if the bailor had been given control or possession of the goods. Com C §7307(b).

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§15.41 3. Loss of Lien

The bailee's lien is lost when he or she voluntarily delivers the goods or unjustifiably refuses to deliver. Com C §7209(e) (warehouse); Com C §7307(c) (carrier).

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§15.42 4. Enforcement of Lien

There are two basic enforcement-of-lien provisions under the Commercial Code, both concerning sale of bailed goods. The more elaborate of the two may be used for enforcing all liens arising under either Com C §7209 or §7307. However, the simpler procedure (described in Com C §§7210(a) and 7308(a)) applies only to goods stored by a merchant in the course of business and to carriers. This enforcement procedure is a great deal less costly when it can be used. (There are also provisions in Com C §§7210 and 7308 applicable to every enforcement proceeding.)

NOTE: A sale under Com C §7210 does not require a prior judicial hearing. A claim that such a sale violates due process was rejected in *Melara v Kennedy* (9th Cir 1976) 541 F2d 802 on the ground that the prerequisite state action was not present. The Supreme Court confirmed the absence of state action under these circumstances in *Flagg Bros. v Brooks* (1978) 436 US 149, 56 L Ed 2d 185, 98 S Ct 1729.

Under Fin C §1670, a bank that receives personal property for safekeeping or storage as bailee may enforce its warehouse's lien either in accordance with the Commercial Code or as described in Fin C §§1671-1673.

The funds retained by a bank for payment of uncashed money orders are not "goods" within the meaning of Com C §7210, because Com C §2105(1) explicitly excludes money used to pay the price of something from the definition of goods. *Cory v Golden State Bank* (1979) 95 CA3d 360, 157 CR 538.

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§15.43 a. Sale of Goods Stored by Merchant

The enforcement procedure applying only to goods stored by a merchant provides that the goods may be sold at any time or place either in bloc or parcels. The sale must be commercially reasonable. The following are described as commercially reasonable: (1) a sale of the goods in the usual manner in any recognized market; (2) a sale at the current market price at the time of the sale; or (3) a sale otherwise in conformity with commercially reasonable practices among dealers in that type of goods. Com C §§7210(a), 7308(a).

A sale of more goods than is apparently necessary to be offered for sale to ensure satisfaction of the obligation is considered not commercially reasonable. The possibility that a better price could have been obtained by sale at a different time or in a different method than that selected by the bailee is not of itself sufficient to establish that the sale was not made in a commercially reasonable manner. Com C §§7210(a), 7308(a).

The warehouse must notify all persons known to claim an interest in the goods of the time and place of public sale (if the sale is to be public), the amount due, and the nature of the proposed sale. Com C §7210(a).

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b. Sale of Other Goods

§15.44 (1) Notification Requirements

The enforcement procedure applying to goods other than those stored by a merchant provides that notice must be given to all persons known to claim an interest in the goods. The notification must be given in person or sent by certified or registered mail to the last known address of any person to be notified. Com C §7210(b)(1)-(2).

The notice must contain (1) an itemized statement of the claim, (2) a description of the goods subject to the lien, (3) a demand for payment allowing the recipient 10 days after receipt in which to act, and (4) a conspicuous statement that unless the claim is paid within the time specified in the notice, the goods will be advertised for sale and sold by auction at the time and place specified. Com C §7210(b)(2).

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§15.45 (2) Advertising Requirements

After the time specified in the notice has expired, an advertisement must be published once a week for two consecutive weeks in a newspaper of general circulation published in the judicial district where the sale is to be held. If no such paper exists, public posting 10 days before the sale in no fewer than six conspicuous places in the neighborhood of proposed sale will meet the advertising requirement. Com C §7210(b)(5).

The advertisement must contain a description of the goods, the name of the person on whose account they are being held, and the time and place of the sale. Com C §7210(b)(5).

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§15.46 (3) Sale Requirements

The goods must be sold at an auction complying with the terms of the notice and advertisement. Com C §7210(b)(3). The sale must take place at the time specified in the notice and at least 15 days after the first publication of the advertisement. Com C §7210(b)(5). It must be held at the nearest suitable place to that where the goods are held (Com C §7210(b)(4)), and must be at the place specified in the notice and advertisement.

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§15.47 c. Provisions Common to Both Enforcement Procedures

Both Com C §§7210 and 7308 have several provisions applicable to either type of enforcement procedure:

- **The right to prevent the sale.** At any time prior to the sale, any person claiming a right in the goods may pay the amount necessary to satisfy the lien and the reasonable expenses incurred by the bailee. Com C §§7210(c), 7308(b). It should be noted, however, that these provisions do not require delivery to the person paying the lien and expenses. Both require that the goods be held subject to the terms of the document. The problem should be carefully considered by the person who is about to tender money to the bailee to prevent the enforcement of the lien. Unless he or she can obtain some assurance from the person entitled under the document that repayment will be made if the goods are claimed, he or she is incurring some risk.
- **Bailees may bid.** Bailees may bid at any public sale held under either Com C §7210 or §7308. One reason for allowing the bailee to bid at these sales is that the bailee's knowledge of the goods may stimulate the bidding and bring a higher price for the goods. Official Comment 2 to UCC §7-210.
- **Good faith purchaser.** A purchaser in good faith of goods sold to enforce a lien takes the goods free of any rights of persons against whom the lien was valid, despite the bailee's noncompliance with the requirements of the enforcement sections. Com C §§7210(e), 7308(d). It should be noted that even the purchaser has a limitation on the rights he or she obtains by purchase at the sale; the lien must be valid.
- **Balance of proceeds of sale.** The balance of the proceeds of sale, after satisfaction of the lien, must be held by the bailee for delivery on demand to any person to whom he or she would have had to deliver the goods. Com C §§7210(f), 7308(e).
- **Lack of compliance with enforcement procedures.** The two standards for liability in the event of failure to comply with the requirements for sale under the enforcement sections are set forth in Com C §§7210(i) and 7308(h). Lack of compliance will result in liability only to the extent of the damages caused unless the violation is willful, in which case the liability of the bailee is for conversion.

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§15.48 5. Other Remedies Against Bailor

It is common practice to include in the contract between the bailee and bailor provisions for collection, which may include the use of the document as a chattel mortgage. These provisions may provide a right for repossession together with the right of foreclosure against the goods repossessed, and also provide for payment of interest, attorney fees, and costs incurred in collection.

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§15.49 6. Remedies Against Consignee-Consignor or Beneficial Owner of Goods

Under common law, the acceptance of goods shipped by common carrier implied an agreement to pay charges. This implication was rebutted only if the person receiving the goods advised the carrier that the carrier was acting as an agent of another, or acting in a status such as trustee or executor. Under federal law, if the consignee accepts the goods and fails at that time to notify the carrier in writing of the consignee's official capacity, the consignee is bound to pay the freight on the shipment. *Pittsburgh C., C. & St. Louis R. v Fink* (1919) 250 US 577, 63 L Ed 1151, 40 S Ct 27.

Civil Code §2138 specifies that a consignee of freight is liable for the freightage whenever the consignee accepts the freight with notice of the intention of the consignor that the consignee should pay it. The consignee is therefore liable if it (1) is the consignee of freight, (2) accepts the freight, and (3) has notice of the intention of the consignor at the time of the acceptance that he or she should pay it. This duty may, of course, be amplified or reduced by provisions in tariffs, rules, regulations, or orders of the regulatory bodies.

Civil Code §2137 creates a presumption that the consignor of the freight is liable for the freightage. That presumption is rebutted if the contract provides that the consignee must pay for pay it and if the carrier releases the property without obtaining the freightage. This presumption may be modified by tariff provisions.

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B. Termination of Storage at Warehouse's Option

§15.50 1. General Right of Termination

The warehouse has the right, in the absence of a fixed period of bailment, to remove the goods and obtain payment of charges, or, when a fixed period is specified, the right to order the bailment terminated at the end of that period. Com C §7206(a).

Those known to claim an interest in the goods must be notified of the intended termination. The warehouse must allow any person entitled to the goods the period fixed in the document, or a period of not less than 30 days after the notification for payment or removal of goods.

In the event of nonpayment or failure to remove, the warehouse may sell the goods under Com C §7210. If any person entitled to the goods makes demand for the goods before the time of sale, the warehouse must deliver the goods to him or her. See Com C §§7206, 7210.

Excess proceeds from the sale must be held for delivery to any person entitled to delivery of the goods. Com C §7206(e).

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§15.51 2. Summary Termination: Value Deteriorated to Less Than Lien

If the warehouse has a good faith belief that the goods are about to deteriorate or decline in value to less than the amount of the lien, the warehouse may terminate the storage and sell the goods on notice to the person entitled to the goods. Com C §7206(b). The requirements for such summary termination include a public sale held not less than one week after a single advertisement or posting. Com C §7206(b).

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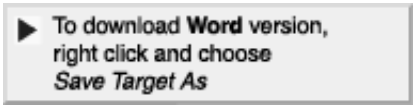
§15.52 3. Summary Termination: Hazard to Other Goods Stored

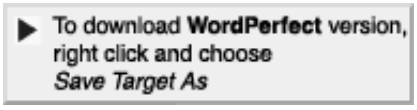
When the condition or quality of the goods is a hazard, the warehouse may terminate the storage, provided that he or she had no knowledge at the time of deposit that the goods were of such condition. Com C §7206(c).

If this right exists, the warehouse is given the broad power to sell the goods, either at public or private sale, without advertising, on reasonable notification to all persons known to claim an interest in the goods. When the warehouse is unsuccessful in obtaining a buyer for the goods after a reasonable effort, the warehouse may dispose of them in any lawful manner without incurring liability. Com C §7206(c).

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§15.53 4. Form: Notice to Merchant of Private Sale





15.53-1 Notice to merchant of private sale

Dear _ _[*name*]_ _:

We have been advised that you claim an interest in the goods stored under our warehouse receipt number _ _[*indicate number*]_ _ at our warehouse located at _ _[*address*]_ _.

Demand is hereby made on you, as well as all persons claiming an interest in the goods, to pay our charges in full and have the person entitled to them remove the goods on or before _ _[*date*]_ _.

Provide our warehouse with 24 hours' notice before you remove the goods. As noted in your warehouse receipt, our working hours are from 8 a.m. to 5 p.m. Monday through Friday.

In the event the person entitled to the goods fails to pay our charges or remove the goods, we shall sell the goods in bulk by private sale on the commodity market at the highest price we can obtain.

These goods are now held subject to the following charges and estimated expenses:

$ _ _[*indicate charges/expenses*]_ _

$ _ _[*indicate charges/expenses*]_ _

$ _ _[*indicate charges/expenses*]_ _

Very truly yours,
__[*Signature*]__

Comment: The suggested notice complies with the procedures set forth in Com C §7210(a) for goods stored by a merchant in the course of business.

The time for removal of the goods must be in excess of the notification period specified in Com C §7206 or §7210, or beyond the storage period fixed in the warehouse receipt.

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§15.54 5. Form: Suggested Notice of Intent to Sell Goods at Public Auction

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

15.54-1 Suggested notice of intent to sell goods at public auction

Dear _ _[*name*]_ _:

We have been advised that you claim an interest in the goods stored under our warehouse receipt number _ _[*indicate receipt number*]_ _ at our warehouse located at _ _[*address*]_ _.

Demand is hereby made on you, as well as all persons claiming an interest in the goods, to pay our charges in full and have the person entitled to them remove the goods on or before _ _[*date*]_ _.

Provide our warehouse with 24 hours' notice before you remove the goods. As noted in your warehouse receipt, our working hours are from 8 a.m. to 5 p.m. Monday through Friday.

In the event the person entitled to the goods fails to pay our charges or remove the goods, we shall advertise the goods for sale.

The advertisement will provide that the goods will be sold at public auction commencing at _ _[*time*]_ _ on _ _[*date*]_ _. The sale will be in parcels, and the warehouse may buy at this sale.

These goods are now held subject to the following charges and estimated expenses:

$ _ _[*indicate charges/expenses*]_ _

$ _ _[*indicate charges/expenses*]_ _

$ _ _[*indicate charges/expenses*]_ _

Very truly yours,
__[*Signature*]__

Comment: The suggested notice is to be used when the goods are not those stored by a merchant in the course of business. Appropriate changes would have to be made for summary notices when the goods are deteriorating or declining in value, or when the goods are a hazard. The notice should be sent by certified or registered mail to the last known address of the person notified.

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VI. REMEDIES ON LOSS, DAMAGE, MISDELIVERY, OR DELAY OF GOODS

§15.55 A. Introduction

The most common problem in bailments is a claim that the bailed goods were lost, damaged, misdelivered, or unduly delayed. Matters relating to value of goods, such as deterioration and depreciation, are the most time consuming.

A bill of lading is considered an adhesion contract, generally prepared by the carrier. Consequently, any ambiguity in the bill of lading is construed in favor of the shipper and against the carrier. *All Pac. Trading, Inc. v Vessel M/V Hanjin Yosu* (9th Cir 1993) 7 F3d 1427, 1431, quoting *Institute of London Underwriters v Sea-Land Serv., Inc.* (9th Cir 1989) 881 F2d 761, 767.

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§15.56 B. Bailee's Duty of Care

The duty of care of warehouses (Com C §7204(a)) and carriers (Com C §7309(a)) requires that they act as reasonably careful persons would under like circumstances.

A common carrier, however, may also have the liability of an insurer against all risks. Com C §7309(a); Official Comment to UCC §7-309. In order to impose liability on the carrier, the claimant must prove only that the goods were delivered to the bailee and were not redelivered, or were returned in a lesser condition, unless the loss suffered falls within one of the contract exclusions. The exclusions can be described as those losses that are uncontrollable, despite the utmost care of the carrier, and can be illustrated by the following clause in use in the contracts of some carriers in California:

It is agreed that the property covered by this order be moved, packed, stored, shipped, forwarded, or otherwise handled at customer's risk with respect to loss, damage, or delay caused by Acts of God, the public enemy, the acts of public authority, quarantine, war, insurrection, strikes, labor disputes, riots, earthquake, deterioration by time, moth, termite, vermin, rodent, leakage, and heat, perils of navigation, occurrence in customer's warehouse, the act or default of the shipper or owner, the nature of property, or defect or inherent cause in the property.

The warehouse is not subject to the common carrier's liability as an insurer. But if there are concurrent causes of damage, and one of them is the failure to exercise reasonable care, then neither the warehouse nor the carrier could be excused from liability.

Another distinction made between the carrier's duty of care and that of the warehouse is that the carrier's duty is "in relation to the goods" (Com C §7309(a)), but the warehouse's duty of care is for "loss of or injury to the goods" (Com C §7204(a)). The language relating to warehouses appears to exclude any reference to delay and misdelivery, thus allowing freedom of contract on that question. Even when the warehouse has agreed to some restrictions on delivery, he or she can take advantage of Com C §7603 when an adverse claim is made against the goods, since the warehouse is given a reasonable period of time to ascertain the claim's validity. The bailee must, in the absence of a contract provision, make delivery without unreasonable delay. See Com C §7403.

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§15.57 C. Bailee's Duty to Deliver

A bailee must deliver the goods to a person entitled under the documents of title and who has complied with the provisions of Com C §7403(b)-(c). Com C §7403(a).

The bailee's duty to deliver is subject to a number of exceptions, which are described in the balance of Com C §7403.

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§15.58 1. Delivery to Rightful Person

When a bill of lading is negotiable, the bailee or carrier is under a duty to ensure delivery of the goods to the proper party, *i.e*., the holder of the original bill of lading or someone to whom the holder directs delivery. Delivery to a person who is not the holder, without the holder's authorization, constitutes a conversion of the goods and a breach of contract. *BII Fin. Co. Ltd. v U-States Forwarding Servs. Corp.* (2002) 95 CA4th 111, 115 CR2d 312. See also *Allied Chem. Int'l Corp. v Companhia de Navegacao Lloyd Brasileiro* (2d Cir 1985) 775 F2d 476 (carrier that delivered goods to consignee without requiring surrender of bill of lading liable for breach of contract where consignee did not hold bill of lading because it had not yet paid for goods). Although a carrier may *choose* to follow a shipper's instruction to deliver goods covered by a negotiable bill of lading without requiring surrender of the original bill, the carrier does so at its own peril, because the shipper may have negotiated the bill before giving that instruction. If the carrier delivers to a party not entitled to possession of the goods, the carrier is liable to the holder of the original bill of lading. *BII Fin. Co. Ltd. v U-States Forwarding Servs. Corp.* (2002) 95 CA4th 111, 125, 115 CR2d 312, citing *C-ART, Ltd. v Hong Kong Islands Line Am., S.A.* (9th Cir 1991) 940 F2d 530.

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§15.59 2. Destruction by Fire

When fire damages goods in storage, the burden of disproving negligence is placed on the warehouse, on the theory that the warehouse is in a better position to know the facts. Com C §7403(a)(2).

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§15.60 3. Routing Problems

Reasonable dispatch is the standard for measuring the timeliness of the delivery of goods shipped. See Com C §7309. Carriers are extensively controlled by tariffs governing delivery. If the carrier is a regular route carrier, the question will be whether the carrier met the schedules established by its tariff, or was excused.

When the carriers operate on an irregular-route basis, the problems are more difficult. The question is then whether the carrier performed the service with reasonable dispatch considering all relevant operating facts.

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§15.61 D. Value Limitations

California case law before the adoption of the Commercial Code was consistent with contract clauses that warehouses and carriers generally use to limit the value of bailed goods. These contract clauses allowed the bailor to agree to a lower bailment rate in exchange for an agreed value of the goods. The value agreements can be continued under the Commercial Code. See Com C §§7204(b), 7309(b).

The Commercial Code sections reflect the differences between storage and carrier service. Value in the event of liability can be limited by prior agreement, provided the bailor has the opportunity of paying a higher price and obtaining protection to the full value of the goods. It is reasonable to believe that the standard limitation of damages clause in a consumer bailment contract would be considered unconscionable unless the consumer has notice of the clause, is given the opportunity to declare a higher value and is able to bargain about the amount the consumer will pay for the bailment. The bailor may seek to protect its interest with insurance in the event the declared value is less than the actual value.

Because goods stored in warehouses stay in the bailee's custody for an extended period of time, the warehouse must allow the bailor to select an alternate rate within a reasonable period of time after the bailor receives the warehouse receipt. Com C §7204(b).

Theories advanced in support of these value agreements include:

- **Undisclosed value.** Often the bailee is dealing with containers of contents of undisclosed value. It would be economically impractical to force the bailee to inspect all items delivered to him or her.
- **Estoppel.** The parties at the outset agree to a value and receive a cheaper rate. The bailor should be estopped to seek a higher value.
- **Undue preference to high-value bailors.** Requiring the bailee to protect property to full value, without giving him or her the alternative of declaring a lesser value for a reduced rate, has the effect of requiring persons with property of a low value to pay a premium to protect others with goods of high value. Without this provision, a person with goods valued at no more than 10 cents a pound would be required to pay charges reflecting the bailee's protection of goods having a value of as much as $10 a pound.

Limitations on liability by agreement are not effective with respect to a warehouse's liability for conversion to its own use. Com C §7204(b). Commercial Code §7309(b) states the same rule for carriers. Thus, the bailee cannot disregard the duty of care entirely and seize goods with values higher than the bailee's limitation of liability. Although the language is not clear, it does not appear to cover the situation in which the bailee's employee has converted the goods without the employer's knowledge and consent. Such an interpretation would effectively destroy the limited liability with respect to missing items.

A rail carrier's limitation of liability or of the amount of recovery for damage or loss of transported goods is void. 49 USC §11706(c). For extensive discussions of value-limitation efforts by warehouses and carriers, see *Hischemoeller v National Ice & Cold Storage Co.* (1956) 46 C2d 318, 294 P2d 433 (upholding limitation when owner storing goods had actual knowledge and understanding of warehouse receipt terms), and *Muelder v Western Greyhound Lines* (1970) 8 CA3d 319, 87 CR 297 (disregarding limitation when carrier was grossly negligent and owner who shipped goods was member of general public unaware of limitation).

A freight forwarder's liability when freight is lost was considered in *Insurance Co. of N. Am. v NNR Aircargo Serv. (USA), Inc.* (9th Cir 2000) 201 F3d 1111. In that case, the insurance carrier sought to recover the amount paid on a claim when the freight forwarder temporarily stored goods in its California warehouse that were in transit to another state, and the goods were stolen from the warehouse. The insurance carrier claimed the requirements of former Com C §7204(1) applied, and the freight forwarder should be considered a warehouse subject to the requirement of reasonable care in safeguarding the shipment. The carrier also argued that the federal Carmack Amendment should apply to the transaction (see Note below). The court concluded that the invoice terms and conditions that the freight forwarder provided to the shipper supplemented the shipping agreement, and that their course of dealing over some 47 prior transactions provided a common basis of understanding concerning the limitation of liability terms. The court cited

Royal Ins. Co. v Sea-Land Serv., Inc. (9th Cir 1995) 50 F3d 723 for the proposition that course of dealing based on the receipt of three to four bills of lading with identical liability limitations was sufficient to put the parties on notice of the terms. The court reiterated that liability is a term inherent to shipping contracts. As the role of the freight forwarder was to pick up and pay for the goods, clear customs, and reship the goods to another state, the court determined that the services of the freight forwarder were not interstate commerce and thus the Carmack Amendment did not apply.

NOTE: With regard to interstate shipments of goods by a common carrier, the Carmack Amendment to the Interstate Commerce Act (49 USC §14706) may preempt state law in this area. See *Dictor v David & Simon, Inc.* (2003) 106 CA4th 238, 130 CR2d 588 (even tort claims, including negligence and conversion, are subject to limitation of liability under bill of lading). See also *White v Mayflower Transit, LLC* (9th Cir 2008) 543 F3d 581 (plaintiff's claim for intentional infliction of emotional distress was preempted because it was based solely on same conduct giving rise to claims for property damage).

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§15.62 E. Time Limitations on Claims

Limitations on the time in which a claim can be presented to the bailee and a lawsuit based on the claim must be instituted are permitted. Com C §§7204(c), 7309(c). A typical provision now used in some contracts in California is the following:

As a condition precedent to recovery, the claim for any loss or damage, injury, or delay, must be filed in writing with carrier within nine (9) months after delivery to consignee and shown on face hereof, or in case of failure to make delivery, then within nine (9) months after reasonable time for delivery has elapsed; and suit must be instituted against carrier within two (2) years and one (1) day after the date when notice in writing is given by carrier to the claimant that carrier has disallowed the claim or any part or parts thereof specified in the notice. When a claim is not filed or suit is not instituted thereon in accordance with the foregoing provisions, carrier shall not be liable and such a claim will not be paid.

A 1-year time limit to present claims set forth on a bill of lading was found to be reasonable under former Com C §7204(3). *Styling Plastics Co. v Neptune Orient Lines, Ltd.* (ND Cal 1987) 666 F Supp 1406. In *Styling Plastics,* the court refused to imply an exception for conversion, but stated that the purpose of former Com C §7204(3) was not to limit liability but to prevent litigation of stale claims, penalize dilatoriness, and to serve as a measure of repose. 666 F Supp at 1411.

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Source: Business Law/California UCC Sales and Leases/15 Documents of Title/§15.63 F. Checklist: Considering Claims Against Bailee

§15.63 F. Checklist: Considering Claims Against Bailee

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- Is the client the bailor or a person otherwise entitled under the document to exercise the rights in the goods?
- What is the classification of bailee or issuer? What service does the bailor or issuer purport to perform?
- Is the bailee or issuer subject to state or federal regulation? If so, will the bailee or issuer provide counsel with an opportunity to examine the regulations, classifications, and tariffs?
- What is the nature of the service defect? Were goods lost? Damaged? Delayed? Misdelivered?
- What was the bailee's duty of care?
- Does it arise under federal or state regulation or under this division?
- Is it the standard of reasonable care?
- Does the person entitled or the bailee have the burden of proving reasonable care?
- Have the parties agreed that the bailee act as an insurer?
- To what extent will the actual value of the goods be protected? Is there a limit of liability in the contract, receipt, or regulation?
- Did the bailor protect himself or herself by paying higher carriage or storage rates? By purchasing an insurance policy?
- Was there a conversion by the bailee to his or her own use?
- Was there a conversion by the bailee's employee with the bailee's knowledge or consent?
- Is there a contractual exclusion of the bailee's or issuer's liability for loss, damage, or delay?
- Is the claim based on deterioration of perishable articles?
- Is the claim for loss of an article of extraordinary value not listed on the document of title?
- Was the claim occasioned by act, omission, or order of shipper?
- Was the claim occasioned by action of insects, moths, vermin, or ordinary wear and tear?
- Was the claim occasioned by a defect or inherent vice in the article?
- Was the claim occasioned by one of several interfering acts of sovereign authority?
- Was the claim occasioned by strike, lockout, or similar activity?
- Was the claim filed within the time specified in the tariff regulation or document of title? Was it in the proper form?
- Was the action instituted within the time specified in the document of title or a regulation?
- If the claim relates to delay by a carrier:
- What are the tariff regulations for that carrier?
- What is the custom of other carriers of the same classification between the same points at that time of year?
- Were there road or other difficulties hindering the performance of carrier's service?
- Did the shipper request and pay a premium for expedited service?
- If the claim relates to delay by a warehouse:
- What were the warehouse's working hours as determined by custom, documents of title, rules, regulations,

or tariffs governing the warehouse?

- Was reasonable notice that delivery was to be made given the bailee by the person entitled under the document of title?

- If the claim is for refusal to deliver:

- Was the person entitled to delivery under the document?
- Was the bailee's lien satisfied?
- Was the person willing to surrender the instrument?
- Did the bailee have the right to refuse to deliver?

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§15.64 G. Aids for Reducing Issues and Settling Dispute

The amount of money in a claim for loss, damage, misdelivery, or delay in the delivery of goods is ordinarily small. Lawsuits on these claims, however, tend to be complex in terms of understanding the interplay among the Commercial Code, tariffs, rules, regulations, and orders of the regulatory body. Moreover, the cases are complex factually, particularly if there is a claim of partial damage or a claim that items were missing at time of delivery.

Because of these practical factors, there is every incentive to resolve the matter short of litigation. The following techniques may assist counsel in settling the claim.

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§15.65 1. Independent Appraisal of Goods

Often the only thing left to be resolved in a dispute is a determination of the value of the goods. To resolve that question, counsel can authorize an appraiser to make a determination of the value.

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§15.66 2. Stipulations

The most common stipulations relate to the application of rules, regulations, classifications, and tariffs of the bailee. Stipulations may also be used to cut down pretrial and trial hearings on such matters as the due execution and validity of the warehouse receipt or bill of lading, the bailee's duty, and the actual value of goods at the time of delivery to the bailee.

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§15.67 H. Suggested Pleadings

The pleadings should describe in detail the area of dispute. The paragraphs in the document of title that are in issue should be pleaded in full. Thus, the court can determine the controversy without consuming an unnecessary amount of time.

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Source: Business Law/California UCC Sales and Leases/15 Documents of Title/§15.68 1. Form: Pleading Allegations as to Breach of Duty by Carrier Resulting in Loss or Damage to Goods

§15.68 1. Form: Pleading Allegations as to Breach of Duty by Carrier Resulting in Loss or Damage to Goods

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15.68-1 Pleading allegations as to breach of duty by carrier resulting in loss or damage to goods

FIRST CAUSE OF ACTION

[*After allegations as to names and capacities of parties*]

1. On or about _ _[*date*]_ _, defendant entered into a written contract with plaintiff for the transfer of certain personal property and household goods from _ _[*city and state*]_ _ to _ _[*city and state*]_ _. Attached as Exhibit A and incorporated in this complaint is a copy of the contract.

2. Under the terms of the contract, the bill of lading issued under it, and the tariffs, defendant agreed to be liable for any physical loss of, or damage from any external cause to, any articles carried in transit or held in storage.

3. Under that contract and subject to the tariff, rules, regulations, orders, and classifications of the _ _[*Public Utilities Commission/Interstate Commerce Commission*]_ _, plaintiff delivered to defendant the following goods, which, at the time of delivery to plaintiff, were of the age and quality shown here:

Item	Year of Purchase	Value Then	Value Now
		$	$
		$	$
		$	$

[*If appropriate, add*]

[4.] The following goods were not returned to plaintiff at destination:

[*Continue*]

[5.] Although plaintiff has requested that the goods be replaced or returned, defendant has failed to respond, except to deny liability.

SECOND CAUSE OF ACTION

1. Plaintiff realleges and incorporates by reference every allegation contained in the First Cause of Action.

2. On redelivery to plaintiff of the goods tendered to defendant for transportation, the goods had been damaged and diminished in value as follows:

Item	When Shipped		When Delivered	
	Value	Condition	Value	Condition

THIRD CAUSE OF ACTION

1. Plaintiff realleges and incorporates by reference every allegation contained in the First and Second Causes of Action.

2. Defendant took the items and sold or otherwise converted them to defendant's own use.

Comment: This complaint may be used for both intrastate and interstate shipments.

Plaintiff need not plead the cause of damage to the goods in the second cause of action in view of the carrier's liability as an insurer. The allegation of conversion in the third cause of action permits invoking the rule of Com C §7309(b), which does not allow the carrier to limit its liability for conversion.

NOTE: With regard to interstate shipments of goods by a common carrier, the Carmack Amendment to the Interstate Commerce Act (49 USC §14706) may preempt state law in this area. See *Dictor v David & Simon, Inc.* (2003) 106 CA4th 238, 130 CR2d 588 (even tort claims, including negligence and conversion, are subject to limitation of liability under bill of lading). See also *White v Mayflower Transit, LLC* (9th Cir 2008) 543 F3d 581 (plaintiff's claim for intentional infliction of emotional distress was preempted because it was based solely on same conduct giving rise to claims for property damage).

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§15.69 2. Form: Pleading Allegations as to Complaint Against Warehouse for Failure to Follow Lien-Enforcement Procedures

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15.69-1 Pleading allegations as to complaint against warehouse for failure to follow lien-enforcement procedures

FIRST CAUSE OF ACTION

[*After allegations as to names and capacities of parties*]

1. At all times mentioned, defendant _ _[*name*]_ _ was engaged in the business of a public warehouse and maintains and controls a warehouse for the storage of goods located at _ _[*address*]_ _.

2. On or about _ _[*date*]_ _, defendant entered into a written contract with plaintiff for the storage of personal property at defendant's warehouse.

3. Defendant issued to plaintiff a warehouse receipt. Attached as Exhibit ____ and incorporated in this complaint is a copy of the warehouse receipt.

4. On or about _ _[*date*]_ _, the goods were sold by defendant without plaintiff's knowledge or consent.

5. Although defendant knew plaintiff's address, plaintiff received no notification of the sale.

SECOND CAUSE OF ACTION

1. Plaintiff realleges and incorporates by reference every allegation contained in the First Cause of Action.

2. On or about _ _[*date*]_ _, defendant sold by private sale the goods subject to the warehouse receipt to _ _[*name of warehouse*]_ _, who was then and is now defendant's warehouse.

3. At the time defendant sold these goods to _ _[*name of warehouse*]_ _, defendant had published a notice of auction sale.

The auction sale was set for _ _[*date*]_ _, at _ _[*time*]_ _, which was _ _[*number*]_ _ days after the sale to _ _[*name of warehouse*]_ _.

At the time of this sale, the defendant knew that the sale did not comply with the enforcement-of-lien provisions of the Uniform Commercial Code of California.

Comment: The first cause of action is used when the bailee-warehouse sold the goods without notice to the bailor in violation of Com C §7210(b)(1), which provides that all persons claiming an interest in the goods must be notified.

The second cause of action is based on the warehouse's sale of the goods before the advertised time of the auction sale.

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§15.70 3. Form: Allegations: Answer Raising Defense of Agreed Value

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15.70-1 Allegations: answer raising defense of agreed value

1. The storage contract between plaintiff and defendant contained the following provision relating to the value of the goods stored:

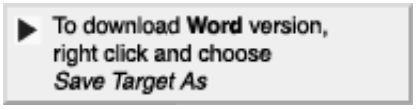
"For the purpose of this contract, rates, including rates, minimum charge, or other minimum provisions are based on the agreed or declared value of the property, regardless of actual known value, and in order to secure the company's basic or lowest rate, I hereby declare the value of all property to be not in excess of FIFTY CENTS PER POUND PER ARTICLE (90 cents per pound per article for motor van or air shipment), unless higher valuations are noted by me under "special provisions" (each article, its value, and weight to be listed), in which latter case I agree to pay any additional charge, as provided in the applicable rate schedule or tariff, in consideration of the rates charged. The amount of company's liability, if any, in case of loss or damage to property in moving, storing, packing, shipping, forwarding, or other handling, in subsequent shipment or removal from storage, is limited to such agreed or declared value. PROTECTION AGAINST LOSS OR DAMAGE EXCEEDING COMPANY'S LIABILITY MAY BE SECURED, IF DESIRED, BY OBTAINING INSURANCE COVERAGE."

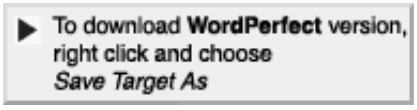
2. Plaintiff agreed to accept the valuation in the contract.

Comment: The parties may agree on a value of the bailed goods, provided the agreement meets the terms of the Commercial Code. It is recommended that the valuation provision in the document of title or applicable tariff be set out in full.

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§15.71 4. Form: Allegations: Defense of Late Filing of Claim





15.71-1 Allegations: defense of late filing of claim

1. The bailment of plaintiff's goods was the subject of a _ _[*bill of lading/warehouse receipt*]_ _ issued by defendant on _ _[*date*]_ _.

Attached as Exhibit ___ and incorporated in this answer is a copy of the _ _[*bill of lading/warehouse receipt*]_ _.

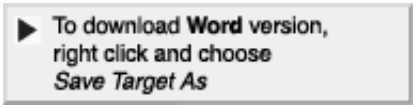
2. The _ _[*bill of lading/warehouse receipt*]_ _ provides in part:

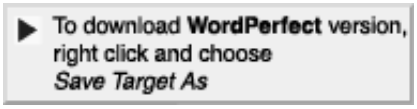
"As a condition precedent to recovery, the claim for any loss or damage, injury, or delay must be filed in writing with _ _[*carrier/warehouse*]_ _ within nine (9) months after delivery to consignee and shown on face hereof, or in case of failure to make delivery, then within nine (9) months after reasonable time for delivery has elapsed."

3. Defendant, after delivery of the bailed goods to plaintiff, delivered to plaintiff a document that plaintiff was to complete and return to defendant as proof of plaintiff's claim. Defendant has not received the proof of claim, nor has defendant received any other statement of plaintiff's claim.

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§15.72 5. Form: Allegations: Answer Raising Defense of Exclusion From Liability





15.72-1 Allegations: answer raising defense of exclusion from liability

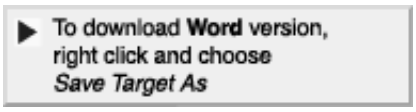
1. The _ _[*bill of lading/warehouse receipt*]_ _ provides in part:

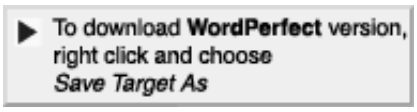
"_ _[*Carrier/Warehouse*]_ _ shall be liable for the physical loss of or damage to any article from external cause while being carried or held in storage in transit EXCEPT articles of extraordinary value that are not specifically listed on the _ _[*bill of lading/warehouse receipt*]_ _."

2. The goods for which plaintiff seeks recovery were of extraordinary value and were not specifically listed on the _ _[*bill of lading/warehouse receipt*]_ _.

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§15.73 6. Form: Allegation: Defense of Valid Enforcement of Lien





15.73-1 Allegations: defense of valid enforcement of lien

The charges were not paid, nor had they been paid for the six months last preceding the first notice of auction, which was sent on _ _[*date*]_ _.

Defendant sold the goods in the course of enforcing defendant's valid lien.

Comment: If the lien-enforcement procedures were complied with, that compliance is a defense to a claim for conversion.

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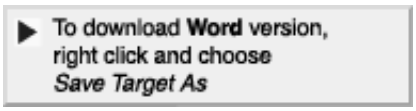
I. Suggested Aids in Settlement

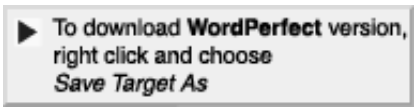
§15.74 1. In General

Often the person entitled to goods recognizes that the bailed goods are worth less than the amount of charges and expenses against them. The person entitled to the goods will authorize the sale of the goods by the bailee to (1) avoid the advertisement that the depositor's goods are to be sold for nonpayment of charges, (2) avoid liability for the deficiency, or (3) obtain a sum in excess of the sale price of goods. By so doing, the bailee avoids the necessity of proceeding under the enforcement section. The following is a suggested authorization-to-sell agreement.

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§15.75 2. Form: Authorization to Sell





15.75-1 Authorization to sell

AUTHORIZATION TO _ _[*name of bailee*]_ _ TO SELL

I, the undersigned, hereby authorize _ _[*name of bailee*]_ _ to sell at public or private sale at any time hereafter, without demand, advertisement, or notice of sale, all goods listed on the _ _[*warehouse receipt/bill of lading*]_ _ issued to me. I warrant that I am the owner of those goods. _ _[*Name of bailee*]_ _ shall apply the proceeds of this sale to payment of my indebtedness. The provisions of the Uniform Commercial Code of California with respect to demand, advertisement, notice of sale, and the manner and procedure of foreclosure sale are hereby expressly waived.

I understand that in consideration of this authorization, _ _[*name of bailee*]_ _ will sell and dispose of the goods and release me from any and all further liability for storage and other charges.

It is further understood that in the event any balance should remain after sale and payment of charges and expenses, the balance shall be paid to me at the address shown below.

Date: _ _ _ _ _ _ __[*Signature of bailor or owner*]__
_ _[*Address*]_ _

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§15.76 3. Protective Measures by Bailor

The bailor may have assumed the risk that the goods would be lost, damaged, or delayed in the course of transportation or storage. The question is: Does the bailor wish to assume this risk? If the bailor decides to place the risk elsewhere, the question is whether he or she wants the risk assumed by the bailee or by an insurer. If the goods are to be insured, the bailor must determine whether the insurance is to be on a specific lot of goods or on all goods being transported or stored. If the bailor wishes to obtain full protection, he or she should examine the following matters.

Items of extraordinary value that are small in size and enclosed in a larger parcel should be listed on the face of any document of title, together with their actual value. The bailor should be cautioned that if this listing is not made, the extraordinary portion of the value will not be protected, notwithstanding an insurance policy or assumption of liability by the carrier.

Additionally, the bailor should be cautioned that such values as sentimental value, emotional distress, and loss of use are not normally compensable by the bailee, but the bailor may be able to obtain insurance against loss of goods with such values. The full value of the shipment must be protected. The premium on an insurance policy will be based on the value claimed, so that if the value of goods is actually $5000, and bailor takes out a policy in the value of $3000, the bailor will pay a premium on $3000. However, the protection will be for only three-fifths of the actual value of each item, rather than three-fifths of the total actual value of the shipment.

A shipper's decision not to declare the value of computer equipment on a bill of lading and thereby reduce the freight charges and risk of loss backfired when the court upheld the bill of lading's declared value limitation following the theft of the goods in interstate commerce. In *Dictor v David & Simon, Inc.* (2003) 106 CA4th 238, 130 CR2d 588, the court reviewed the authority of the federal government to regulate interstate shipments, noting that the Carmack Amendment to the Interstate Commerce Act (49 USC §14706) is paramount and supersedes all state laws as to the rights, liabilities, and exemptions created by such transactions. The Carmack Amendment requires a carrier to issue a bill of lading and subjects it to absolute liability for actual loss incurred during the transport. However, the carrier may limit its liability, provided the shipper is given the opportunity to impose a greater or lesser liability by paying a greater or lesser charge for the transportation. In this case the shipping company employed an independent carrier to move computer equipment having a market value of $267,488 using the bill of lading created by the shipper, which declared a value of $7106 for the shipped goods based solely on their weight, and limited liability to that amount. The shipper alleged an oral agreement by the shipping company to reimburse the full value of the shipment in the event of loss. The shipping company, not surprisingly, asserted the liability limitation stated in the bill of lading. The trial court decided there was insufficient evidence to establish a contract to reimburse for a greater amount, citing California law (CC §2176) that a carrier is liable only for the amount asserted on the bill of lading. The appellate court determined that the Carmack Amendment applied (preempting state law), but confirmed that the carrier is allowed to limit its liability under the Carmack Amendment. Even potential tort claims are limited by this amendment. Further, the appellate court would not allow the reformation of the bill of lading contract on the grounds that there was, in fact, no mistake and the claim did not meet federal standards for reformation.

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§15.77 VII. INTERVENING RIGHTS OF THIRD PARTIES

Disputes arising out of claims to the bailed goods by a third party are frequent. Often counsel is not brought into the matter until one party has precipitated the dispute by some formal legal action. In many instances, however, counsel may enter the matter before the legal proceeding and resolve the dispute before formal legal action. This is the desirable approach because, when the values in the bailed goods are small, the ownership dispute can result in absorbing that value by the accumulation of bailee's charges.

The types of disputes fall into patterns that should be understood if the attorney's efforts are to be successful. The intervening third party has the problem of choosing between giving a notice of interest, formally demanding delivery of the goods, or proceeding with a claim and delivery or similar action. The bailee's response to these approaches is varied, but in all cases the bailee notifies the bailor or the holder of the document of title.

After waiting a reasonable time for a response from the person entitled under the document, the bailee may do any of the following:

- Do nothing and await formal legal action by one of the parties.
- Deliver the goods at the bailee's own risk to either of the parties (usually with an agreement that the bailee's charges be paid in full and that it be held harmless and indemnified from the claims of the other party or parties).
- Contact all interested parties and attempt to obtain an agreement between them that the goods will be held subject to their joint instructions pending the resolution of their dispute.
- Obtain the agreement of all interested parties that the goods should be sold and the proceeds deposited to their joint demand in a bank or other institution.
- Implead the parties.

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§15.78 A. Personal Disputes

Carriers and warehouses become embroiled in personal disputes with some regularity. On order from a party, the carrier unsuspectingly picks up the goods and, either during the loading or later, the other party in the dispute will arrive, sometimes with the police. The property picked up by the carrier is a mixture of their property, and their respective property rights have yet to be determined by a court.

The carrier in the process of loading might do one of several things:

- Offload the goods and leave the parties to their own dispute. This approach will probably cause the earner some difficulties in obtaining payment for the amount of service rendered. It also raises the issue of whether the goods are a unit. If they are, and possession was not complete, the carrier would not be obligated to act as stakeholder. If the goods are treated as severable, the carrier would have to act as stakeholder for the goods already loaded.
- Complete the pickup and determine the rights of the parties at the carrier's own risk, or store the goods jointly under the names of the parties, and then implead the parties.
- Stop loading, store the partial load, and implead the parties, or attempt to determine at the carrier's own risk the rights of the parties to the goods already loaded.

The atmosphere of the situation is charged with emotion, and either or both parties may be giving orders to the carrier. The bailee should recognize that it is excused from delivery until it has had a reasonable time to ascertain the validity of the adverse claim (see Com C §7603), and the bailee should advise the parties of this. Further, the bailee should advise them that it does not care to initiate a lawsuit, but would be forced to do so unless they agree that the bailee should hold the goods subject to their joint instructions pending a final determination of their respective rights in the goods. Because this last result is a most practical one, the bailee will usually be successful unless emotions are allowed to overcome reason.

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§15.79 B. Attaching or Executing Creditor

If goods in the possession of a bailee are represented by a negotiable document of title, unless the document is surrendered to the bailee or its negotiation enjoined, the bailee cannot be compelled to surrender the goods. Com C §7602. Essentially, the bailee is protected against having to choose to whom to deliver. The document itself may be attached by following the procedure in CCP §§488.445 and 700.120.

Goods represented by nonnegotiable documents are subject to attachment, like any other tangible personal property in the possession of another person. See CCP §488.365. On the rights of a bailee when there is a conflict of claims to the goods, see Com C §7603.

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§15.80 C. Commercial Code Treatment of Bailee's Stakeholder Role

The Commercial Code preserves the position of the bailee as a stakeholder when faced with conflicting rights between persons entitled under the document and intervening third parties. Commercial Code §7603 gives the bailee the necessary flexibility to act reasonably with respect to the disputing parties, the bailee's own interest, and the goods. This section is reinforced by Com C §7403(a)(1), which provides that a "delivery of the goods to a person whose receipt was rightful as against the claimant" is a lawful excuse for failure to deliver to the person entitled under the document. Again, under Com C §7404, good faith receipt and delivery of goods with the observance of reasonable commercial standards will protect the bailee from liability to the intervening third party.

If the warehouse's or carrier's lien is valid under Com C §§7209, 7307, and 7503, the bailee can (despite the dispute) terminate the bailment under Com C §7206, or foreclose the bailee's lien under Com C §7210 or §7308.

After the bailee has had a reasonable period of time (Com C §7603) to evaluate the situation, he or she may determine that he must follow the consignor's instructions on a nonnegotiable bill. Com C §7303(a)(2). The bailee may recognize that one of the claimed interests is subsequent in time to a duplicate document of title. The bailee's duty then is to deliver the goods to the person holding the document issued first.

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D. Settlement Aids

§15.81 1. Stakeholder Agreement

The parties may enter into a stakeholder agreement initiated by any party. The essence of the agreement is the recital of possession in the bailee, the bailee's consent to be subject to the stakeholder agreement, and a provision that delivery of the disputed goods by the bailee will be made only on joint instructions from all parties to the agreement. It may or may not include a statement of the issues in the dispute, but it should make clear how the accruing charges are to be paid in order to prevent foreclosure of the bailee's lien pending settlement of the dispute.

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§15.82 2. Agreement to Sell and Deposit Proceeds

When disputed goods are subject to rapid deterioration or obsolescence, the parties claiming the goods may agree to allow the bailee to sell the goods subject to the bailee's lien and expenses and deposit the proceeds in the bank. The proceeds of the sale will draw interest pending a resolution of the dispute, and bailment charges will be eliminated. The parties can readily divide their interests in the money when the dispute is resolved.

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§15.83 3. Compound Sales and Stakeholder Agreement

A combination of the two previous agreements can be used when the dispute will take time to resolve. The parties may agree that goods without sentimental value can be sold or given away, and the proceeds deposited or given to the bailee to apply on the storage charges for the remainder portion of the lot.

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§15.84 4. Indemnity, Hold Harmless, and Surety Agreement

Often the bailee is told by the intervening third party or the person entitled under the document that he or she will indemnify, hold harmless, guarantee, make good, or otherwise protect the bailee in the event delivery by the bailee is improper. This proposal should be viewed with skepticism. In the event of suit, the bailee must still defend, thus consuming the bailee's own time and that of its employees.

The agreement is only as good as the promisor's finances, and, if there is some doubt about credit, the bailee should require a surety bond covering the obligation.

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§15.85 E. Form: Complaint in Interpleader

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15.85-1 Complaint in interpleader

[*After allegations as to names and capacities of parties*]

1. Plaintiff has a lien on the following goods: _ _[*identify goods*]_ _ in the amount of _ _[*dollar amount*]_ _ for _ _[*storage/carriage*]_ _. Additional charges accrue at _ _[*dollar amount*]_ _ per month.

2. On or about _ _[*date*]_ _, plaintiff was advised by defendant _ _[*name of claimant notifying plaintiff*]_ _ of defendant's alleged right in the goods.

3. Plaintiff then advised defendant _ _[*name of bailor*]_ _, the person who had bailed the goods, that an adverse claim to the goods had been received.

4. Defendant _ _[*name of claimant*]_ _ demanded delivery of goods subject to the document, which plaintiff did not deliver.

5. Plaintiff is ignorant of the rights of the defendants in the goods.

6. Plaintiff has no claim in the goods other than the proper storage charges, and is ready and willing to deliver to such person as the Court may direct or to hold the goods subject to the present lien and accruing charges.

7. Defendant _ _[*name of bailee*]_ _, to whom the document was issued, agreed at the time of issuance that in the event plaintiff was required to interplead to determine title to the goods, defendant _ _[*name of bailee*]_ _ would pay plaintiff all costs incurred and attorney fees, and indemnify plaintiff for, and hold plaintiff harmless from, any other expenses incurred by reason of the interpleader.

8. Plaintiff has incurred the following costs and attorney fees: _ _[*list costs and fees*]_ _.

WHEREFORE, plaintiff prays judgment that:

1. The Court issue its injunction against each defendant from taking any further legal proceedings against plaintiff in respect to the goods;

2. Defendants be required to interplead their claims to the goods;

3. The Court designate that plaintiff hold the goods pending determination of the rights of the parties, subject to plaintiff's lien;

4. On delivery plaintiff be discharged from any and all liability to any defendant;

5. Defendant _ _[*name of bailee*]_ _ pay attorney fees, costs, and other expenses as shown; and

6. For such other relief as the Court may consider proper.

Comment: The complaint in interpleader should first allege the plaintiff's capacity as bailee, the issuance of the document of title, and the bailor's name.

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Source: Business Law/California UCC Sales and Leases/15 Documents of Title/§15.86 F. Checklist for Reviewing Third Party Claims

§15.86 F. Checklist for Reviewing Third Party Claims

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- What are the rights of the intervening third party?
- What are the rights of the person entitled under the document?
- What is the dispute?
- Are the parties amenable to a stakeholder agreement?
- In the event it is a dispute between landlord and tenant:
- Is the landlord claiming a lien on exempt goods?
- Is the landlord claiming a lien in excess of the value of the rent?
- Is the intervening right based on an attachment or execution? If so, are the goods subject to an outstanding negotiable document?
- Does the bailee continue to have possession?
- Did the bailee act in good faith and in accord with reasonable commercial standards?
- Is there a clear legal solution to the dispute between the parties?
- Will the party claiming the goods indemnify bailee?
- Will the claimant obtain a surety bond covering the propriety of bailee's delivery?
- Is the matter sufficiently risky to warrant the use of interpleader action?

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VIII. DEATH OF PERSON ENTITLED UNDER DOCUMENT

§15.87 A. In General

The effect of the bailor's death on other persons entitled to the goods is not discussed in the Commercial Code. The problems relate to questions of estate administration and taxation. However, because of the practical nature of the problem, a short comment is appropriate.

When a negotiable document of title has been issued to bearer or has been duly endorsed in blank, no further problems are created by the death of the holder of the document. When the document is issued to the order of the decedent or is nonnegotiable in nature, the bailee will require the return for cancellation of the document. The bailee also will require a certified copy of letters testamentary or letters of administration and an order of the probate court directing delivery to the person named in the order.

Probate Code §13100 provides for the collection of estates by affidavit 40 days or more after death when the value of the estate does not exceed $100,000, excluding the value of motor vehicles and other property listed in Prob C §13050. A person or the person using an affidavit to obtain possession must have the right to succession, be the sole beneficiary of all of the beneficiaries under the last will, a trustee of a trust the beneficiaries of which bear the requisite relationship to the decedent, and, with some restrictions, to the custodian nominated under the decedent's will to receive bequests under the California Uniform Transfers to Minors Act (Prob C §§3900-3925). The following Affidavit/Declaration To Collect or Transfer Personal Property Without Probate may be used to satisfy the provisions of Prob C §13100.

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Source: Business Law/California UCC Sales and Leases/15 Documents of Title/§15.88 B. Form: Declaration Under Probate Code to Collect or Transfer Personal Property

§15.88 B. Form: Declaration Under Probate Code to Collect or Transfer Personal Property

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15.88-1 Declaration under Probate Code to collect or transfer personal property

Declaration Under California Probate Code §§13100-13115

_ _[*I/We*]_ _, _ _[*name(s) of declarant(s)*]_ _ **say:**

1. _ _[*Name of decedent*]_ _ died on _ _[*date*]_ _, at _ _[*place of death*]_ _. At least 40 days have elapsed since the death of the decedent, as shown in a certified copy of the decedent's death certificate attached to this affidavit. No proceeding is now being or has been conducted in California for administration of the decedent's estate. The gross value of the decedent's real and personal property in California, excluding the property described in California Probate Code §13050, does not exceed one hundred thousand dollars ($100,000).

2. A true description of the property of the decedent sought by _ _[*me/us*]_ _ hereunder is as follows:
_ _[*Describe property*]_ _

3. The name(s) of the successor(s) of the decedent to the above described property _ _[*is/are*]_ _
_ _[*name(s)*]_ _. **No other person has a right to the interest of the decedent in the described property.**

[*Add one of the following alternatives*]

[*Alternative 1]*

4. _ _[*I/We*]_ _ _ _[*am/are*]_ _ the successor(s) of the decedent (as defined in California Probate Code §13006) to the decedent's interest in the described property.

[*Alternative 2]*

4. _ _[*I/We*]_ _ _ _[*am/are*]_ _ authorized under California Probate Code §13051 to act on behalf of the successor(s) of the decedent (as defined in California Probate Code §13006) with respect to the decedent's interest in the described property.

[*Continue*]

_ _[*I/We*]_ _ request that the described property be paid, delivered, or transferred to _ _[*me/us*]_ _.

_ _[*I/We*]_ _ affirm or declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date: _ _ _ _ _ _ __[*Signature(s) of declarant(s)*]__
_ _[*Typed name(s*]_ _

Comment: When completed, the declaration is filed with the holder of the decedent's property. If the decedent had evidence of ownership of the property, the holder has the right to require surrender of the evidence by the person presenting the declaration or, if the evidence is not presented, to require a bond from that person in an amount sufficient to indemnify the holder from all claims arising by reason of the transfer. Prob C §13102. Delivery of the property can then be made to the declarant because the holder is relieved and discharged from further liability for the property. Prob C §13106.

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16

Breakdown of the Bargain

Michael K. Slattery

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§16.1 I. SCOPE OF CHAPTER

This chapter discusses the options available to the parties when the sales transaction becomes problematic but neither party has yet committed an actionable breach of contract. For example, the following circumstances may indicate a breakdown of the bargain:

- The circumstances create reasonable grounds for one party to feel insecure about the other party's intention or ability to perform (see §§16.2-16.20);
- Before its performance is due, one of the parties unequivocally communicates its intention not to perform (see §§16.21-16.39); or
- One of the parties claims that its performance is excused on grounds of impracticability (see §§16.60-16.78).

Performance by the buyer and seller are discussed in chaps 9 and 10, respectively. Remedies for breach are discussed in chaps 17-18.

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II. RIGHT TO ASSURANCE OF PERFORMANCE

§16.2 A. Background

Division 2 of the Commercial Code imposes an implied obligation on each party to a contract to preserve the other party's expectation of return performance. Commercial Code §2609(1) authorizes a party to demand assurance that the other party will perform when circumstances give the party reasonable grounds for doubting that the performance is forthcoming. The right to demand assurance of performance, however, is limited by certain conditions discussed in §§16.3-16.8.

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B. Requirements for Demanding Assurance of Performance

§16.3 1. Written Demand

Although Com C §2609 expressly requires a written demand for assurances of performance, some courts have held that an oral demand will suffice. See, *e.g., AMF, Inc. v McDonald's Corp.* (7th Cir 1976) 536 F2d 1167, 1171 (plaintiff never received written demand but, after meeting with defendant, had "clear understanding" that defendant's performance would be suspended until it received adequate assurance of plaintiff's performance). A court may also infer a demand for assurance in the writings exchanged by the parties. For example, in *Diskmakers, Inc. v DeWitt Equip. Corp.* (3d Cir 1977) 555 F2d 1177, the sales contract obligated the buyer to tender an irrevocable letter of credit. After the contract was signed, the buyer began to doubt whether the seller could furnish product in the quantity required. The buyer tendered a *revocable* letter of credit and made an inspection of the product a condition of payment. The court held that the revocable letter of credit could have been construed as a demand for assurances.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.4 2. Reasonable Grounds for Insecurity

§16.4 2. Reasonable Grounds for Insecurity

A party has the right to demand adequate assurance of due performance only if reasonable grounds for insecurity arise with respect to the performance of the other party. Com C §2609(1). The requirement of reasonable grounds establishes that the standard of insecurity is objective, not subjective. Commercial Code §1304 mandates that the demand be made in good faith.

If both parties to a contract are merchants (see Com C §2104; §1.24), the reasonableness of grounds for insecurity is measured by commercial standards. Com C §2609(2).

When one of the parties to the contract is not a merchant, Com C §2609 does not expressly require that the reasonableness of the grounds for insecurity be measured by commercial standards. A court might, however, apply the standards of a trade usage of which the nonmerchant party is, or ought to be, aware. See Com C §1303; §§4.100-4.103.

Official Comments 3 and 4 to UCC §2-609 provide the following examples of circumstances that would be reasonable grounds for insecurity:

- The buyer falls behind in payments on its account with the seller;
- The buyer discovers that the seller is making defective deliveries to other buyers unless the buyer has assumed the risk of payment before inspection, as in a "C.I.F." term contract. See §§9.26-9.38;
- A manufacturer breaches a dealer's exclusive dealing clause;
- A buyer suddenly expands its use of credit terms; or
- A buyer stops taking advantage of early payment discounts.

Although there are no reported California cases evaluating the circumstances that can constitute reasonable grounds for insecurity, decisions from the federal courts and other jurisdictions provide the following illustrations:

- The buyer was in arrears for goods already delivered, its Fifth Avenue "showroom" was only an answering service, its "factory" was the business premise of a third party, and another supplier told the seller that the buyer had failed to pay for delivered goods. See *Turntables, Inc. v Gestetner* (NY App Div 1976) 382 NYS2d 798.
- The prototype for an order of 23 machines had malfunctioned for a year. The manufacturer extended the proposed delivery schedule and (because of the prototype's lack of performance) had attempted to reduce the quantity of the order from 23 to 5 machines. See *AMF, Inc. v McDonald's Corp.* (7th Cir 1976) 536 F2d 1167.
- At a meeting to discuss a $38,000 delinquent account, the buyer paid $5000 and promised further prompt payments if the seller continued deliveries. The seller continued to deliver in reliance on the buyer's promises, but the buyer made no further payments and failed to deposit sufficient cash in escrow to pay for the delivered materials. See *Kunian v Development Corp. of Am.* (Conn 1973) 334 A2d 427.
- The defendant chartered a tugboat for a 3-year term with an option to purchase at its expiration. Approximately 2 ½ years into the term of the charter, the defendant learned that the plaintiff had defaulted on two mortgages that encumbered the boat before the grant of the charter and encumbered the boat with a third mortgage. The defendant then requested assurance of the plaintiff's ability to convey marketable title on the defendant's exercise of its purchase option. See *Clem Perrin Marine Towing, Inc. v Panama Canal Co.* (5th Cir 1984) 730 F2d 186.
- At an acrimonious meeting to resolve disputes about performance, the defendant's attorney suggested that the parties' written agreement was not enforceable. The defendant's general manager also stated that he no longer wished to do business with the plaintiff. Subsequent to the meeting, the defendant's attorney sent a letter that reaffirmed the defendant's intent to unilaterally alter the terms of the contract. See *Copylease Corp. of Am. v Memorex Corp.* (SD NY 1975) 403 F Supp 625.

Conversely, courts have also held that the following circumstances did *not* create reasonable grounds for insecurity:

- A seller contracted to construct a water tank and agreed to payment of the purchase price 30 days after testing

of the completed tank. The seller then learned that the buyer had secured a loan, apparently to finance the cost of the tank. The seller demanded that loan proceeds in an amount equal to the purchase price of the tank be escrowed and that the buyer's president also guarantee the payment of the purchase price. The seller suspended performance after this demand. The seller's demand and suspension of performance were not justified because there was no evidence that the buyer's ability to pay had diminished. See *Pittsburgh-Des Moines Steel Co. v Brookhaven Manor Water Co.* (7th Cir 1976) 532 F2d 572.

- A lumber buyer made separate contracts for the purchase of plywood, select pine, and studs. After the buyer resold the rights to the carload of plywood, the seller refused to ship the merchandise. The buyer purchased substitute plywood elsewhere and refused to pay for the carload of select pine. The seller's suspension of performance of the contract for studs was not authorized because "the mere fact that payment under one contract is not made when due is not necessarily a reasonable ground for insecurity as to payment under another contract." See *Northwest Lumber Sales, Inc. v Continental Forest Prods.* (Or 1972) 495 P2d 744, 750.
- A buyer agreed to purchase corn. The delivery was to be made over a two-month period. The buyer subsequently threatened to cancel the order unless the seller provided assurances that the seller's supplier would provide the corn needed. The buyer's demand was not authorized because the contract did not contemplate that the seller would procure corn from a particular source. See *In re Coast Trading Co.* (Bankr D Or 1982) 26 BR 737.

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§16.5 3. Reasonable Grounds in Installment Contracts

Under Com C §2612, if a contract requires or authorizes delivery in separate lots to be separately accepted:

- The buyer may reject any installment whose nonconformity cannot be cured and that substantially impairs the value of that installment;
- The buyer must accept a defective installment on the seller's adequate assurance of cure unless the defect substantially impairs the value of the whole contract; and
- The buyer confronted with a defective installment that substantially impairs the value of the whole contract may declare a breach of the entire contract.

Neither Com C §2612 (installment contracts; breach) nor Com C §2609 (right to adequate assurance of performance) indicates how, if at all, the two statutes are intended to interrelate. For example, must the buyer exercise the right to adequate assurance and afford the seller an opportunity to provide assurances before it

- Rejects an incurable and substantially defective installment?
- Rejects a curable but substantially defective installment?
- Declares a breach of the entire contract because of defective installments?

The courts that have addressed this issue have uniformly held that the right to demand assurance of performance is a purely elective remedy, the exercise of which is not a precondition to the exercise of other rights provided by the Commercial Code. The demand for assurance may be the only course of action, however, if the right to cancel the installment contract is questionable. Com C §2612.

For example, in *National Farmers Org. v Bartlett & Co. Grain* (8th Cir 1977) 560 F2d 1350, a purchaser of grain withheld a portion of its payments as a fund to set off its damages for repeated late deliveries. The seller refused further deliveries without full payment of the withheld funds, and the buyer alleged an anticipatory repudiation. The court held that the seller had no immediate right to cancel the contract under UCC §2-612 when the buyer withheld payments because only the seller's security with regard to future installments was impaired. The court noted in dictum that the seller could have availed itself of a UCC §2-609 remedy. 560 F2d at 1355.

In *Cherwell-Ralli, Inc. v Rytman Grain Co.* (Conn Super Ct 1980) 433 A2d 984, 987 the court stated that if there is reasonable doubt as to whether the buyer's default is substantial, the seller may suspend performance and request adequate assurance of future payments. If the buyer's conduct is sufficiently egregious, that in itself will constitute a substantial impairment of the value of the whole contract and present a breach of the contract. See also *Indussa Corp. v Reliable Stainless Steel Supply Co.* (ED Pa 1974) 369 F Supp 976 (seller may exercise rights to stop goods in transit on discovery of buyer's insolvency without having to provide buyer with opportunity to make adequate assurances).

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§16.6 4. Contractual Definitions of Grounds for Insecurity

If the parties choose, they may specify the circumstances and events that will or will not constitute reasonable grounds for insecurity. This specification is advisable because it is difficult to abstract general rules from the highly fact-specific case law and Official Comments discussed in §§16.4-16.5. The parties' specifications may not be manifestly unreasonable, or give the buyer or seller the unfettered discretion to declare its insecurity without reference to objective factors or criteria. See Com C §1302(b). See also forms 16.7-1, 16.8-1.

DRAFTING CONSIDERATIONS: The attorney responsible for drafting a contract should be alert for potential problems that should be excluded as grounds for insecurity. For example, if the client customarily takes cash discounts but expects to have a diminished cash position for a time during the execution of the contract, the client may want to provide that a delay in payment for a certain period will not give the seller reasonable grounds for insecurity. See Official Comment 4 to UCC §2-609. Similarly, if the seller expects problems with its production schedule, the agreement should eliminate production problems as ground for the buyer's insecurity.

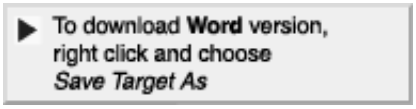
In addition to specifying what will or will not be grounds for insecurity, the parties may also find it advantageous to specify which assurances are required if grounds for insecurity exist. For a discussion of assurances, see §§16.9-16.17. See also form 16.8-1.

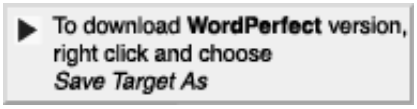
DRAFTING CONSIDERATIONS: Because the buyer and seller will have strongly differing interests in the content of an "insecurity clause," the attorney who drafts a contract addressing this issue should keep in mind the provisions of Com C §2207 concerning additional or conflicting terms in acceptances and confirmations. The operation of Com C §2207 may defeat the intent of both parties. For example, assume that the buyer's purchase order specifies that no deviation from quality or quantity specifications for installment deliveries is permissible, but the seller's invoice provides that specified deviations do not constitute reasonable grounds for insecurity. A court may determine that the conflicting terms cancel each other and interpret the contract by reference to the Commercial Code "gap-filler" terms, prior dealings between the parties, and industry or trade group customs. If both parties are merchants, the differing term chosen by the sender of the acceptance may control unless the offeror makes a timely written objection. See §§5.13-5.23.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.7 5. Form: Certain Events Are Not Grounds for Demanding Assurance of Performance

§16.7 5. Form: Certain Events Are Not Grounds for Demanding Assurance of Performance





16.7-1 Certain events are not grounds for demanding assurance of performance

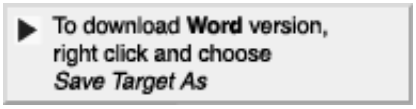
The parties agree that _ _[*describe event, e.g., the buyer's failure to take cash discounts/the* _ _[*buyer's/seller's*]_ _ *breach of or failure to perform any other contract with the* _ _[*buyer/seller*]_ _*/unfavorable credit reports concerning the buyer*]_ _ **will not be grounds for demanding assurances of performance.**

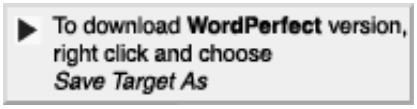
Comment: The events described in this clause are only a few of the numerous events that might otherwise justify a demand for assurances of performance that a party may want to exclude as grounds for insecurity. In addition, the attorney may be able to eliminate some technical breaches (*e.g.,* short and immaterial delays or minor, curable quality deviations) as grounds for insecurity, and thereby extend the time for performance or expand the right to cure. The perfect tender rule (see §9.51), which allows a buyer of goods to reject a tender of delivery that fails in any way to conform to the contract, makes it particularly important to eliminate breaches that are in fact not significant. See Com C §2601.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.8 6. Form: Certain Events Are Grounds for Demanding Assurance of Performance

§16.8 6. Form: Certain Events Are Grounds for Demanding Assurance of Performance





16.8-1 Certain events are grounds for demanding assurance of performance

The parties agree that _ _[*describe event, e.g., strict performance of all contract terms is required and that any breach/the buyer's commencement of accounts receivable financing/sales by the seller to any other buyer within the described territory/breach of any express or implied warranty of quality made to any buyer*]_ _ **will give the** _ _[*buyer/seller*]_ _ **reasonable grounds for insecurity.**

Comment: The events that the contract identifies as grounds for insecurity may, but need not, constitute a breach of contract. The parties may also specify the assurances that must be furnished if particular grounds for insecurity arise. See form 16.13-1.

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C. Demand for Adequate Assurance

§16.9 1. In General

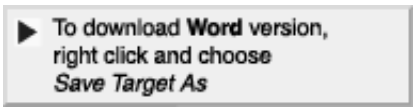
The form and timing of the demand for assurance of performance may be specified by the parties' contract. See form 16.11-1.

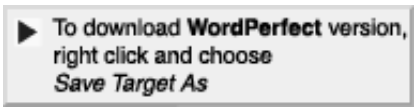
Because Com C §2609(4) conditions the duty to provide assurances on the receipt of a justified demand, the risk of a failure in communication of the demand is on the sender. See Com C §1202.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.10 2. Form: Demand for Adequate Assurance

§16.10 2. Form: Demand for Adequate Assurance





16.10-1 Demand for adequate assurance

Recent events have raised our concerns about your ability or willingness to finish performance of our contract, dated _ _[*date*]_ _**, for** _ _[*describe contract*]_ _**. Specifically, we are concerned about** _ _[*e.g., failure to deliver an installment/failure to make a payment when due/adverse credit information*]_ _**.**

Under the circumstances, the law entitles us to demand your assurance that you will indeed perform the contract as promised. Please provide us that assurance by _ _[*e.g., giving your personal guaranty/providing the guaranty of a creditworthy third party/tendering a letter of credit payable to* _ _[*name of seller*]_ _ *on presentment of* _ _[*the invoice/bill of lading/inspection certificate*]_ _*/posting a surety bond/shipping all overdue goods and the next installment within ten days*]_ _**.**

Until we have received your assurance, we will suspend our own performance of the contract. Your assurance must be received by us by _ _[*date and time*]_ _**, or we will consider you to be in breach of the contract.**

Comment: It is probably a good idea to specify the grounds for insecurity so that any misunderstanding can be corrected as soon as possible. The nature of the assurance demanded also may be specified by the contract, or may be left to an ad hoc determination.

For discussion of suspension of performance and consequences of failure to furnish adequate assurances, see §§16.16-16.17.

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§16.11 3. Form: Form or Timing of Demand Specified

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16.11-1 Form or timing of demand specified

A demand for adequate assurance must be in writing, signed by an executive officer of the _ _[*buyer/seller*]_ _**, transmitted by** _ _[*certified mail, with return receipt requested/first class mail, postage prepaid/telecopier or facsimile/overnight courier*]_ _ **and received by the** _ _[*seller/buyer*]_ _ **at** _ _[*location*]_ _ **within** _ _[*e.g., ten*]_ _ **days after the sender first has grounds for insecurity about the recipient's performance. All grounds for insecurity relied on must be stated in the demand, together with all information causing the sender to consider itself insecure and the sources of the information.**

Comment: This clause may cover any number of variables. The details that may be specified by a potential recipient may include the form of communication to be used, the manner of its transmission, the person or office to which it must be delivered, and the amount of detail it must contain. Conversely, because the recipient's duties begin on its receipt of the demand (Com C §2609(4)), the sender will want to select a manner of transmission (*e.g.,* air freight courier under an air bill or mailing with return receipt requested) that simplifies its proof that the demand was received in a timely manner. The contract may specify all these matters as long as the clauses are not manifestly unreasonable. See Com C §1302(b).

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D. Adequacy and Timeliness of Assurance

§16.12 1. Adequacy

Commercial Code §2609 does not define which assurances will be adequate, but the Official Comments provide some examples of particular fact situations.

The examples, which hypothesize a seller's defective installment contract delivery, reflect the drafter's intent that the adequacy of assurance will depend on the seller's business reputation and on whether the seller's nonconforming partial performance has any utility to the buyer. Official Comment 4 to UCC §2-609 states that:

- If the buyer can use the defective delivery, a promise by a reputable seller that it will give the matter its attention, or that the problem will not recur, may be sufficient;
- If the seller is disreputable, a speedy replacement might be required; and
- If the buyer cannot use the delivery, no verbal assurance is adequate unless accompanied by a cure.

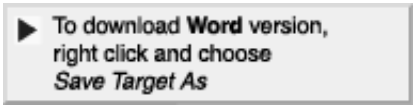
The statute and case law offer very little guidance, however, for determining which assurances are required when conduct falls short of a breach. To avoid disputes about the adequacy of an assurance, the sales contract should specify which assurances would adequately address specified grounds for insecurity.

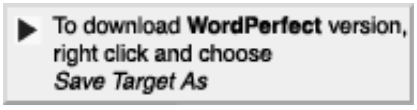
The attorney should explain to the client that an unjustified demand requires no return assurance and may itself be a breach of the contract. Further, a refusal to respond to a demand on the ground that it is not justified or that it seeks excessively burdensome assurances may be a repudiation of the contract. See §§16.21-16.32. Thus, the attorney should carefully review the facts and circumstances before advising the client on whether and how to respond to a demand for adequate assurances.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.13 2. Form: Type of Assurance to Be Furnished

§16.13 2. Form: Type of Assurance to Be Furnished





16.13-1 Type of assurance to be furnished

If the _ _[*buyer/seller*]**_ _ at any time demands assurance of performance, the _ _**[*seller/buyer*]**_ _ agrees promptly to _ _**[*e.g., tender a letter of credit payable on presentment of the _ _*[*invoice/bill of lading/inspection certificate*]*_ _/provide a guaranty of its payment obligations by a creditworthy third party/furnish a payment bond in the amount of the unpaid balance/ship all goods required by the contract but undelivered/furnish credit reports from its banker*]*_ _ _ _*[*and furnish all further assurances that the _ _*[*buyer/seller*]*_ _ may reasonably demand/No further assurances will be required under the contract*]*_ _***.**

Comment: Although it is possible to define in the contract what will be adequate assurance of performance, it may be very difficult to anticipate specific performance problems and to predict what kind of assurance will be adequate. The definition of adequacy must not be manifestly unreasonable. Com C §1302(b).

The contract clause may recite that a specific type of assurance is adequate or provide that it is not exclusive and that additional types of assurances may be required.

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§16.14 3. When Assurance Must Be Given

If the demand for assurance is justified, or the recipient of the demand chooses not to risk contesting it, the recipient must furnish adequate assurance within a reasonable time not to exceed 30 days or be held to have repudiated the contract. Com C §2609(4). For discussion of repudiation, see §§16.21-16.34.

It appears that the 30-day period was specified to restrict the range of time periods that can be found to be reasonable. See Official Comment 5 to UCC §2-609. The 30-day period will have little relevance when, *e.g.,* delivery is being held and assurance of payment is demanded within a few hours, or the goods are perishable. The nature, purpose, and circumstances of an action determine the reasonableness of the time for its performance, assuming no time is specified in the contract for a party to respond to a demand. Com C §1205(a). The course of dealing and performance between the parties and relevant industry and trade group customs are also important in making this determination. Official Comment 2 to UCC §1-205. See Com C §1303.

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§16.15 4. Fixing Time for Assurance

Subject to the outside limit of 30 days specified in UCC §2-609(4), the parties may fix by contract a time within which assurance of performance must be given, if the time specified is not manifestly unreasonable. Com C §1302(b). Different time periods can be set for different events if they can be predicted and defined at the time the contract is drafted. The practical effect of fixing a time period may be to extend the time for performance, because the defaulting party will know that there is a minimum time before which it cannot be held to have repudiated the contract. Attorneys who want to insert a clause fixing time into a form contract should consider the provisions of Com C §2207 (additional terms in acceptance or confirmation). See chap 5.

If the contract does not set a time for furnishing assurances, the aggrieved party may try to avoid a dispute over this issue by stating in the demand a time by which the other party must respond.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.16 E. Permissible Action While Waiting for Assurance

§16.16 E. Permissible Action While Waiting for Assurance

A party demanding assurance cannot suspend its own performance for which it has received the agreed return. Com C §2609(1). For example, a buyer cannot refuse to pay for goods it has received, and a seller cannot refuse to ship goods for which it has been paid. If a party has not received the agreed return, it may suspend performance if it is commercially reasonable to do so. Com C §2609(1).

In suspending performance, the aggrieved party may withhold preparatory action, which could delay performance for a considerable time. Official Comment 2 to UCC §2-609.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.17 F. Effect of Failure to Furnish Adequate Assurance

§16.17 F. Effect of Failure to Furnish Adequate Assurance

Failure to furnish assurance of performance after a justified demand is a repudiation of the contract. Com C §2609(4). See §§16.21-16.34 for discussion of repudiation and its effects.

A party that has repudiated may change its mind and retract the repudiation if the other party has not acted on the breach. Official Comment 5 to UCC §2-609. See §§16.35-16.39 for further discussion.

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§16.18 G. Acceptance of Improper Performance Is Not Waiver

Acceptance of an improper delivery or payment does not prejudice the recipient's right to demand adequate assurance of performance. Com C §2609(3). The intent of this rule is to preclude the argument that a party's acceptance constitutes a waiver. Because improper performance often creates the insecurity, it is advantageous to permit the parties to use the goods or apply the payment to the extent that is possible.

A history of unquestioned acceptance of improper performance, however, would certainly weaken a claim that the improper performance created reasonable grounds for insecurity.

For discussion of waivers and their retraction, see Com C §2209. See also §§6.12-6.22.

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H. Related Remedies

§16.19 1. Insolvent Buyer

If the seller discovers that the buyer is insolvent (see Com C §1201(b)(23)) *before* delivery, the seller may refuse delivery except for cash payment (including cash payment for goods previously delivered on credit) and may exercise its right to stop the delivery of goods in transit. Com C §2702(1). See §§17.14-17.22.

If the seller discovers that the buyer has received goods on credit while insolvent *after* delivery, the seller may reclaim the goods by demand within ten days after the buyer's receipt. Com C §2702(2). There is no limitation on the timing of the seller's demand if the buyer has made a written representation of its solvency within three months before the delivery. Com C §2702(2). See §§17.24-17.31.

The seller's exercise of either of the rights discussed above is not conditioned on a prior, unheeded request for adequate assurance of performance. *Indussa Corp. v Reliable Stainless Steel Supply Co.* (ED Pa 1974) 369 F Supp 976.

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§16.20 2. Insolvent Seller

If a buyer has made a partial payment for unshipped goods that have been identified to the contract of sale, and the seller becomes insolvent within ten days after its receipt of the first partial payment, the buyer may tender the remaining unpaid portion of the purchase price and claim the goods. Com C §2502. Absent proof of a fraudulent transfer, the rights of the seller's unsecured creditors are subject to this right of the buyer. Com C §2402(1). See §§17.75-17.79.

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III. ANTICIPATORY REPUDIATION AND ITS RETRACTION

§16.21 A. Introduction

A party repudiates a contract before the performance is due if (1) the party unequivocally communicates an intent not to perform, or (2) by actions, renders performance impossible. For purposes of the Commercial Code, the repudiation must also substantially impair the value of the contract to the nonrepudiating party. Com C §2610.

If a party repudiates, the nonrepudiating party may either continue to wait for performance for a commercially reasonable time or resort to its remedies for breach of contract. Com C §2610(a)-(b). In either case, the nonrepudiating party may suspend its return performance or exercise its rights to identify goods to the contract or to salvage unfinished goods. Com C §2610(c).

The events and situations that create reasonable grounds for insecurity under Com C §2609 (see §§16.4-16.5) may also be considered an anticipatory repudiation, if sufficiently indicative of risk of nonperformance. Assuming the time for performance has not lapsed, these events and situations cannot constitute an actual breach. As discussed in §16.29, an anticipatory repudiation (unlike an event that merely creates reasonable grounds for insecurity) entitles the nonrepudiating party to immediately resort to its remedies for breach of contract. See Com C §§2701-2725 for available remedies. For discussion of remedies, see chaps 17-18.

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B. Manifestation of Repudiation

§16.22 1. Generally

"Repudiation" generally has the same meaning under the Commercial Code as it had under the common law. For example, in *Guerrieri v Severini* (1958) 51 C2d 12, 18, 330 P2d 635, the California Supreme Court noted that a party positively repudiates the contract by either acts or statements that indicate that the party will not, or cannot, substantially perform the essential terms of the contract. See *Atkinson v District Bond Co.* (1935) 5 CA2d 738, 743, 43 P2d 867, in which the court said a party's refusal to perform must be of the whole contract and must be distinct, unequivocal, and absolute. *Taylor v Johnston* (1975) 15 C3d 130, 123 CR 641.

Anticipatory repudiation is not defined in the Code; however, Official Comment 1 to UCC §2-610 refers to an overt communication of intention or an action that renders performance impossible or demonstrates a clear determination not to continue with performance.

It is not necessary that the performance be utterly impossible. See Official Comment 2 to UCC §2-610. Repudiation can result from action that reasonably indicates a rejection of the continuing obligation.

Repudiation also occurs when a party (1) states that it will not perform unless it receives a performance to which it is not entitled under the contract, or (2) fails to provide an assurance of performance that has been rightfully demanded. A mere demand for more than the contract calls for in the way of counterperformance is not in itself a repudiation. Official Comment 2 to UCC §2-610.

Although a justified demand for assurance is certainly not a repudiation, an unjustified demand coupled with a suspension of performance will be considered to be a repudiation. See *National Farmers Org. v Bartlett & Co. Grain* (8th Cir 1977) 560 F2d 1350 (seller repudiated when it refused to make further deliveries to buyer unless buyer made payments on other contracts); *Pittsburgh-Des Moines Steel Co. v Brookhaven Manor Water Co.* (7th Cir 1976) 532 F2d 572 (seller repudiated when it suspended performance without reasonable grounds for insecurity until buyer placed payments for purchase of water tank in escrow).

The clearest repudiation of a contract is a party's statement that it will not or cannot perform. Nevertheless, if there is any doubt about the reliability of such a statement (*e.g.,* when the authority of the person making it may not be clear, or it may be considered only a bargaining tactic), the situation should be clarified by demanding adequate assurance of performance. See Com C §2609.

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2. Bankruptcy Issues

§16.23 a. Automatic Stay

It is uncertain whether insolvency may constitute a repudiation of the contract. The attorney can avoid the issue by requesting assurance of performance, which will typically either provoke repudiation or result in the giving of an assurance of performance.

If a party petitions for bankruptcy relief, the automatic stay provisions of 11 USC §362(a)(6) clearly prohibit the aggrieved party from declaring repudiation and resorting to its remedies for breach.

A contractual clause specifying that a party's petition for bankruptcy relief will constitute a repudiation is unenforceable unless (11 USC §365(e)(1)-(2)):

- The debtor's rights or duties under the contract are nonassignable or nondelegable under applicable nonbankruptcy law (*e.g.,* a personal service contract); or
- The contract is to make a loan or extend other "financial accommodation" to the debtor.

The attorney should read with great caution the qualifications to the general rule that bankruptcy clauses are invalid. See *Computer Communications, Inc. v Codex Corp.* (*In re Computer Communications, Inc.)* (9th Cir 1987) 824 F2d 725, in which the nondebtor party violated the automatic stay by terminating the contract even when the contract was nonassignable under state law.

Even if the attorney for the nondebtor believes that the client's contract for the sale or purchase of goods is nonassignable or nondelegable, or that the client's delivery and payment terms represent a "financial accommodation" to the debtor, the attorney should seek the approval of the bankruptcy court by requesting relief from the automatic stay to terminate the contract, to fix a time within which the trustee must assume or reject the contract (see §§16.24, 19.123-19.130) or to request "adequate protection" of the client's interest in the contract under 11 USC §363(e).

It is arguable that a suspension of return performance (*e.g.,* a seller's stopping regular deliveries of goods) could also violate the automatic stay. The decisions that support this position reason that:

- Contract rights become part of the debtor's estate; and
- The nondebtor's attempt to terminate the contract impairs the estate's intangible property right to continued performance.

See, *e.g., Computer Communications, Inc. v Codex Corp.* (*In re Computer Communications, Inc.)., supra,* in which the contract obligated a communications equipment manufacturer to purchase a minimum quantity of the debtor's computer equipment. The court held that the nondebtor violated the automatic stay by terminating the contract because the debtor filed a petition for bankruptcy relief.

As indicated above, a prudent nondebtor will request adequate protection of its interest in the contract.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.24 b. Assumption and Rejection of Contracts

§16.24 b. Assumption and Rejection of Contracts

The Bankruptcy Code's rules concerning executory contracts provide some protection for the nondebtor party. If the debtor has petitioned for relief under Chapter 7 of the Bankruptcy Code, the trustee must elect to assume an executory contract within 60 days after the commencement of the case (or within any additional time that the bankruptcy court grants for cause), or the contract is considered to be rejected by the trustee. 11 USC §365(d)(1). Rejection constitutes a breach by the debtor that is considered to have occurred immediately before the commencement of the case and excuses the nondebtor party from performance.

If the trustee elects to assume an executory contract, the trustee must do the following (11 USC §365(b)):

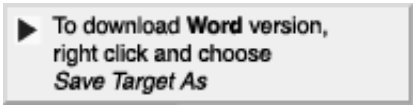
- Protect the interests of the nondebtor party by curing (or providing adequate assurance of prompt cure of) all defaults;
- Compensate the nondebtor for all pecuniary loss from the debtor's defaults, or provide assurance that compensation will be made promptly; and
- Provide adequate assurance of future performance of the contract.

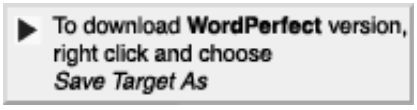
If the debtor has petitioned for relief under Chapter 11 or Chapter 13 of the Bankruptcy Code, the trustee may assume or reject an executory contract for the sale of goods at any time before the confirmation of a reorganization plan. The nondebtor party must affirmatively seek relief by requesting that the court specify a time within which the trustee must elect to assume or reject an executory contract. 11 USC §365(d)(2).

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.25 C. Form: Acts Constituting Repudiation

§16.25 C. Form: Acts Constituting Repudiation





16.25-1 Acts constituting repudiation

Whether or not it interferes with performance, _ _[*describe acts considered to be repudiations, e.g., substantial interference with operations from labor difficulties*]**_ _ will be considered to be a repudiation by _ _**[*name of party*]**_ _ substantially impairing the value of the contract within the meaning of California Commercial Code §2610.**

Comment: Although the opportunity to obtain adequate assurances of performance will usually remedy uncertainties, a party may want to be able to treat an insecurity as a breach. This clause permits the party to do so provided that this action is not considered to be manifestly unreasonable. The clause also prevents disputes over (1) whether a particular act is repudiation, and, assuming it is, (2) whether it substantially impairs the value of the contract. See §16.26.

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§16.26 D. Substantial Impairment of Value of Contract

Regardless of the clarity of the anticipatory repudiation, the aggrieved party has a remedy under Com C §2610 *only* if the loss of performance will substantially impair the value of the contract. The test for substantial value is whether material inconvenience or injustice will result if the aggrieved party is forced to wait and receive an ultimate tender minus the part or aspect repudiated. Official Comment 3 to UCC §2-610.

If the repudiation results from a failure to give adequate assurance of due performance after a justified demand order, the requirement that the repudiation must substantially impair the value of the contract apparently does not apply. See Com C §2609(4); Official Comment 2 to UCC §2-610.

Commercial Code §2612 (see §§9.57, 12.5) uses the "substantial impairment" standard to determine breach of an installment contract. Similarly, Com C §2608 limits a buyer's right to revoke acceptance to circumstances in which the defect substantially impairs the value of the goods to the buyer. See §§10.32-10.34, 17.61-17.66 for discussion of revocation of acceptance.

A court may be reluctant to find a substantial impairment if a request for assurances could have provided effective relief. This issue will often arise when the buyer has failed to make a partial payment required by the contract. Although the buyer's default would ostensibly provide cause for the seller to fear future defaults, it may not constitute an anticipatory repudiation. The actions of the parties and the facts of each case are carefully analyzed by the courts. See *T & S Brass & Bronze Works, Inc. v Pic-Air, Inc.* (4th Cir 1986) 790 F2d 1098; *Cosden Oil & Chem. Co. v Karl O. Helm Aktiengesellschaft* (5th Cir 1984) 736 F2d 1064.

Because it is difficult to predict whether a court will find that a repudiation substantially impairs the value of a contract, the parties may consider defining substantial impairment. See form 16.39-1, which attempts to meet the problem by simply declaring that a certain act is a repudiation that substantially impairs the value of the contract.

On substantial impairment from breach of an installment contract under Com C §2612(2)-(3), see §16.5.

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E. Aggrieved Party's Choices

§16.27 1. Introduction

After a repudiation, the aggrieved party may:

- Await performance for a commercially reasonable time; or
- Resort to remedies for breach of contract (even if the party has urged performance) and suspend its return performance or, if the aggrieved party is a seller of goods, proceed in accordance with its rights to identify finished goods or salvage unfinished goods.

See Com C §§2610(a)-(c), 2704. In any action it takes, of course, the aggrieved party must act in good faith. Com C §1304; Official Comment 4 to UCC §2-610.

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§16.28 2. Await Performance

The aggrieved party may decide that the repudiating party will reconsider its action or later become able to perform again, or it may temporarily have no choice but to wait. The party may wait for performance without prejudice to its right to pursue other actions if it does not wait more than a commercially reasonable time. Com C §2610(a).

This time limitation limits the damages recoverable by the aggrieved party. See Official Comment 1 to UCC §2-610. Although the aggrieved party clearly has the option of simply waiting for the promised performance, the drafters of the Commercial Code intended that the waiting time also be used as an opportunity to cover (see §§17.67-17.69) or resell (see §§17.38-17.46) and thus mitigate the damages for which the repudiating party otherwise would be liable.

If the circumstances in which breach may occur are sufficiently predictable, the parties can contractually agree on a commercially reasonable time period for awaiting performance. See Com C §2610(a).

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§16.29 3. Resort to Remedy for Breach

The aggrieved party need not wait for continued performance after a repudiation. It may immediately resort to any remedy for breach, including those listed in Com C §§2703 (seller's remedies) and 2711 (buyer's remedies). For full discussion of remedies for breach, see chaps 17-18.

The Commercial Code is careful not to force the aggrieved party to make a remedy election. The Code permits the party to exercise its remedies even if it has notified the repudiating party that it would wait for performance. Com C §2610(b).

The power to resort to remedies for breach when a party repudiates often has the practical effect of accelerating a performance that is not yet due.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.30 4. Suspend Performance or Identify or Salvage Goods

§16.30 4. Suspend Performance or Identify or Salvage Goods

Whether the aggrieved party elects to (1) wait for the repudiating party's performance (see §16.28) or (2) exercise its remedies for breach (see §16.29), the aggrieved party is free to suspend performance. Com C §2610(c). If the repudiating party retracts the repudiation, the aggrieved party is excused for any delay caused by the repudiation. Com C §2611(3). See §§16.35-16.39 for discussion of the retraction of repudiation.

A seller that is confronted with repudiation may identify or salvage previously *unidentified* goods under Com C §2704 as an alternative to the suspension of its performance. Com C §2610(c).

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.31 a. Identify Completed Goods

§16.31 a. Identify Completed Goods

Only existing goods may be identified to a contract. The Commercial Code does not define "identification." The usage of the term in several Code sections clearly connotes some act of the seller or buyer by which certain specific goods in the seller's inventory are designated as the subject matter of a specific contract, *e.g.,* by marking the goods with the buyer's name or by making reference to a unique serial or stock number in the contract of sale.

Identification of goods is a prerequisite to:

- A seller's action for the contract price under Com C §2709(1)(b). See §§18.17-18.19.
- A seller's resale of the goods at a public sale, unless there is a recognized market for a public sale of futures in goods of the kind. See Com C §2706(2), (4)(a); Official Comment 9 to UCC §2-706. See also §§17.38-17.46.

Identification can be made at any time and in any manner explicitly agreed on by the parties. In the absence of explicit agreement, identification occurs when the contract is made if it is for the sale of goods already existing and identified. Com C §2501(1)(a). This circular definition of "identification" provides little, if any, clarification. Official Comment 5 to UCC §2-501 explains that the mere making of a contract for the sale of an undivided share of a fungible bulk (*e.g.,* grain in an elevator) effects identification. Under Com C §2501(1)(b), which deals with the identification of not yet manufactured "future goods," identification occurs when the seller ships, marks the goods, or otherwise designates them as the goods referred to in the contract.

See chap 8 for full discussion of identification.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.32 b. Salvage or Complete Manufacture of Unfinished Goods

§16.32 b. Salvage or Complete Manufacture of Unfinished Goods

When the buyer has repudiated, a seller of unfinished goods is directed to minimize its losses under Com C §2704(2). The seller must do one of the following under Com C §2704(2) and comply with the standard of reasonable business judgment:

- Complete manufacture of the goods and wholly identify the goods to the contract;
- Cease manufacture of the goods and sell the components of the unfinished goods as scrap; or
- Proceed in any other reasonable manner.

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F. Damages After Anticipatory Repudiation

§16.33 1. Seller's Damages

The measure of damages for nonacceptance or repudiation by the buyer is the difference between the goods' market price at the time and place for tender and the unpaid contract price, together with any incidental damages, less any expenses saved in consequence of the buyer's breach. Com C §2708(1).

If the buyer has repudiated a long-term contract, the seller's action for damages may be tried before tender is due. Under these circumstances, any damages based on market price are determined according to the price of the goods prevailing when the aggrieved party learned of the repudiation. Com C §2723.

A seller that makes a good faith, commercially reasonable resale of goods intended for the repudiating or breaching buyer may recover the difference between the resale and contract price, together with any incidental damages, less any expenses saved in consequence of the buyer's breach. Com C §2706(1). The requirement of commercial reasonableness will limit the damages recoverable by a seller that, *e.g.,* delays in reselling the goods in a rapidly falling market.

For further discussion of damages available to the seller, see §§18.2-18.15. For discussion of seller's remedies generally, see chaps 17-18.

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§16.34 2. Buyer's Damages

The measure of damages for nondelivery or repudiation by the seller is the difference between the market price when the buyer *learned of the breach* and the contract price, together with any incidental and consequential damages, less any expenses saved in consequence of the seller's breach. Com C §2713. The phrase "learned of the breach" has spawned considerable judicial controversy. For example, does the buyer learn of the breach at the time it learns of the repudiation, or when it learns of the repudiation *plus* a commercially reasonable time, or at the time performance is due on the contract? See, *e.g., Cosden Oil & Chem. Co. v Karl O. Helm Aktiengesellschaft* (5th Cir 1984) 736 F2d 1064.

In cases from other jurisdictions that have applied provisions similar to Com C §2713, the courts have generally held that the buyer learns of the breach at the time of repudiation, not at the time specified for the seller's performance. The courts have measured the buyer's damages according to the market price within a commercially reasonable time after the buyer learns of the repudiation. See *Cosden Oil & Chem. Co. v Karl O. Helm Aktiengesellschaft, supra*; *First Nat'l Bank v Jefferson Mortgage Co.* (3d Cir 1978) 576 F2d 479. If the buyer is unable to cover, damages are measured by the market at the time for performance. See *Cargill, Inc. v Stafford* (10th Cir 1977) 553 F2d 1222.

A buyer that makes a good faith purchase of substitute (cover) goods without unreasonable delay may recover the difference between the cover and the contract price. Com C §2712. See, *e.g., U.S. ex rel Bartec Indus., Inc. v United Pac. Co.* (9th Cir 1992) 976 F2d 1274, modified (9th Cir 1994) 15 F3d 855 (damages equaled contract price less cover price, plus incidental and consequential damages). A nonrepudiating party may wait only a commercially reasonable period before exercising its remedies, because Com C §2610(a) limits the damages recoverable by a buyer that delays in covering goods in a rapidly rising market.

For further discussion of damages available to the buyer, see §§18.20-18.45. For discussion of buyer's remedies generally, see chaps 17-18.

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G. Retraction of Anticipatory Repudiation

§16.35 1. Introduction

If the aggrieved party chooses to await performance after repudiation, the repudiating party may retract its repudiation until the time that its next performance is due. Com C §2611.

The aggrieved party controls the duration of the power of retraction. Com C §2611(1); Official Comment 1 to UCC §2-611. The right to retract a repudiation lapses when the aggrieved party does one of the following:

- Cancels the contract;
- Materially changes its position in reliance on the repudiation; or
- Otherwise indicates that it considers the repudiation to be final.

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§16.36 2. Time for Retraction

As indicated in the preceding section, the repudiating party may retract its repudiation until the repudiated performance is due or until the aggrieved party has canceled the contract, materially changed position, or otherwise indicated that it considers the repudiation to be final. Com C §2611(1).

Cancellation of a contract occurs when either party ends the contract because of the other party's breach. The cancellation discharges all unperformed obligations on both sides but does not impair the canceling party's remedies for breach of contract. Com C §2106(4).

The phrase "a material change of position" is not defined by either Com C §2611 or its Comments. An aggrieved seller's resale of the goods or an aggrieved buyer's purchase of substitute goods, however, would clearly constitute material changes.

Several cases that were decided before the enactment of the Commercial Code are helpful on the issue of what type of actions constitute material changes of position. See *Guerrieri v Severini* (1958) 51 C2d 12, 330 P2d 635 (nonrepudiating buyer of wine materially changed position in reliance on repudiation when it purchased winery to provide substitute source of supply). See also *Freedman v Rector of St. Matthias Parish* (1951) 37 C2d 16, 230 P2d 629 (sale of land to another buyer after seller acted on buyer's repudiation constituted material change of position).

Cases in which the courts apply the doctrine of promissory estoppel also present analogous factual situations. The Commercial Code does not require the aggrieved party to notify the repudiating party of a material change in its position that will prevent a retraction of the repudiation.

At least one significant fact situation is not noted in Com C §2611. Specifically, circumstances that are not under the control of the aggrieved party may change in a way that makes it unfair for the repudiating party to retract. For example, if the price of a product falls after the seller repudiates, the seller may profit by retracting the repudiation before the buyer has canceled the contract or had time to contract for the goods elsewhere. Section 2611(1) refers only to changes resulting from the affirmative action of the aggrieved party. In situations like the one described, the attorney may want to advise cancellation if price fluctuations favorable to the repudiating party have occurred or are expected to occur. The obligation of good faith (see Com C §1201(b)(20)) presumably also applies to a party that has repudiated a contract. The obligation should also bar speculation at the expense of the aggrieved party.

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§16.37 3. Method and Consequences of Retraction

A party may retract its repudiation by any method that clearly indicates to the aggrieved party that the repudiating party intends to perform. Com C §2611(2). It is important to note that, if the aggrieved party claims that ambiguous words or conduct constituted a repudiation, the attorney framing a retraction should avoid making an admission of repudiation. See form 16.38-1. After a repudiation, if the repudiating party offers to perform on terms *other* than those specified in the contract, the party has not retracted the repudiation. See *Freedman v Rector of St. Matthias Parish* (1951) 37 C2d 16, 230 P2d 629 (case decided before enactment of Commercial Code).

Repudiation is sufficient to create reasonable grounds for insecurity about the repudiating party's performance. Official Comment 2 to UCC §2-611. See §16.4. Consequently, a retraction must include any assurance justifiably demanded under Com C §2611(2). See Com C §2609.

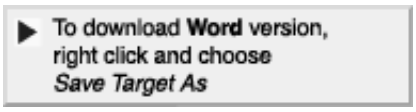
Although the statutory language quoted above suggests that retraction and assurance of performance must be made simultaneously, Official Comment 2 to UCC §2-611 appears to moderate the requirement by stating that after a timely and unambiguous expression of retraction, a reasonable time for the assurance should be allowed by the aggrieved party before cancellation.

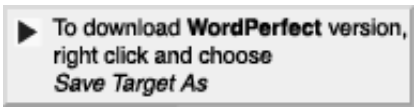
If the repudiating party fails to give adequate assurance, the nonrepudiating party may, if it is commercially reasonable, suspend any performance for which the party has not already received the agreed return. Com C §2609(1).

Retraction reinstates the repudiating party's rights under the contract but entitles the aggrieved party to "due excuse and allowance" for any delay caused by the repudiation. Com C §2611(3). For example, the retraction would extend the time for payment for a buyer that deferred its efforts to secure financing for the purchase of the goods after the seller repudiated. It would also extend the time for delivery to a buyer that deferred its efforts to secure transportation or storage for the goods after the seller repudiated.

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§16.38 4. Form: Retraction of Repudiation





16.38-1 Retraction of repudiation

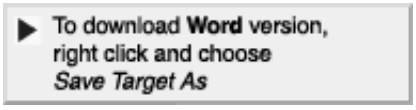
Notwithstanding any different impression that you may have received from any previous communication or conduct, we intend to perform the contract between us, dated _ _[*date*]_ _, for _ _[*describe contract*]_ _.

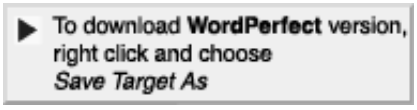
Comment: This language avoids an express admission that there was a repudiation. The attorney may want to insert additional language specifically denying that there had been a repudiation or that one had been intended.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.39 5. Form: Cancellation of Contract Because of Repudiation

§16.39 5. Form: Cancellation of Contract Because of Repudiation





16.39-1 Cancellation of contract because of repudiation

We hereby cancel our contract with you, dated _ _[*date*]_ _, for _ _[*describe contract*]_ _, on the ground that you have repudiated it. _ _[*Describe basis for assertion that contract has been repudiated.*]_ _

We reserve all remedies for repudiation and breach.

Comment: If the aggrieved party has not materially changed its position in reliance on the repudiation, the party should cancel the contract if it wishes to prevent a retraction of the repudiation. If the factual situation is unclear or disputed, cancellation will tend to "fix" the rights of the parties at a definite time and will determine the issues in litigation.

It is not essential to recite that remedies are retained (see Com C §2106(4)), but the recitation may be useful as a reminder to the repudiating party.

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IV. RISK OF LOSS

§16.40 A. Introduction

Contracts for the sale of goods frequently require transportation of the goods from the seller's to the buyer's place of business, which presents an attendant risk that the goods will be lost or destroyed in transit.

Before the enactment of the Uniform Commercial Code, if the parties had not contractually assigned the risk of loss, the courts assigned the risk to the party that was vested with "property" in the goods at the time of their loss or destruction. See former CC §17420.

The drafters of the Uniform Commercial Code intended to free the courts of the time-consuming burden of ascertaining the parties' intention about passage of "property" in the goods. Consequently, the Code rejects "property" or "title" as the test for which party has the risk of loss and places the risk on the party with control of the goods. This approach assumes that the party in control will be in the best position to prevent loss or to insure the goods against the loss. See Com C §2509. This provision tacitly assumes that the goods have not been destroyed or lost as a consequence of either party's negligence. Com C §2509.

Division 2 of the California Commercial Code does not address insurance law except to define "insurable interest" (Com C §2501(2)) and allude to the parties' insurance coverage in Com C §2510. Consequently, if the parties are insured, non-Code law must be consulted on issues of subrogation, claims against an insured carrier, and disputes between insurance companies.

A sale on approval and a sale or return (see Com C §2327(1)-(2); §§10.25-10.28, 12.54-12.55) are governed by special risk of loss rules.

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B. Basic Rules

§16.41 1. Introduction

The basic risk of loss provision, Com C §2509, assumes that both the buyer and the seller have properly performed their obligations. If either has breached the contract, Com C §2510 applies.

Commercial Code §2509(1)-(2) addresses the following two situations:

- When the contract requires or authorizes the seller to ship the goods by carrier; and
- When the goods are in the custody of a bailee and are to be delivered to the buyer without being moved.

All other situations are governed by Com C §2509(3) (*e.g.,* when the buyer is to pick up the goods at the seller's place of business). See §16.45.

The parties may allocate risk of loss by their agreement; the rules of Com C §2509 apply only when the parties have not otherwise agreed. Com C §2509(3). Often, the parties' use of a particular mercantile shipment term will suffice. See §16.42. For discussion of mercantile terms, see chap 9.

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§16.42 2. Shipment Contracts

If a carrier ships the goods, but the contract does *not* require the seller to deliver the goods to a particular destination (shipment contract), then the risk of loss passes to the buyer when the seller delivers the goods to the carrier. This is true even if the shipment is "under reservation." Com C §2509(1)(a).

When the contract requires the seller to deliver the goods to a particular destination (destination contract), the seller bears the risk of loss until the goods are tendered to the buyer at the specified destination. Com C §2509(1)(b).

A contract should be considered to be a shipment contract absent an express destination term. See Com C §2504. See also §9.3.

If goods are sold during shipment (*e.g.,* the seller buys goods already in transit and diverts them to the buyer) and the contract is a shipment contract, the risk of loss shifts to the buyer when the goods are identified to the contract rather than when the goods were originally delivered to the carrier. Official Comment 2 to UCC §2-509. On identification, see Com C §2501. See also §§8.28-8.29.

Many of the Commercial Code's mercantile shipment terms specifically allocate risk. For example, a "C.I.F." term indicates that the seller has included the cost of freight to the destination and insurance in the price of the goods. See §§9.26-9.38. Despite the fact that the seller obtains the insurance, the risk of loss passes to the C.I.F. buyer on shipment. Official Comments 1, 16 to UCC §2-320. For this reason, the buyer should be certain that the coverage offered is adequate. Alternatively, the buyer may wish to obtain its own insurance, which would change the shipment term to "C. & F." See Official Comment 16 to UCC §2-320. See also §9.37.

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§16.43 3. Table: Shift of Risk of Loss

Term	Kind of Contract	Point at Which Risk Passes	Applicable Sections
F.O.B. point of shipment	Shipment	Possession of the carrier	Com C §§2319(1)(a), 2509(1)(a)
F.O.B. vessel, car, or other vehicle, point of shipment	Shipment	Delivery on board carrier	Com C §§2319(1)(c), 2509(1)(a)
F.O.B. destination	Destination	Tender of goods in possession of carrier at destination	Com C §§2319(1)(b), 2509(1)(b)
F.O.B. vessel, car, or other vehicle, destination	Destination	Tender of goods on board carrier at destination (usually for transshipment by buyer)	Com C §§2319(1)(c), 2509(1)(b)
F.A.S. vessel, named port	Shipment or destination	Delivery along-side vessel	Com C §§2319(2)(a), 2509(1)(a)-(b)
C.I.F., C. & F., and variations	Shipment	Possession of the carrier after loading	Com C §§2320(2)(a), 2509(1)(a)
Ex ship	Destination	On unloading at destination	Com C §§2322(2)(b), 2509(1)(b)

If goods in a documentary transaction are sold during shipment, the risk shifts to the new buyer when goods that have been properly shipped are identified to the contract. Official Comment 2 to UCC §2-509. On identification, see Com C §2501; §§8.28-8.29.

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§16.44 4. Contracts for Goods Held by Bailee

Commercial Code §2509(2) governs sales of goods held by a bailee if delivery is to be made without moving the goods. If the goods *are* to be moved, Com C §2509(1) controls, even when a bailee holds the goods. Under Com C §2509(2), risk of loss passes to the buyer:

- When the buyer receives a negotiable document of title covering the goods (bills of lading and warehouse receipts are typical of documents of title; see §9.46);
- When the bailee acknowledges the buyer's right to possession of the goods; or
- After the buyer has received and had a reasonable time to present a nonnegotiable document of title, or other written direction to deliver, that is honored by the bailee.

The bailee's acknowledgment must be directed to the buyer rather than the seller. *Jason's Foods, Inc. v Peter Eckrich & Sons, Inc.* (7th Cir 1985) 774 F2d 214. The court also held that the buyer's expectation that bailed goods were transferred to its account was insufficient to shift the risk of loss from the seller.

The buyer may object to delivery of a nonnegotiable document and may insist that the seller procure the bailee's acknowledgment of the buyer's right to possession of the goods. Com C §2503(4)(b).

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§16.45 5. Other Situations

Many transactions in goods are not covered by the risk of loss rules found in Com C §2509(1)-(2), such as retail sales from the seller's place of business and sales in which the seller itself transports the goods to the buyer or the buyer picks them up from the seller. These residual situations are governed by Com C §2509(3). If the seller is a merchant, the risk of loss passes to the buyer on its receipt of the goods. If the seller is not a merchant, the risk of loss passes on tender of delivery. Com C §2509(3).

Tender of delivery requires that the seller put and hold conforming goods at the buyer's disposition and give the buyer any notification reasonably necessary to enable it to take delivery. Com C §2503(1).

Commercial Code §2509(3) is intended to place the risk of loss on the party that is able to exercise continuing control over the goods and that is therefore more likely to insure them. Official Comment 3 to UCC §2-509.

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§16.46 6. Contrary Agreement

The buyer and seller are free not only to alter the statutory provisions and to allocate risk of loss but also to divide it between themselves by a contrary agreement. Com C §§2303, 2509(4). A contrary agreement may be inferred from course of performance, course of dealing, usage of trade, or circumstances of the case. Official Comment 5 to UCC §2-509. See Com C §1303. See also §§4.94-4.104.

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C. Effect of Breach on Risk of Loss

§16.47 1. Preliminary Note

If neither of the parties is in breach, the risk of loss is determined by Com C §2509. If one of the parties is in breach, however, the risk of loss is determined by Com C §2510.

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2. Seller's Breach

§16.48 a. Defect Entitles Buyer to Reject Tender

If the seller's tender or delivery fails to conform to the contract so as to give a right of rejection, the risk of loss remains with the seller until the defect is cured or the buyer accepts the goods. Com C §2510(1).

Because the "perfect tender" rule permits the buyer to reject goods for any nonconformity (see Com C §2601; §§9.51, 10.35-10.47, 17.53-17.60), the phrase "so fails to conform" refers most meaningfully to an installment delivery. An installment delivery may be rejected only if the nonconformity substantially impairs the value of the installment and cannot be cured. See Com C §2612. See also §§9.53-9.57.

The risk of loss rules in Com C §2510(1) are keyed to the goods' nonconformity rather than whether the buyer has exercised its right of rejection. The seller must bear the risk of loss of goods that have been received by the buyer but destroyed before the buyer had a reasonable opportunity to inspect or notify the seller of the defect. The buyer's receipt of the goods cannot constitute an acceptance until the buyer has had a reasonable opportunity to inspect the goods. See Com C §2606(1)(a)-(b).

If the buyer rejects the seller's tender, the risk of loss will pass to the buyer on the completion of the seller's cure. The cure contemplated by Com C §2510 is repair, partial substitution, or sorting out from an improper mixture because cure by repossession and a new tender has no effect on the risk of loss of the goods originally tendered. Official Comment 2 to UCC §2-510. For discussion of cure, see §§9.62-9.67.

Commercial Code §2510(1) also governs tenders by defective documents of title. Cure or waiver of the defect will shift the risk of loss to the buyer unless the buyer waives the documentary defect in ignorance of the prior destruction of the goods covered by the documents. Official Comment 2 to UCC §2-510.

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§16.49 b. Buyer Revokes Acceptance

When the buyer accepts the seller's tender or delivery, the risk of loss shifts to the buyer. Com C §2510(1).

Although acceptance terminates the buyer's right to reject the goods, the buyer may still revoke acceptance if (1) a defect that was not readily apparent is discovered later, or (2) the goods were accepted on the reasonable assumption that a known defect would be cured and the seller fails to cure it. Com C §2608. See §§10.32-10.34, 17.61-17.66.

If a buyer rightfully revokes its acceptance of a tender or delivery of goods before their loss or destruction, the risk of loss retroactively revests in the seller to the extent of any deficiency in the buyer's effective insurance coverage. Com C §2510(2). This right will be useless, however, if the goods are lost or destroyed before the buyer has notified the seller of its revocation. See §§10.33, 17.64-17.66.

A deficiency in the buyer's insurance coverage presumably is the difference between what the buyer actually collects from its insurance carrier on account of the loss and what the buyer is entitled to recover from the seller as a result of its rightful revocation, *i.e.,* amounts paid on the price of the goods and any recoverable damages. See Official Comment 3 to UCC §2-510. See §§17.61-17.63, 18.20-18.24 for discussion of the buyer's right of recovery when it rightfully revokes acceptance.

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§16.50 3. Buyer's Breach

If the risk of loss has already passed to the buyer under Com C §2509, the buyer's breach has no effect on the allocation of risk. For example, if the sales agreement calls for delivery "F.O.B. seller's plant" and the buyer repudiates while the goods are in transit, the risk of loss (which shifted to the buyer at the seller's plant) remains with the buyer.

In contrast, if the buyer repudiates or is in breach before the risk has shifted, Com C §2510(3) places the risk of loss on the buyer *only*:

- For conforming, identified goods;
- For a commercially reasonable time; and
- To the extent that the seller cannot recover its losses from its own insurance.

For example, this rule protects a seller that discontinues insurance coverage on its delivery of conforming goods but is then confronted with an unjustified rejection by the buyer. The rule immunizes the seller from risk of loss for the commercially reasonable time necessary to procure insurance coverage for the rejected shipment.

Because Commercial Code §2510(3) operates *only* after conforming goods have been *identified* to the contract, the statute does not apply when a buyer of specially manufactured goods repudiates before the completion of their production. In this situation, the risk of loss remains with the seller.

A deficiency in insurance coverage is not explained in the statute. It can be inferred that a seller that does not collect the full price from its insurer can recover from the buyer the difference between the price and the proceeds. See Com C §§2510(3) and 2709(1)(a), which make the buyer liable for the price of conforming goods that are lost or damaged within a reasonable time after risk has passed. For further discussion of Com C §2709, see §18.17.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/ V. LOSS OF OR DAMAGE TO IDENTIFIED GOODS/§16.51 A. Summary of Rule

V. LOSS OF OR DAMAGE TO IDENTIFIED GOODS

§16.51 A. Summary of Rule

If a contract requires goods that are identified when the contract is made, and the goods suffer casualty through no fault of either party before the risk of loss has passed to the buyer, the following results occur (Com C §2613):

- If the loss is total, the contract is voided; or
- If the loss is partial or the goods have so deteriorated that they no longer to conform to the contract, the buyer may demand inspection and at its option *either*:
- Treat the contract as voided; *or*
- Accept the goods with due allowance from the contract price for the deterioration or the deficiency in quantity but without further right against the seller.

Commercial Code §2613 is a codification of the common law defense of impossibility of performance. It typically serves as a seller's affirmative defense to an action for damages for breach, when the goods that were the subject matter of the contract were damaged, destroyed, lost, or stolen before delivery to the buyer.

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§16.52 B. Goods Affected

For Com C §2613 to apply, specific goods must be identified as the subject of the contract. The burden of proof is on the party seeking to invoke the statute's protection. See *Bunge Corp. v Recker* (8th Cir 1975) 519 F2d 449 (Missouri's version of §2613 did not excuse seller's failure to deliver soybeans identified only by kind and amount; contract did not specify that soybeans be grown on identified tract of land); and *Dreyfus Co. v Royster Co.* (ED Ark 1980) 501 F Supp 1169 (similar facts and holding regarding sale of certified soybeans).

In contrast, Pennsylvania's version of §2613 applied to the theft of a sports car because the contract specified the vehicle's identification number and the car had been identified by having been removed from the display showroom and stored by the seller before its theft. Consequently, the buyer's estate could cancel the contract and recover the down payment. *Emery v Weed* (Pa Super Ct 1985) 494 A2d 438. The court reasoned that the goods are not required to be unique under Com C §2613. The contract need only designate particular goods for the performance of the contract at the time the contract is made.

The issue of whether Com C §2613 applies often arises when the contract is for the sale of fungible goods. For example, if a lumber broker sells an identified railroad car of fir two-by-fours and the car is destroyed in a fire, the applicability of Com C §2613 depends on whether the performance consists of furnishing (1) *any* carload of fir two-by-fours, or (2) a carload logged from a particular location or from a particular supplier's inventory. If the performance consists of the former, the broker is liable for breach of contract and is still obligated to perform. If the performance consists of the latter, the seller's performance is excused if it cannot obtain other lumber from the same location or inventory. See *Valley Forge Flag Co. v New York Dowel & Moulding Import Co.* (Sup Ct 1977) 395 NYS2d 138, in which a shipment of wooden dowels was destroyed during a heavy storm while en route to the United States from Malaysia. New York's version of Com C §2613 did not excuse the seller's nonperformance, because the loss was of fungible goods that were not identified to the contract and the seller did not enter into the contract with the supplier of the dowels until *after* the contract was made with the buyer.

For fungible goods to be "identified" for purposes of Com C §2613, the parties must identify the particular goods to be sold by marking or otherwise designating the goods when the contract is made. *Valley Forge Flag Co. v New York Dowel & Moulding Import Co., supra*. Identification of goods only by type and amount is insufficient. *Bende & Sons, Inc. v Crown Recreation, Inc.* (ED NY 1982) 548 F Supp 1018.

For a clause that specifies whether particular goods are required for performance, see form 16.58-1. For discussion of identification generally, see chap 8 and §§17.32-17.37.

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§16.53 C. Risk of Loss

After the risk of loss of the goods has passed to the buyer, it cannot avoid its duty to pay for goods that suffer casualty. Ordinarily, if the seller is a merchant, the risk of loss will shift to the buyer when it receives the goods. Otherwise, the risk will shift when the seller tenders delivery. Com C §2509(3). If (1) the goods are delivered by carrier, (2) the goods are held by a bailee to be delivered without being moved, or (3) the parties have allocated the risk of loss differently in their agreement, a separate set of rules apply. See Com C §2509(1)-(2), (4). Usage of the trade may be considered to be an implied term of the parties' agreement. Official Comment 2 to UCC §2-613. See Com C §1201(b)(3). See also §§4.100-4.103.

If the parties have divided the risk so that each bears a part of it (see Com C §2303), the result under Com C §2613 is not clear. Under these circumstances, the buyer should logically be able to treat the contract as voided (or accept the goods with allowances) to the extent of the seller's prorata share of the risk of loss. For a clause expressing such a result, see form 16.59-1.

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§16.54 D. Casualty Without Fault

Commercial Code §2613 does not apply unless the goods suffer casualty without fault of either party before the risk of loss passes to the buyer, or unless the contract contains a "no arrival, no sale" term. See Com C §2324. See also §§9.41-9.43, 16.57. "Fault" is intended to include negligence not merely willful wrong. Official Comment 1 to UCC §2-613.

The term "suffer casualty" apparently is intended to include deterioration and partial loss of the goods. See Com C §2613(b).

The party seeking to benefit by Com C §2613 has the burden of proving that the casualty occurred through no fault of either party. *Carlson v Nelson* (Neb 1979) 285 NW2d 505, modified (1980) 288 NW2d 489.

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§16.55 E. Total Loss

If the loss of the goods is total, the contract is voided and the buyer has no further rights against the seller other than a return of any downpayment. Com C §2613(a); *Carlson v Nelson* (Neb 1979) 285 NW2d 505, modified (1980) 288 NW2d 489. This outcome, however, may be varied by the parties' agreement. Com C §1302(a). The parties' bargaining position may be such that the seller can force the buyer to pay, or the buyer can hold the seller for damages notwithstanding the loss or destruction of the goods.

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§16.56 F. Partial Loss

If the loss is partial or the goods have deteriorated so that they no longer conform to the contract, the buyer has a choice of (1) voiding the contract or (2) accepting the goods with a reduction in the contract price to reflect the insufficiency of quantity or deterioration in quality of the goods. The buyer has an explicit right of inspection before the choice must be made. Com C §2613(b).

This statute encourages salvage of the goods and informal settlement of claims between the parties. Of course, the contract can specify the allowances to be given to the buyer for shortages or eliminate the buyer's right to choose altogether. See Com C §1302(a)-(b).

Although the buyer that accepts goods has no right against the seller except for the deduction in price, defects that are not the result of the loss or casualty should still be actionable. For example, a deduction for damage to the goods should not preclude an action for breach of warranty if the goods do not function properly.

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§16.57 G. Casualty in "No Arrival, No Sale" Contracts

A "no arrival, no sale" term creates a hybrid destination/shipment contract. The seller must tender conforming goods on their arrival but is not liable for breach of contract if the goods fail to arrive on time and in good condition, unless the failure was caused by the seller. Com C §2324. The term is frequently used when there is a significant risk of loss in transit, *e.g.,* international shipments. See §§9.41-9.43.

The effect of the cross-references between Com C §§2324 and 2613 is to apply the Commercial Code's casualty loss rules to any kind of goods sold under a "no arrival, no sale" contract and to treat late arrival of goods under this type of contract as a casualty. See Official Comment 3 to UCC §2-613; Com C §2324(b).

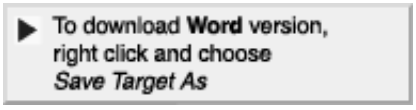
Although the language of loss and deterioration is not entirely appropriate to late arrival, the buyer that receives the goods late under a "no arrival, no sale" contract is given the alternatives of voiding the contract or accepting the goods, with allowance for their tardiness.

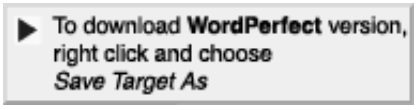
On the duties of a buyer toward nonconforming goods, see §§10.46-10.47, 17.60.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.58 H. Form: Identified Goods Required or Not Required for Performance

§16.58 H. Form: Identified Goods Required or Not Required for Performance





16.58-1 Identified goods required or not required for performance

The buyer and seller agree that the goods sold under this contract are identified _ _[*and are/but are not*]**_ _ required for the performance of the contract within the meaning of California Commercial Code §2613.**

[*Option 1: Identified goods are required for performance*]

Casualty to the goods through no fault of either party before risk of loss passes to the buyer will give the buyer the alternatives of avoiding the contract or accepting the goods with allowances and will excuse the seller from further performance.

[*Option 2: Identified goods are not required for performance*]

If the goods suffer casualty before risk of loss passes to the buyer, the seller will not be excused from performance but must furnish substitute conforming goods.

Comment: The seller may want to invoke the provisions of Com C §2613 by agreement to immunize itself from liability if the goods are lost or damaged. A "no arrival, no sale" clause accomplishes much the same result but often is more obtrusive and objectionable. The buyer normally wants to retain the right to obtain damages and clarify that the contract is not for particular goods but rather for any goods that fit the description.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.59 I. Form: Consequences of Casualty If Risk of Loss Divided

§16.59 I. Form: Consequences of Casualty If Risk of Loss Divided

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16.59-1 Consequences of casualty if risk of loss divided

If the goods suffer casualty through no fault of either the buyer or the seller, the buyer may exercise its rights under California Commercial Code §2613 with respect to the same portion of the goods as those for which the seller has the risk of loss.

Comment: This clause is intended to permit a prorated application of Com C §2613 when the parties have contractually divided the risk of loss.

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VI. EXCUSE BECAUSE OF IMPRACTICABILITY

§16.60 A. Summary of Rule

California law long ago expanded the defense of impossibility of performance to encompass not only objective impossibility in the true sense, but also impracticability due to excessive and unreasonable difficulty or expense. See *Christin v Superior Court* (1937) 9 C2d 526, 533, 71 P2d 205.

Commercial Code §2615 codifies this doctrine of excusing performance when it becomes impracticable. If the seller's capacity to perform is only partially affected, Com C §2615(b) requires the seller to allocate available production among the seller's various buyers.

Section 2615 identifies two broad types of circumstances that might render performance impracticable:

- The occurrence of a contingency the nonoccurrence of which was a basic assumption on which the contract was made; or
- A party's need to comply with government regulations and orders.

By its terms, Com C §2615 excuses three types of deviation from strict performance: (1) delay in delivery, (2) nondelivery in whole, and (3) nondelivery in part.

Commercial Code §2615 and the Official Comments do not distinguish between situations that justify delay in delivery from those that justify nondelivery.

If collateral aspects of performance (*e.g.,* the contractually agreed manner of delivery or payment) become commercially impracticable, Com C §2614 may excuse nonconforming performance and compel the aggrieved party to accept a commercially reasonable substitute manner of delivery or a substantial equivalent manner of payment. See §9.69.

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B. Factors in Claiming Excused Performance

§16.61 1. Occurrence Contrary to Basic Assumptions

The first type of commercial impracticability for which Com C §2615 grants relief is the occurrence of a contingency the nonoccurrence of which was a basic assumption on which the contract was made. Com C §2615(a). Stated differently, the statute grants relief if something unexpected happens after the execution of the contract that fundamentally alters one party's expectations about its performance. See, *e.g., Eastern Air Lines, Inc. v McDonnell Douglas Corp.* (5th Cir 1976) 532 F2d 957, 991 (unanticipated circumstances made the performance so vitally different from what was anticipated that the contract cannot govern).

Cost impracticability cases are more difficult to resolve. The drafters of the Commercial Code clearly intended that fluctuation in the market price of goods, components, and production costs would not excuse performance unless the increase was due to some unforeseen contingency that alters the essential nature of the performance because of war, embargo, local crop failure, unforeseen shutdown of major sources of supply, or the like. Official Comment 4 to UCC §2-615.

Very few decisions have excused performance on account of increased cost. See, *e.g., Eastern Air Lines, Inc. v Gulf Oil Corp.* (SD Fla 1975) 415 F Supp 429, 438, in which the court held that an unforeseen cost increase that would excuse performance must be more than merely onerous or expensive. It must be unjust to bind the parties. See also *Neal-Cooper Grain Co. v Texas Gulf Sulphur Co.* (7th Cir 1974) 508 F2d 283, 293, in which the court held the fact that performance has become economically burdensome is not sufficient for performance to be excused.

An agreed source of supply that fails for reasons beyond the seller's control should excuse the seller from performing if the seller turns over its rights against the supplier to the buyer. Official Comment 5 to UCC §2-615. *Squillante v California Lands, Inc.* (1935) 5 CA2d 89, 42 P2d 81, a pre-Commercial Code case, illustrates the point. After visiting the seller's vineyard, the plaintiff contracted to buy ten carloads of grapes from the seller. When damage to the crop rendered the seller's performance impossible after five carloads of grapes had been delivered, the court inferred that the parties intended grapes to come from the specific vineyard.

It is often difficult, however, to determine whether a particular source of supply was contemplated or assumed by the parties at the time of contracting. See Official Comment 5 to UCC §2-615. If a source of supply is exclusive or so dominant in the field that its elimination would cause a radical change in the availability or price of goods, failure of that source should excuse the seller's duty of performance. See Official Comment 5 to UCC §2-615.

Of course, when a contingency is foreseeable, the sales agreement should address how its occurrence would affect the duty of performance. If the agreement does not address this issue, the court will likely decide that the promisor has assumed an unconditional obligation to perform. See Official Comment 8 to UCC §2-615. For a sample clause, see form 16.67-1.

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§16.62 2. Compliance With Government Regulations

The compliance in good faith with any applicable foreign or domestic governmental regulation or order (whether or not it later proves to be invalid) is the second type of commercial impracticability for which Com C §2615(a) grants relief. Although this language does not require that the regulation or order be unforeseeable, California decisions have held that a government regulation is not an excuse if it was reasonably foreseeable when the contract was made. For example, in *Lloyd v Murphy* (1944) 25 C2d 48, 52, 153 P2d 47, the parties entered into a lease of property for an automobile dealership. The lease was executed in 1941, when the automotive industry was in the process of conversion to wartime production. The court held that the defendant could not escape its lease obligations on grounds of commercial impracticability, because:

- The government's wartime regulation of production was foreseeable;
- The regulation in question did not entirely prohibit the business from being carried on, but only restricted it, making it less profitable; and
- The lease had no provision relating to the effect of war, giving rise to the inference that the risk was assumed.

A contingency that is foreseeable at the time of contracting is an impliedly assumed business risk. See Official Comment 8 to UCC §2-615.

Domestic or foreign government directives may excuse performance regardless of their form (*i.e.,* statutes, regulations, or orders). Official Comment 10 to UCC §2-615. It should not matter whether the regulation applies to the seller directly or only to its suppliers.

A finding on judicial review that a government order was invalid will not affect the order as an excuse from performance. The seller's good faith belief in the validity of the regulation is the test. The best evidence of the seller's good faith is the general commercial acceptance of the regulation. See Official Comment 10 to UCC §2-615.

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§16.63 3. Assumption of Risk That May Interfere With Performance

If a risk that may interfere with performance is imminent at the time of contracting, a court may find that a party assumed that risk. See Com C §2615; Official Comment 8 to UCC §2-615. For example, in *U.S. v Wegematic Corp.* (2d Cir 1966) 360 F2d 674, 675, a computer manufacturer secured a government contract by its promise to deliver a revolutionary system. After several delivery delays, the manufacturer requested cancellation of the contract because engineering difficulties made its performance impracticable. The court upheld an award of damages for the government because, among other reasons, the evidence of true impracticability was not compelling.

DRAFTING CONSIDERATIONS: In drafting a contract, the attorney should be alert for difficulties that may impact the contract, *e.g.,* labor problems, not only of the client but also of the client's suppliers and transportation companies. If the seller knew or should have known that labor contract negotiations were occurring in the steel industry, the seller may not be able to claim excuse as a defense if supplies become insufficient for full performance.

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§16.64 C. Allocation of Production and Deliveries

If, despite unforeseen contingencies or government regulation, a seller is *partially* able to perform, the seller must allocate available production and deliveries among its customers rather than fully perform some contracts and completely disregard others. Com C §2615(b). The Commercial Code expressly conditions the seller's excuse on its fair allocation of available production. Com C §2615(b).

"Customers" for this purpose means persons or entities that are parties to an executory sales contract with the seller *and* persons or entities that, although not presently party to a contract, have previously and regularly purchased goods from the seller. Com C §2615(b); Official Comment 11 to UCC §2-615.

The allocation may be made in any manner that is fair and reasonable. Com C §2615(b). Because the allocation may include the requirements of regular customers not presently under contract, if a regular customer is under contract for a smaller than customary quantity, it should be entitled to a prorata share based on either its (1) present commitments or (2) customary purchases.

By hypothesis, impracticability will excuse the seller's performance only if the goods that it has contracted to sell become unavailable or prohibitively expensive. In such a market, the seller would clearly maximize its sales revenue by weighting the allocation to favor contracts entered into at a higher price. When prices have advanced, good faith requires that the seller exercise real care in making allocations. Contract customers should be favored and supplies prorated evenly among them regardless of price. Official Comment 11 to UCC §2-615.

See also *Terry v Atlantic Richfield Co.* (1977) 72 CA3d 962, 968, 140 CR 510, in which the court held that a ratable allocation of available gasoline supplies in proportion to the previous year's purchases was prima facie reasonable because a fair and reasonable allocation of the supply distributed the benefits and hardships equably.

The seller is allowed to include "[its] own requirements for further manufacture" in its allocation. Com C §2615; Official Comment 11 to UCC §2-615. For example, a seller may sell both raw and finished products, such as metal ingots and extruded shapes. If unavailability of ingots renders full performance of the seller's contracts impracticable, the seller may treat itself as an ingot customer to the extent of its manufacturing requirements.

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§16.65 D. Notice of Allocation

The seller is required to seasonably notify the buyer of any delay or nondelivery and of the buyer's estimated quota when an allocation is required. Com C §2615(c).

The term "seasonably" as used in this section of the code is not defined. The parties may define it by contract. If the term is not defined by contract of the parties, the court will determine whether or not a notice was "seasonably" given by the facts and circumstances of each case. As with all obligations of parties under the UCC, conduct will be measured by the standard of good faith.

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E. Power to Shift Risks by Agreement

§16.66 1. Introduction

The seller may contractually obligate itself to perform notwithstanding disabling contingencies. Com C §2615. An unconditional obligation to perform may also be inferred when the contingency in question is sufficiently foreshadowed at the time of contracting to be included among the business risks, which are fairly to be regarded as part of the "dickered terms." Official Comment 8 to UCC §2-615.

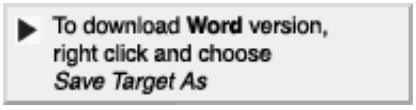
It is unclear whether the seller can contract for greater protection from unforeseen contingencies than the Commercial Code affords, although there is no logical reason why the seller should not be able to do so. Commercial Code §2615 begins with the admonition, "except so far as a seller may have assumed a greater obligation." Official Comment 8 to UCC §2-615 states that "this section itself sets up the commercial standard for normal and reasonable interpretation and provides a minimum beyond which agreement may not go."

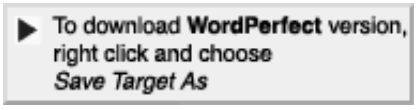
Such a limitation on the seller's contractual flexibility, however, would be patently inconsistent with (1) the seller's ability to obtain broad protection from the hazards of transportation through a "no arrival, no sale" term (see Com C §2324; §§9.41-9.43, 16.57), and (2) the parties' freedom to specify "the consequences of exemption," as provided in Com C §§2615(b)-(c) and 2616. See Official Comment 8 to UCC §2-615. Presently, however, there appear to be no court decisions that have addressed the issue of the validity of a reduction by agreement in a seller's obligations under UCC §2-615.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.67 2. Form: Performance Is Conditional

§16.67 2. Form: Performance Is Conditional





16.67-1 Performance is conditional

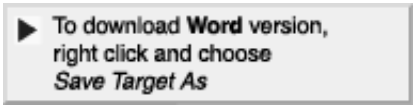
In addition to any excuse provided by California Commercial Code §§2613-2615 or by other applicable law, the seller will be excused from liability for nondelivery or delay in delivery arising from any events beyond the seller's control, whether or not they were foreseeable by either party when entering into the contract, specifically including _ _[*describe events, e.g., labor disturbances/wars/material shortages/adverse weather*]**_ _.**

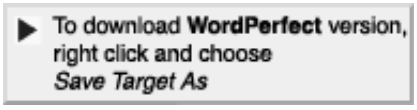
Comment: This clause attempts to discharge the seller's obligation on the occurrence of a foreseeable risk that impairs its ability to perform. For discussion of the parties' power to limit the seller's obligation in this way, see §16.65. The clause dispenses with the foreseeability requirement but specifies that the cause must be beyond the seller's control; otherwise, the contract would be vulnerable for lacking mutuality of obligation because it would permit the seller to withdraw at will.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.68 3. Form: Modification of Allocation

§16.68 3. Form: Modification of Allocation





16.68-1 Modification of allocation

The seller agrees that, if it is required to allocate production or delivery among its customers, it will include in the allocation _ _[*e.g., no customers not then under contract/all customers that have purchased goods from the seller since* _ _[*date*]_ _]_ _

[*Add if appropriate*]

unless the total goods to be allocated to all such customers is less than _ _[*e.g., 5 percent in value*]_ _ **of all goods to be allocated**

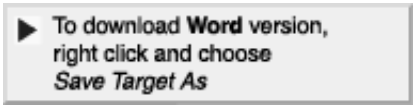
[*Add if appropriate*]

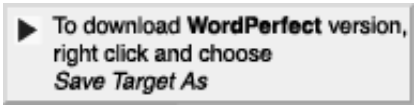
and will allocate to itself, for further manufacture or otherwise, not more than _ _[*e.g., 10 percent in value*]_ _ **of all goods to be allocated.**

Comment: This clause is one example of a modification of the seller's allocation of production or delivery. See generally §§16.64-16.65. The seller should avoid any formula that preferentially allocates scarce goods to higher priced contracts. See Official Comment 11 to UCC §2-615.

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§16.69 4. Form: Notification of Delay and Quota





16.69-1 Notification of delay and quota

As a result of _ _[*e.g., production controls imposed by the federal government/material shortages*]**_ _, our ability to perform our contract with you, dated _ _**[*date*]**_ _, for _ _**[*identify contract*]**_ _ will be impaired.**

[*Option 1: No further deliveries can be made*]

We will be unable to deliver any _ _[*further*]**_ _ goods under the contract.**

[*Option 2: Partial delivery can be made*]

We will be able to deliver _ _[*e.g., 75 percent*]**_ _ of the goods on the contract date for performance. We will be unable to deliver the remaining _ _**[*e.g., 25 percent*]**_ _ of the goods. We will ship the remaining _ _**[*e.g., 25 percent*]**_ _ of the goods as soon as possible. We estimate that we will be able to ship _ _**[*e.g., 5 percent*]**_ _ of the goods per month.**

[*Add if seller wishes to perform once the contingency is removed*]

If _ _[*e.g., the controls are lifted*]**_ _ and it becomes possible, we will ship _ _**[*the quantity of goods that you ordered/the goods according to the original schedule*]**_ _ according to the terms of the contract.**

[*Add if there is to be an allocation*]

We are allocating our supply of these goods among _ _[*e.g., our regular customers/the buyers under contract with us at this time*]**_ _. Your share of the allocation is _ _**[*e.g., 30 percent*]**_ _ of our _ _**[*stock/estimated output*]**_ _.**

Comment: The notification sent under Com C §2615(c) should specify any delayed delivery date, what goods will then be delivered, any goods that will not be delivered at all, whether the goods will be allocated, and the buyer's quota under the allocation.

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§16.70 F. Buyer's Excuse

Although Com C §2615 literally applies only to a seller's contract obligations, in certain situations a buyer may also claim excuse.

Typically, the buyer's obligation is simply to pay the purchase price, so its performance will not be considered "impracticable." If the buyer's contract is conditioned on a definite and specific venture or assumption, its performance may be excused by the failure of the venture or the underlying assumption, *e.g.,* a subcontract that is understood to be based on a prime contract that may be terminated, or a supply contract for a particular construction venture that is never built. See Official Comment 9 to UCC §2-615.

As with the seller's defense of impracticability, the buyer will not be excused unless it can demonstrate that the risk of the frustrating event was not reasonably foreseeable and that the value of counterperformance is totally or nearly totally destroyed. See *Lloyd v Murphy* (1944) 25 C2d 48, 54, 153 P2d 47, a pre-Commercial Code case, for analysis. For instance, a subcontractor buyer may have a contract to purchase materials to be used in the construction of a building. When the prime contractor becomes insolvent and cannot complete the project, the buyer's performance may be excused *if* the insolvency was reasonably unforeseeable and the materials to be purchased would otherwise have no value to the buyer.

The buyer may also consider the defense of impossibility or impracticability. See §16.60.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.71 G. Effect of Seller's Excused Performance on Third Persons

§16.71 G. Effect of Seller's Excused Performance on Third Persons

If the seller is excused from performing because of a contingency impairing performance by the seller's supplier, the event that excuses the seller may also excuse the supplier. If, however, the supplier's default is not excusable, or the supplier contracted to perform despite having grounds for excuse, the supplier is liable to the seller for its default.

When the supplier is liable but the seller is excused, the seller as a condition of relying on the defense of excuse must turn over to the buyer its cause of action against the supplier. Official Comment 5 to UCC §2-615. This right of subrogation prevents a seller from receiving a windfall absent the subrogation provision because the seller could otherwise recover damages from the supplier although the seller suffered no liability to the buyer.

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H. Procedure on Seller's Notice Claiming Excuse

§16.72 1. Buyer's Choice of Responses

When a seller justifiably claims that its failure to perform is excused, the buyer has a choice of responses (Com C §2616):

- The buyer may terminate the contract.
- The buyer may modify the contract by agreeing to take available quota in substitution, *i.e.,* by accepting the seller's announced allocation or delayed delivery schedule, or both.
- The buyer may choose to do nothing. After a reasonable time passes (not exceeding 30 days), the contract will lapse with respect to any affected deliveries.

The buyer is not required to act until it actually receives the seller's notification of delay or allocation. The time within which the buyer must respond, or be considered to have rejected the proposed modification, is measured from the receipt of the seller's notice.

When the seller has notified the buyer of a delay in performance or an allocation of performance between the buyer and the seller's other customers (see §§16.63-16.64), the options described above will arise only if the delay or allocation proposed by the seller is material or indefinite. Materiality is most likely measured by impact on the buyer, which by reason of transportation or resale contracts may be significantly affected by even a short delivery delay. By negative inference, an immaterial delay caused by unforeseen circumstances should excuse the seller from liability and prevent the buyer from terminating the contract. See Com C §2504(c), which allows a buyer to reject a delivery for which the seller has made an improper shipment contract only if material delay or loss would ensue.

These choices cannot be taken away from the buyer by agreement. See Com C §2616(3); Official Comment to UCC §2-616. If the buyer chooses to terminate or modify the contract, it must notify the seller of its choice in writing.

DRAFTING CONSIDERATIONS: Although the provisions of Com C §2616 cannot be negated by agreement, the parties presumably can supplement them by specifying the form and manner of any notice to be given and by defining what will be considered "receipt" of notice. The attorney should be careful that such clauses do not reduce the seller's obligations or impair the buyer's right to terminate or modify the contract. See Official Comment to UCC §2-616.

If the buyer does nothing after receiving the seller's notice, the contract "lapses," which means that the contract is terminated. Com C §2616(2). See Official Comment to UCC §2-616. On termination, all obligations that are still executory on both sides are discharged, but any right based on prior breach or performance survives. Com C §2106(3).

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§16.73 2. Termination and Discharge

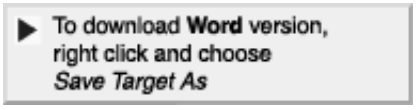
The buyer need not remain bound by a contract from which the seller is excused. If the buyer can obtain goods elsewhere, it may want to terminate the contract. See Com C §2616(1)(a). Termination means that the executory parts of the contract are discharged, but rights based on prior breach or performance survive. Com C §2106(3). For a clause terminating the contract, see form 16.74-1.

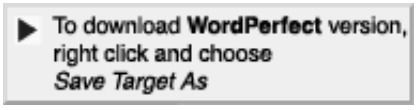
If the seller claims that its performance under the original contract is excused, a buyer that wishes to modify the contract as a result must do so within a reasonable time (not exceeding 30 days) or the contract will lapse for any affected deliveries. Com C §2616(2). Lapse has the same effect as affirmative termination. See Official Comment to UCC §2-616.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.74 3. Form: Termination for Delay or Allocation of Production and Deliveries

§16.74 3. Form: Termination for Delay or Allocation of Production and Deliveries





16.74-1 Alternative: Termination for delay or allocation of production and deliveries

We have received your notification of _ _[*delay in/allocation of production and*]**_ _ deliveries under our contract, dated _ _**[*date*]**_ _, for _ _**[*identify contract*]**_ _.**

_ _[*The delay you propose is material/The allocation you propose is unsatisfactory*]**_ _. We therefore terminate the contract under California Commercial Code §2616(1)(a).**

16.74-2 Alternative: Termination for delay or allocation of production and deliveries (installment contract)

We have received your notification of _ _[*delay in/allocation of production and*]**_ _ deliveries.**

_ _[*The delay you propose is material/The allocation you propose is unsatisfactory*]**_ _ and substantially impairs the value of the contract under California Commercial Code §2612. We therefore refuse to accept the installment and terminate the contract under California Commercial Code §2616(1)(a).**

Comment: With this language, the buyer explicitly claims that the delay or allocation proposed by the seller is material or unsatisfactory, thereby justifying the buyer's termination of the contract under Com C §2616(1)(a).

If the seller refuses to perform altogether, the buyer should have no further obligations under the contract and retains any claims of breach for past performance, including a claim that the seller's excuse was unjustified.

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§16.75 4. Modification of Contract

The buyer must notify the seller in writing of its election to accept the seller's proposed allocation or delivery delay. For such a clause, see form 16.76-1.

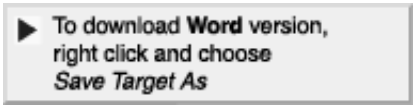
Although Com C §2616(1)(b) refers only to the buyer's agreement to take available quota in substitution, the accepted modification should be binding whether it is a substitution of fewer goods or a later delivery date. See Official Comment to UCC §2-616. Because a modification may bind the parties even without new consideration (see Com C §2209), the proposed modification could also contemplate the seller's substitution of different goods.

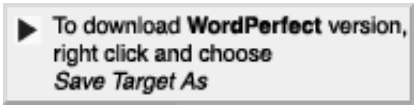
If the seller's original obligations are modified unconditionally, the seller's original obligations will *not* be reinstated during the seller's performance of its modified obligations, even if the unforeseen circumstances that justified the modification are abated while the seller is performing the modified obligations.

Consequently, the parties may wish to provide, either in the original contract or in the modification notice or any response to it, that the original contract quantity or schedule is reinstated if the contingency is abated. Although there is no express Commercial Code authority for such an agreement, and Com C §2616(1) purports to limit the buyer's choices to termination of the contract or acceptance of the seller's proposal, the agreement certainly does not prevent the parties from agreeing on a modification of the contract. On modification by agreement, see Com C §2209. See also chap 6.

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§16.76 5. Form: Buyer's Agreement to Modify





16.76-1 Buyer's agreement to modify

We have received your proposed _ _[*allocation of goods/delayed delivery schedule*]_ _ **for our contract, dated** _ _[*date*]_ _**, for** _ _[*identify contract*]_ _**.**

We agree to your proposed modification of our contract.

Comment: See forms 16.68-1 and 16.69-1 for clauses proposing the seller's modification.

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§16.77 6. Installment Contracts

An installment contract is one that requires or authorizes the delivery of goods in separate lots to be separately accepted. Com C §2612(1). If there is a material or indefinite delay or an allocation that affects an installment, the buyer has three choices:

- The buyer may terminate and discharge the contractual obligations related to the installment, either by notice or by inaction. Com C §2616(1)(a), (2). On termination, see §16.73.
- The buyer may modify the contract by written notice to the seller that it will accept its allocation of goods in substitution for those originally bargained for or, if delivery of the goods is merely delayed, that it will take delayed delivery. Com C §2616(1)(b).
- If the value of the whole contract will be substantially impaired by the delay or allocation, the buyer may terminate and discharge the entire executory part of the contract. Com C §2616(1).

As indicated in §16.75, Com C §2616(1)(b) is apparently intended to unconditionally modify the seller's obligations under the original agreement and does not reinstate those obligations if the unforeseen circumstances that justified the delay are abated during the seller's performance of the modified contract. If the buyer terminated only the obligations related to the defective installment, the abatement of the contingency should reinstate the contract in its original form for all other installments. If the buyer, however, agreed to a modification that affected the present and all future installments, it is uncertain whether the abatement of the contingency would reinstate the seller's original obligations for all undelivered installments.

As with noninstallment contracts, the parties may want to address these uncertainties by specifying in the proposed modification or acceptance that the original contract quantity or schedule for future installments is reinstated if the contingency is abated. The parties might also specify that, on abatement of the contingency, quantity deficiencies in past installments will also be remedied. For such a clause, see form 16.69-1.

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§16.78 7. Validity of Claim of Excuse

If the buyer contests the seller's claim of excuse, the buyer should notify the seller of this and treat the claim of excuse as grounds for insecurity and demand adequate assurance of due performance. Com C §2609. See §§16.4-16.6. If the seller's proposed modification would substantially impair the value of the contract, the buyer should treat the seller's claim of excuse as an anticipatory repudiation. Com C §2610. See §16.26.

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VII. INSPECTION FOR RESOLUTION OF DISPUTES

§16.79 A. Inspection Is Not Acceptance

Both the buyer and the seller have the right to sample, inspect, or test tendered goods in its or the other party's possession or control to foster the adjustment of any claim or dispute about the conformity of the goods. Com C §2515. This right promotes settlement of quality disputes and preserves evidence for litigation if the parties do not reach a settlement. See Official Comments 1-2 to UCC §2-515. The right also protects the buyer from the allegation that by testing the goods, the buyer has performed an act inconsistent with the seller's ownership and has thereby accepted the goods. Com C §2606(1)(c).

Commercial Code §2515 may not be broad enough to permit a buyer to retain goods as evidence without risking acceptance, because the buyer must promptly exercise the right to sample, inspect, or test to preserve the seller's right to resell rejected goods. Official Comment 2 to UCC §2-515. In addition, Com C §2602(2)(b) obligates the buyer to hold rejected goods at the seller's disposition. Sampling of goods contemplates the retention of a de minimis quantity of bulk goods.

The parties' right of inspection under Com C §2515 should not be confused with the buyer's right to inspect goods before acceptance and payment. See Com C §2513(1). By its express terms, Com C §2515 presupposes the buyer's claim or dispute, which presumably arose on the buyer's initial inspection of the goods.

This right of inspection is not intended to alter the buyer's duties under a contractual provision that obligates it to make payment on the tender of documents of title without a prior right of inspection. See Com C §2513(3); Official Comment 2 to UCC §2-515.

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§16.80 B. Notification and Access to Goods

The general Commercial Code obligation of good faith (see Com C §1201(b)(20)) governs the time, place, and nature of the inspection process. By its terms, Com C §2515(a) also requires reasonable notification of a party's intent to inspect. Prompt exercise of the right to inspect may be required if, for example, the goods are deteriorating or the other party wishes to resell rejected goods. See Official Comment 2 to UCC §2-515.

A party's refusal to permit an inspection of goods in its possession would probably support an inference in subsequent litigation that the willfully suppressed evidence of the condition of the goods would have been adverse to its case if it had been produced. See Evid C §413 (party's failure to explain or deny evidence).

After the commencement of litigation, CCP §§2031.010-2031.510 (part of the California Discovery Act of 1986), rather than Com C §2515, governs the rights and duties of the parties to compel and produce goods for inspection. If a request to produce goods for inspection, copying, testing, or sampling is not honored, the party who wishes to inspect them may move for an order compelling their production. CCP §2031.300. If an order that the goods be produced for inspection, copying, testing, or sampling is disobeyed, the court may sanction the party that opposes the production for "misuse of the discovery process" by finding that the condition of the goods, for purposes of the action, is as claimed by the party demanding inspection. CCP §§2023.030(b)-(d), 2031.300.

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C. Third Party Inspection

§16.81 1. Summary

Commercial Code §2515(b) permits the parties to agree that, in the event of a dispute:

- A third party will inspect the goods to determine their condition or conformity; and
- The third party's findings will bind the buyer and seller in any subsequent litigation.

The scope of matters to be determined can range from "conformity" of the goods (a legal analysis of whether their tender satisfies all the seller's contractual obligations) to merely the "condition" of the goods (a factual determination of the degree of damage or deterioration which the goods show). Official Comment 3 to UCC §2-515.

If the agreement does not clearly specify the scope of matters to be determined, it is presumed to extend only to the relation between the contract description and the goods as delivered. This language suggests a determination of the condition of the goods rather than an issue regarding conformity of the goods. Official Comment 3 to UCC §2-515.

A third party inspection may also be used to aid partial settlement of disputes. Official Comment 3 to UCC §2-515; Com C §1307.

The third party's written and authenticated report of the inspection or tests may be admitted in evidence as a third party document. Official Comment 3 to UCC §2-515. Any document that is authorized or required by the contract to be issued by a third party is admissible evidence of the facts as stated in the document by the third party. Com C §1307(1).

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.82 2. Relationship to Arbitration

§16.82 2. Relationship to Arbitration

In California, the use of the Commercial Code's third party inspection procedure may be complicated by applicability of the arbitration statutes codified in CCP §§1280-1294.2 (contract arbitration) and 1141.10-1141.31 (judicial arbitration). Official Comment 3 to UCC §2-515 expressly denies that UCC §2-515 repeals or amends any arbitration statute.

The contract arbitration statute provides a mechanism for the enforcement of written contractual agreements, including oral or implied renewals and extensions, and for appraisals and similar proceedings to resolve controversies between the parties. See CCP §§1280(a), (f), 1281.

If the arbitration statute applies to an agreement for a third party inspection or survey under Com C §2515(b), the third party becomes an arbitrator and is subject to the procedural rules set forth in CCP §§1282-1284.2. Unless otherwise agreed, the arbitrator must preside over a formal hearing held after at least seven days' notice and permit examination and cross-examination of witnesses under oath. The arbitrator may not base its award on any information not obtained at the hearing without first disclosing that information to all parties and giving them an opportunity to meet it. CCP §1282.2(a), (e), (g).

If the arbitrator is notified that the amount in controversy exceeds $50,000, the arbitrator must provide 60 days' notice of the hearing and each party has the right to demand that the other designate witnesses that it will call and documents that it will produce at the hearing. CCP §1282.2(a)(2). The parties are entitled to be represented by an attorney (CCP §1282.4); to subpoena witnesses, records, and documents (CCP §1282.6); and to take depositions for discovery and the preservation of testimony (CCP §§1283, 1283.05).

All these formalities may be dispensed with in the agreement for inspection and arbitration. For a clause dispensing with the need for a formal hearing, see form 16.83-1.

The contract arbitration statute also provides for summary proceedings to:

- Compel arbitration (CCP §1281.2);
- Stay actions involving arbitrable issues (CCP §1281.4);
- Appoint an arbitrator whenever the agreement fails to provide a method for appointment or if the agreed method fails (CCP §1281.6); and
- Confirm, enforce, correct, or vacate an award (CCP §§1285-1287.6).

These rules, which apply to contractual agreements to arbitrate, must be carefully distinguished from the mandatory arbitration provisions of the California Judicial Arbitration Law. That statute requires all superior courts with ten or more judges (18 or more judges if the county does not have a municipal court) to submit all actions to arbitration if, in the opinion of the court, the amount in controversy will not exceed $50,000 for each plaintiff. CCP §1141.11(a).

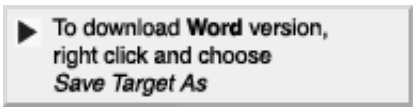
Limited civil actions are exempt from this rule, unless the court has adopted a local rule providing for mandatory arbitration of such disputes. CCP §1141.11(c). A limited civil action is essentially one that would have been subject to municipal court jurisdiction before the municipal and superior courts were consolidated, *i.e.,* one involving an amount in controversy of $25,000 or less. See CCP §86. See generally CCP §§90-100.

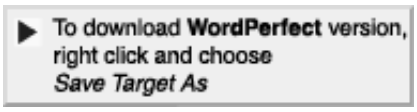
Either party may request de novo trial of a mandatory judicial arbitration award. The award is final only if neither party elects de novo review within 30 days after the arbitrator files the award with the court. CCP §1141.20.

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Source: Business Law/California UCC Sales and Leases/16 Breakdown of the Bargain/§16.83 3. Form: Conditions of Third Party Inspection

§16.83 3. Form: Conditions of Third Party Inspection





16.83-1 Conditions of third party inspection

In the event of a dispute about the condition or conformity of the goods, as indicated below, either party may cause _ _[*name of third party/describe method of selecting third party, e.g., the independent third party selected by the buyer*]**_ _ to undertake any investigation reasonably necessary to resolve the dispute, to make findings, and to submit those findings in a written report to each party. The findings will be binding on the parties in any subsequent litigation or adjustment. The types of dispute that may be so determined are _ _**[*describe, e.g., origin and cause of any damage to or deterioration of goods/degree of damage or deterioration of goods/whether goods comply with contract description*]**_ _.**

The inspector will not be required to hold any hearing, to invite or take evidence from either party, or to disclose to either party the basis for its findings but will make a fair and objective investigation and determination, based on its informal examination of the _ _[*describe subject of investigation, e.g., goods being sold/shipping documents*]**_ _ and on its expert knowledge, experience, and judgment. The cost of the inspection, investigation, and findings will be _ _**[*divided equally between the parties/allocated by the inspector*]**_ _.**

Comment: This clause eliminates the right of either party to insist on a hearing and other potentially costly and time-consuming procedures under CCP §1282.2. See §§16.81-16.82.

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17

Prelitigation Remedies

Loyd P. Derby
Richard J. Maire, Jr.
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§17.1 I. SCOPE OF CHAPTER

The Commercial Code offers a variety of measures, short of litigation, for resolving disputes between sellers and buyers. This chapter discusses Code remedies available to both parties after the bargain has broken down, by which performance may be obtained or the value of the bargain preserved, without pursuing litigation. In some cases the remedies discussed in this chapter may be used in coordination with appropriate judicial proceedings.

For discussion of the buyer's responses in breach of warranty situations, see chap 3. For litigation remedies and the measurement of damages, see chap 18.

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§17.2 II. STRATEGIC PLANNING

In exercising one or more prelitigation remedies, the seller's ultimate goals are to transfer and deliver the goods that the buyer agreed to purchase and to receive payment, while the buyer's ultimate goals are to accept the goods that the seller agreed to furnish and to pay in accordance with the contract. See Com C §2301. Exercising these remedies does not preclude appropriate litigation if the benefit of the contract has not been realized.

In planning a strategy to secure these goals for a client, an attorney should analyze the following factors:

Factual background of dispute. The first step in devising a strategy is to obtain a full understanding of the background of the dispute. The attorney should arrange an interview with the client to review the sales contract and other documents that relate to the transaction, including price quotations, purchase orders and acknowledgments, memorandums of negotiations, letter agreements, draft agreements, any formal or informal modifications to the contract, and any correspondence purporting to address or interpret disputed provisions. The client should also provide documentation on recent communications with the other party, such as memorandums of telephone conversations relating to the dispute. Electronic communications, including e-mail, must also be reviewed. Drafts of documents are often retained electronically and can provide a history of the negotiations. Counsel will also need to consider any course of performance that may indicate either a construction of, or variation from, the terms of the agreement.

Depending on the complexity of the dispute, the time available, and whether litigation appears likely, the scope of the attorney's fact-gathering effort may expand beyond the basic contract documents. For example, if the dispute centers on technical questions about whether the goods conform to the specifications, it may be necessary to employ one or more experts.

PRACTICE TIP: Because the outcome in some cases turns on fine distinctions or issues of fact, the practitioner's early mastery of the facts is essential to success.

Experts may also be necessary to provide information about industry practices. If the dispute involves some characteristic of goods that are in the possession or control of the other party, Com C §2515 permits reasonable access for the purpose of inspecting, testing, or sampling the goods to preserve evidence relating to the dispute. See §§16.79-16.83.

Applicable law. As discussed more fully in chap 1, Commercial Code Division 2 governs transactions whose predominant feature is the sale of goods. The first consideration, therefore, is whether the Commercial Code is applicable. See §§1.2-1.18.

If the transaction involves consumer goods, other statutory provisions may apply as well (*e.g.,* the Consumers Legal Remedies Act (CC §§1750-1784), the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8), or the Unruh Act governing retail installment sales (CC §§1801-1812.20). If the provisions of the Commercial Code conflict with those of the Song-Beverly Consumer Warranty Act, the latter provisions will prevail. CC §1790.3.

If the goods are "distributed in commerce" (see 15 USC §2301(13)), the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312) may apply.

If the sale of goods is between parties whose places of business are in different nations, the United Nations Convention on Contracts for the International Sale of Goods (CISG) (sometimes referred to as the Vienna Sales Convention; see 15 USC App) may apply. See the discussion in §9.1 about the scope and application of the CISG.

Laws that regulate business practices may also have an impact on the analysis. See, *e.g.,* the California Fair Dealership Law (CC §§80-86), the Unfair Practices Act (Bus & P C §§17000-17101), the Fair Packaging and Labeling Act (Bus & P C §§12601-12615.5), the Robinson-Patman Price Discrimination Act (15 USC §§13-13b, 21a), the Consumer Product Safety Act (15 USC §§2051-2089), and other federal enactments found in Title 15 of the United States Code.

The attorney should also consider the goods themselves. Many types of goods are regulated by special legislation, both state and federal. See, *e.g.,* the following:

- The Rees-Levering Motor Vehicle Sales and Finance Act (CC §§2981-2984.4);
- The Sherman Food, Drug and Cosmetic Law (Health & S C §§109875-111915);

- The Federal Seed Act (7 USC §§1551-1611);
- The Saltonstall-Kennedy Act (domestically produced fishery products) (15 USC §713c-3);
- The Flammable Fabrics Act (15 USC §§1191-1204);
- The Federal Hazardous Substances Act (15 USC §§1261-1278); and
- The Petroleum Marketing Practices Act (15 USC §§2801-2841).

The attorney should bear in mind that federal law may preempt state law in certain transactions. The Commercial Code's remedies are cumulative and nonexclusive. Com C §§1103(b), 2701, 2721; Official Comment 1 to UCC §2-703.

If the transaction involves the law of multiple jurisdictions, including other states or countries, the attorney should consider which substantive law will govern the transaction. Often this is agreed to by the parties. However, the parties' right to select applicable law may be limited. The parties may agree that the law of a state or nation having a "reasonable relation" to the transaction will govern. See Com C §1301. Subject to the limitations for particular transactions described in Com C §1301(c), the parties may agree that California law will govern, in whole or in part, in certain transactions involving $250,000 or more, regardless of whether the transaction bears a reasonable relation to California. CC §1646.5.

PRACTICE TIP: When one of the parties to the transaction is a foreign person or entity, careful attention needs to be given to the application of the United Nations Convention on Contracts for the International Sale of Goods (CISG) (sometimes referred to as the Vienna Sales Convention; see 15 USC App). Under certain circumstances, an express choice of law provision (*e.g.,* selecting California law) may result in application of the CISG, unless its application is expressly excluded. Careful consideration should also be given to choice of venue and forum, including use of arbitration.

If there is no effective agreement, California's Commercial Code will apply to transactions bearing an "appropriate relation" to this state. See Com C §1301(b). Thus, if the governing law is not established by an enforceable agreement of the parties and more than one jurisdiction is involved, the attorney should consider initiating litigation promptly in the preferred jurisdiction to enhance the client's ability to establish the law of that jurisdiction as the governing law. See §18.59 for further discussion.

Type of goods. The type of goods may also dictate or limit the choice of prelitigation remedies. Are the goods perishable? Are they fungible, or are they so specialized that no subsequent buyer would be interested in them? Are they in a finished condition? If not, what additional expenses would the client have to incur to prepare them for sale?

Client's willingness to engage in conflict. Parties to a commercial dispute may have different styles or preferred approaches to dispute resolution. This factor is particularly important when the attorney represents foreign clients who may have vastly differing views on appropriate methods of dispute resolution and the role the attorney should play. The attorney should ascertain the client's preferences in this regard so that the attorney's strategy meets the client's objectives. Is it important to the client that the business relationship with the other party remains on good terms, to the extent that it is possible? Does the client wish instead to make an example of the other party as a means to discourage similar disputes with its other commercial partners? How inclined is the client to take the dispute to litigation, and how aggressively does the client wish to deal with the other party, short of litigation?

Even if adequate prelitigation remedies may be available, under certain circumstances (*e.g.*, when both seller and buyer may have colorable claims for breach of contract), a party may desire to initiate litigation as the plaintiff to obtain the perception as the aggrieved party.

Litigation potential. Analysis of available prelitigation remedies cannot be carried out in a vacuum. Commencement of litigation by any one of the interested parties is always a possibility. It is essential to consider how each action and remedy the client considers will impact the client's potential litigation position with respect to all parties to the transaction.

Availability of arbitration or other dispute resolution procedures. The parties' agreement may provide for arbitration of any dispute. See CCP §§1280-1294.2. The parties may choose that the arbitrator's decision be either binding on the parties or merely advisory and nonbinding. The parties may also agree to other methods of resolving disputes, *e.g.,* mediation or adjudication of the dispute by a private judge or referee (see Cal Const art VI, §21; CCP §§638-645.2). Mediation may be particularly helpful if the parties are willing to negotiate a resolution to the dispute but have reached an impasse. Here, an impartial third party may help one or both parties view their positions differently.

PRACTICE TIP: If the amount in controversy is $50,000 or less for each plaintiff, judicial arbitration may be mandatory, depending on the county in which the action is brought. See generally A Litigator's Guide to Effective Use of ADR in California (Cal CEB 2005).

If the subject of the sale is a new motor vehicle purchased primarily for personal, family, or household purposes, the buyer may be required to go through a "qualified third-party dispute resolution process" before the buyer can obtain the benefit of certain statutory presumptions in a dispute with the manufacturer or its agent. CC §1793.22(c). Some warranties also may require the consumer to resort to an informal dispute settlement procedure before it may bring a civil action for breach of the warranty. See 15 USC §2310(a)(3).

Anticipation of countermoves. Although litigation is a possible response to the client's assertion of any of the remedies discussed in this chapter, the prelitigation remedies that may be available to the other party should also be considered. Because the other party may be able to assert legitimate, colorable, or at least alleged defenses, the attorney should objectively assess the facts and circumstances from the other party's perspective to anticipate and evaluate potential countermoves. For example, the buyer should consider the impact of the seller's right to a lien on goods in its possession, and whether this may impact a strategy.

Parties' financial circumstances. As a practical matter, the parties' financial circumstances may limit or determine available remedies. For example, can one or both parties sustain protracted litigation? Does the contract contain a clause for attorney fees? Does the opposing party have the financial capacity to pay a money judgment? Is bankruptcy by one of the parties a possibility? Experienced attorneys will counsel their clients on potential costs, both to ensure that the client will adopt the best course of action and to avoid later problems in the attorney-client relationship.

Rights of third parties. The interests of parties other than the buyer or seller may be implicated. Interested third parties may include the seller's suppliers, the buyer's customers, warehousemen in possession of the goods, shippers in possession of the goods, insurers, or lenders providing financing to the buyer or seller. (See chap 12 for discussion of the rights of third parties in sales transactions.) Depending on the nature of the financing arrangement, the financing documents may have extensive affirmative or negative covenants that the lender may assert. Consequently, the lender may be in a position to influence a party's selection of remedies. Warehousemen or shippers in possession of goods may have promissory liens securing unpaid fees.

If either party's loss is covered by insurance, the insurer may be subrogated to the rights of the aggrieved party and have the exclusive right to assert Commercial Code or other remedies. A defendant facing a subrogee has a different set of strategic circumstances to consider and may in fact have fewer opportunities to offer noncash solutions to resolve the dispute.

Commercial practices. The attorney should consider the prevailing commercial practices ("usage of trade") with respect to the goods in question. Compliance with recognized commercial practices might be evidence that a party acted in a commercially reasonable manner. See Com C §1303(c). Moreover, the courts are likely to consider usage of trade in interpreting the parties' agreement and determining their respective rights and obligations under the agreement.

Prior dealings between parties. A court might also consider the prior dealings between the parties in determining rights and obligations under their agreement. Com C §1201(b)(3). The attorney should question the client about any prior dealings to (1) assess how the contract might be interpreted, (2) better anticipate countermoves, and (3) predict the other parties' behavior in the dispute-resolution process. Some parties are predisposed to settle all disputes, while others are predisposed to litigate all disputes. If the client has a long history of prior dealings with the opposing party, that history may greatly affect the choices made by both parties in the present dispute.

Contractual modifications or limitations on remedies. Any contract pertaining to the transaction should be reviewed to determine whether it has modified or limited the remedies available to either party. The obligations of good faith, diligence, reasonableness, and care, however, may not be disclaimed by the agreement. See Com C §1302(b). A contractual modification must also provide an aggrieved party with "at least minimum adequate remedies." Official Comment 1 to UCC §2-719. Specific provisions of the Commercial Code authorize variation by agreement in particular matters, including liquidation or limitation of damages (Com C §2718), contractual modification or limitation of remedy (Com C §2719), reduction of the limitations period (Com C §2725), and exclusion or modification of warranties (Com C §2316).

Ethical considerations. The attorney should become familiar with the nature and extent of the prior business dealings between the buyer and the seller and the way they may have resolved any earlier problems or disputes. The

attorney should also evaluate any conversations or correspondence concerning the dispute at issue. Given this information, the attorney and the client will be better able to assess the best legal action. Once the attorney and the client agree on a course of action, it should be carried out in a manner that will not jeopardize the reputation of either the client or the attorney.

The factors listed above are not the only ones the attorney should consider; however, the list can be used as a starting point in analyzing the dispute and in planning to achieve the best possible result for the client.

While fashioning the case strategy, the attorney should keep in mind the underlying policy of the Commercial Code regarding remedies. The remedies provided are to be liberally administered so that the aggrieved party may be placed in as good a position as if the other party had fully performed its obligations under the contract. Com C §1305(a). Any right or obligation defined by the Commercial Code is enforceable by action unless a different and limited effect is specified in the provision that declares the right or obligation. Com C §1305(b). The Commercial Code imposes an obligation of good faith in the performance and enforcement of any contract or duty. Com C §1304.

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III. CONSIDERATIONS APPLICABLE TO BOTH BUYER AND SELLER

§17.3 A. Cumulation of Remedies

Commercial Code remedies are cumulative and combinations of prelitigation remedies are usually available. The common law doctrine of election of remedies that limits the aggrieved party to the first selected remedy does not apply to transactions subject to the Commercial Code. See Official Comment 1 to UCC §2-703; Com C §§2711, 2721. Remedies for breach of any obligation or promise, either collateral or ancillary to a contract for sale, are not impaired by the remedies provided by the Commercial Code. Com C §2701.

PRACTICE TIP: When the seller successfully reclaims the goods from an insolvent buyer, the Commercial Code expressly provides that successful exercise of the remedy of reclamation is the exclusive remedy of the seller. Com C §2702(3). See §§17.24-17.31. Recognizing the potentially harsh impact of this rule, some courts have sought methods to soften its impact. See, *e.g.*, *Burk v Emmick* (8th Cir 1980) 637 F2d 1172 (reclaiming cash seller allowed to recover deficiency judgment against breaching buyer when buyer was not prejudiced by seller's delay in reclaiming cattle; UCC §2-702(3) distinguished as applying to *credit* sales only). When exercising this remedy, the interplay with federal bankruptcy laws requires careful consideration.

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§17.4 1. Supplementary Principles of Law Applicable

The principles of law and equity, including the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, and bankruptcy, unless displaced by particular provisions, supplement the Commercial Code provisions. Com C §1103(b). Conversely, remedies for material misrepresentation or fraud include all remedies available under Division 2 of the Commercial Code for nonfraudulent breach. Com C §2721. See, *e.g., Six Rivers Nat'l Bank v Lancaster (In re Lancaster)* (Bankr ND Cal 2000) 252 BR 170 (court held that Com C §1103 allows suits for fraud notwithstanding antideficiency laws).

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Source: Business Law/California UCC Sales and Leases/17 Prelitigation Remedies/§17.5 2. Preserving Evidence of Goods in Dispute

§17.5 2. Preserving Evidence of Goods in Dispute

The Commercial Code gives both the buyer and the seller certain rights for purposes of establishing and preserving evidence. In particular, Com C §2515 provides the following:

- Either party on reasonable notification to the other has the right to inspect, test, and sample goods in the possession or control of the other; and
- The parties may agree to a third party inspection or survey to determine the conformity or condition of the goods. The parties may also agree that the findings shall be binding on them in any subsequent litigation or adjustment.

Early exercise of this right may deter a party from destroying evidence.

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§17.6 B. Installment Contracts

An installment contract is one that either requires or authorizes the delivery of goods in separate lots to be separately accepted, even though the contract contains a clause that states "each delivery is a separate contract" or its equivalent. Com C §2612(1).

Whenever the buyer has wrongfully rejected or failed to pay for one or more installments of goods, a seller must ascertain whether the contract is an "installment contract" within the meaning of Com C §2612. If the contract is in fact an installment contract, the next inquiry is whether the seller may cancel the contract for later installments. The test of whether the nonconformity in an installment justifies the cancellation of future installments depends on whether the nonconformity substantially impairs the value of the whole contract. See Official Comment 6 to UCC §2-612. The seller may demand assurances of performance from the buyer if there is uncertainty about future performance by the buyer. Com C §2609. See §§16.2-16.18.

If the buyer wrongfully rejects installments or fails to pay for them, a repudiation of the contract may occur that permits the seller to exercise all remedies, including cancellation of the contract. Com C §2703. The seller may cancel the installment contract only if the buyer's default, with respect to one installment, substantially impairs the value of the whole contract to the seller. See Official Comment 6 to UCC §2-612.

A buyer may reject a nonconforming installment received from the seller if the nonconformity substantially impairs the value of that installment and the seller cannot cure the nonconformity. If the seller is able to give adequate assurances that the nonconformity will be cured, the buyer must accept the installment. If the nonconformity of one or more installments *substantially* impairs the value of the whole contract, the buyer may treat the whole contract as having been breached. See Official Comment 6 to UCC §2-612.

A contract is reinstated by an aggrieved party if a nonconforming installment is accepted without seasonable notice having been given regarding the cancellation or if the party brings an action with respect to only past installments or demands performance as to future installments. Com C §2612(3).

For additional special rules relating to installment contracts, see §§9.53-9.58.

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IV. SELLER'S REMEDIES

§17.7 A. Summary of Remedies

The seller may choose from a variety of remedies under the Commercial Code, depending on the buyer's actions and the seller's objectives. An aggrieved seller's general prelitigation approach before delivery should be to stop delivery of the goods and then attempt to dispose of them to establish its damages. If the goods have been shipped, the seller should seek to recover them. Once the goods are successfully recovered, the seller should resell them to fix damages.

The seller's attorney should consider the factors discussed in §17.2 and decide which combination of prelitigation remedies set forth in the Commercial Code are appropriate for the seller. The seller should also consider the litigation remedies described in chap 18 if the prelitigation remedies are not suitable. For a chart summarizing the following options, see Appendix C.

The buyer repudiates or fails to pay as agreed. Ordinarily, the seller will want to withhold delivery (see §§17.10-17.11) or stop delivery of the goods (see §§17.14-17.22). It is usually to the seller's advantage to identify the goods to the contract (see §§17.32-17.37) and resell them (see §§17.38-17.46) to fix the damages. The seller may also cancel the contract, particularly if the contract is an installment or requirements contract (see §§17.48-17.50).

The buyer wrongfully rejects or revokes its acceptance. If the goods have been rejected on delivery or if the buyer initially accepted the goods but later revoked its acceptance, the seller will generally want to resell them to fix the damages (see §§17.38-17.46). The seller may choose to cancel the partially performed contract (see §§17.48-17.50). If some of the goods have not been delivered, the seller may withhold their delivery or stop them in transit. The seller may elect to identify the goods to the contract, resell them to fix the damages, and cancel the contract, depending on the particular facts.

The buyer becomes insolvent. The seller may refuse delivery except for cash (see §§17.12-17.13), stop delivery of goods already in transit (see §§17.14-17.22), and reclaim goods already delivered (see §§17.24-17.31). Even if the buyer has not yet sought protection under bankruptcy laws, the impact of bankruptcy laws on the efficacy of the remedy should be considered. Successful reclamation of the goods excludes other remedies. Com C §2702(3). If the buyer files for bankruptcy relief (or an order for relief has been entered against the buyer), the automatic stay provided by 11 USC §362(a) will prevent the seller from taking any action against the buyer, or the buyer's property, until the seller has obtained relief from the automatic stay. See generally Debt Collection Practice in California, chap 12 (2d ed Cal CEB 1999).

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§17.8 B. Who Can Assert Seller's Remedies?

Some of the seller's remedies are also available to persons "in the position of a seller." This term is defined as an agent who has paid or become responsible for the price of goods, on behalf of his or her principal, or anyone who holds a security interest or right in goods similar to that of a seller. Com C §2707(1).

Persons "in the position of a seller" include secured lenders, factors, and possibly guarantors. A person "in the position of a seller" has the right to withhold or stop delivery, resell the goods, and recover incidental damages. Com C §2707(2).

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§17.9 C. Choosing Appropriate Remedies

When a buyer defaults in its contractual obligations, the aggrieved seller has two main concerns: to be paid for the goods sold, and to dispose of the goods not accepted. Disposing of the goods may mean dealing with goods shipped to the buyer that have been rejected and are now situated in a distant place or may mean getting rid of goods that the seller had intended for the buyer but that have not yet been delivered. A seller often faces problems associated with making a proper resale of the goods or dealing appropriately with unfinished goods. The seller's options may be limited if the goods are sold through an installment contract. See §§9.53-9.58, 10.70-10.71, 16.5, 17.6.

Perishable goods, fungible goods, and unique goods each require special consideration. Perishable goods should be resold as quickly as possible so that the seller can recover their value and preclude allegations that the seller's actions were not commercially reasonable. See §§17.38-17.46 for the special considerations regarding the resale of goods.

Fungible goods give the seller more flexibility. The seller must be careful to document identification of such goods to the contract in dispute (see §§8.28-8.29, 17.32-17.37) to avoid evidentiary problems in proving damages on resale. Unique or specially manufactured goods rejected by the buyer often must be modified to make them more salable, so the seller does not have to scrap the goods.

If the prelitigation remedies discussed in §§17.10-17.50 are not applicable or practical in a particular situation, the seller should review the litigation remedies discussed in chap 18.

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D. Remedies Available

1. Withholding Delivery

§17.10 a. Grounds

An aggrieved seller still in possession or control of goods sold or contracted to be sold may withhold their delivery. This remedy is authorized when:

- **The buyer wrongfully rejects or revokes acceptance of the goods.** A buyer rarely rejects or revokes acceptance of the goods before delivery, but, should it occur, withholding delivery is an available remedy. Com C §2703.
- **The buyer fails to make a payment when due on or before delivery.** Such a failure of payment may include the dishonor of a check on due presentment, the nonacceptance of a draft, and the failure to furnish an agreed letter of credit. Official Comment 3 to UCC §2-703.
- **The agreed means or manner of payment fails because of domestic or foreign government regulation.** The seller must accept payment, however, if the buyer provides a means or manner of payment that is "commercially a substantial equivalent." Com C §2614(2).
- **The buyer repudiates the contract in whole or in part.** If the buyer repudiates the whole contract, the seller may withhold delivery of all goods in its possession or control. (See §§16.21-16.34 for discussion of anticipatory repudiation.) Repudiation of only one installment of a contract may or may not justify the seller's treating the breach as a breach of the whole contract. The test is whether the value of the whole contract is "substantially impaired" by the one installment. See Com C §2612. If the repudiation does not qualify as a breach of the whole contract, the seller may withhold delivery of the installment that was repudiated but must deliver future installments. Official Comment 6 to UCC §2-612. If one installment is repudiated and the seller has reasonable doubts about the buyer's intentions on the balance of the installments, the seller may demand adequate assurances of performance under Com C §2609. The buyer's failure to deliver these assurances may permit the seller to repudiate the contract. Com C §2609(4).
- **There are reasonable grounds for insecurity with respect to the buyer's performance.** If the seller justifiably demands assurance of performance, the seller may, if commercially reasonable, suspend performance until the assurance has been received. Com C §2609(1). This allows the seller to strategically "force the issue" on performance. In most cases, suspension of performance would include withholding delivery. See Official Comment 2 to UCC §2-609. See also §§16.2-16.18 on demanding assurances of performance.
- **The buyer fails to cooperate seasonably to enable the seller to perform.** The buyer's failure to cooperate seasonably so as to enable the seller to perform will excuse the resulting delay in the seller's performance and permit the seller to withhold delivery of the goods. Com C §2311(3)(a).

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§17.11 b. Effect

The right to withhold delivery may be exercised without being considered a breach of the seller's obligation to tender delivery of the goods. The seller must be certain that the buyer has committed a breach (see Com C §2703) before delivery is withheld. If the seller wrongfully withholds (*e.g.,* the seller mistakenly believes that the buyer repudiated the contract), the seller's action will be a breach and the buyer will be entitled to damages.

In some circumstances, the buyer may desire another opportunity to perform. For example, the buyer may wish to retract its anticipatory repudiation. Com C §2611. Although the seller could treat the repudiation as final and proceed with its remedies, the seller may find that it is good business practice and less expensive to permit the buyer to cure the default and resume performance. The seller may wish to notify the buyer that delivery of the goods is being withheld to preclude the buyer from thinking the seller canceled the contract or initiated the breach.

Although withholding delivery gives the seller substantial leverage, this step is usually taken while the seller prepares to exercise some further remedy because the withholding does not fulfill the seller's contract obligations. Unless the buyer cures the default, the seller has a choice of additional remedies, which include stopping delivery by any bailee, canceling the contract, reselling the goods in its possession and recovering damages, and recovering the contract price of the goods. Com C §2703. See §§18.17-18.19.

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2. Refusing Delivery Except for Cash

§17.12 a. Grounds: Buyer's Insolvency

If the seller discovers that the buyer is insolvent, the seller may refuse delivery unless payment is received in cash. See Com C §2702(1).

A buyer is considered "insolvent" if the buyer has ceased to pay its debts in the ordinary course of business (other than as a result of a bona fide dispute), cannot pay debts as they become due, or is insolvent within the meaning of the federal bankruptcy law. Com C §1201(b)(23)(A)-(C). The Bankruptcy Code describes an entity (other than a partnership or municipality) as insolvent when the sum of the entity's debts is greater than all its property at fair valuation (exclusive of exempt and fraudulently transferred or concealed property). See 11 USC §101(32)(A). If the entity is a partnership, the Bankruptcy Code's definition also takes into account the positive net worth of the individual partners. See 11 USC §101(32)(B).

As a practical matter, the difficulty of assessing the buyer's solvency limits the usefulness of this remedy. The Commercial Code defines "discover" as "knowledge" as opposed to "reason to know." Com C §1202(c). The seller must therefore actually have knowledge that the buyer has ceased to pay debts in the ordinary course of business, cannot pay those debts as they become due, or is insolvent within the meaning of the Bankruptcy Code. Otherwise, the seller risks breaching the agreement if it refuses delivery unless it is paid in cash.

The best approach, for a seller who reasonably suspects that the buyer is insolvent, is to demand assurances of performance. See Com C §2609(1); §§16.2-16.18. If the buyer is unable to provide the assurance, the seller may avail itself of the full range of remedies provided by the Commercial Code. Com C §§2609(4), 2703.

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§17.13 b. Effect

The seller's refusal to deliver the goods unless cash payment is received will prompt the buyer to either (1) tender payment, or (2) make the disclosure that payment cannot be made to the seller. If the buyer is unable to pay for and claim the goods, further remedies may be worthless to the seller because the buyer is insolvent (*e.g.,* reselling the goods and suing for damages, or suing the buyer for the contract price).

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3. Stopping Delivery

§17.14 a. Grounds

The seller may stop delivery of any shipment of goods destined for the buyer, regardless of its size, or whether it is in the possession of the shipping carrier or certain other bailees *if* the seller discovers that the buyer is insolvent, or the agreed means or manner of payment fails because of domestic or foreign government regulation. See Com C §§2614(2), 2702(1), 2705(1). This remedy is different from the remedy of withholding delivery because the goods are no longer in the seller's possession.

Regardless of the buyer's status as solvent or insolvent, the seller may also stop delivery of carload, truckload, planeload, or larger shipments when the buyer fails to make a payment due before delivery or if for another reason the seller has a right to withhold or reclaim the goods. Com C §2705(1). See Official Comment 1 to UCC §2-705. On withholding delivery, see §§17.10-17.11. On reclaiming the goods, see §§17.24-17.31.

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§17.15 b. Effect

The right to stop delivery on discovery of the buyer's insolvency extends the seller's control over the goods to situations in which the seller has already released and shipped the goods. The seller's position after stopping delivery in transit is the same as it would have been had the seller held the goods and refused to deliver them, or delivered the goods only on receipt of cash from the buyer. See Official Comments 1, 6 to UCC §2-705. The practical impact of this remedy on resolution of the dispute makes this a desirable approach.

The seller bears the expense and liability of stopping delivery. The seller has the same rights in the goods when they are stopped in transit as if delivery was withheld before shipment. See Official Comments 5-6 to UCC §2-705.

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Source: Business Law/California UCC Sales and Leases/17 Prelitigation Remedies/§17.16 c. Limits on Right to Stop Delivery

§17.16 c. Limits on Right to Stop Delivery

The right to stop delivery ends when any one of the following occurs:

The buyer or a purchaser from the buyer receives the goods. Com C §2705(2)(a); Official Comment 2 to UCC §2-705. The Commercial Code defines "receipt" of goods as "taking physical possession of them." Com C §2103(1)(c). Consequently, the right to stop goods in transit may continue after delivery to the carrier and until the buyer is in physical or constructive possession of the goods. A contract provision on passage of title is not relevant because the right of stoppage is not affected by the location of title. *Abilene Nat'l Bank v Fina Supply, Inc*. *(In re Brio Petroleum)* (5th Cir 1986) 800 F2d 469. The seller's right to stop will terminate on tender of the goods to the carrier when the terms of delivery to the buyer are F.O.B. carrier. See, *e.g., Warrior Tombigbee Transp. Co. v 5,775.674 Net Tons of Coal* (SD Ala 1983) 570 F Supp 1405 ("F.O.B. barge" meant that coal was effectively delivered to buyer when it was loaded onto barge; once coal had been loaded, delivery was complete and goods could not be stopped).

A bailee of the goods (except a carrier) acknowledges to the buyer that it holds the goods for the buyer. The seller can no longer stop delivery if a bailee has acknowledged to the buyer that it is holding the goods for the buyer. Com C §2705(2)(b)-(c). The Commercial Code defines "bailee" as "the person who by a warehouse receipt, bill of lading or other document of title acknowledges possession of goods and contracts to deliver them." Com C §7102(a)(1).

A carrier acting as a warehouse acknowledges to the buyer that it holds the goods for the buyer. Once a carrier stores the goods in its warehouse, the acknowledgment that the goods are being held for the buyer signifies that the carrier is now acting as a "warehouse" and that delivery to the buyer has occurred and terminated the seller's right to stop delivery. A separate contract by the carrier is required to establish the carrier as a "warehouse." Official Comment 3 to UCC §2-705; *Ceres, Inc. v ACLI Metal & Ore Co*. (ND Ill 1978) 451 F Supp 921.

A carrier reships the goods at the buyer's instructions. "Reshipment" for this purpose occurs when a carrier ships goods to another destination or purchaser at the *buyer's* instruction. For example, a seller in New York contracts to ship goods to a buyer in San Francisco. The buyer has already resold the goods to a subpurchaser in Dallas. It would be uneconomical to ship the goods to San Francisco and then on to Dallas. Reshipment can be accomplished by having the carrier transport the goods from New York directly to Dallas. The seller in this situation should not be able to stop the goods in transit from New York to Dallas because the Commercial Code views this situation conceptually as though the goods had already been received by the buyer in San Francisco and reshipped to Dallas. Commercial Code §2705(2)(c) recognizes this concept and business practice by providing that a "reshipment" terminates the seller's right to stop goods in transit.

EXAMPLE: A railroad's redirection of a shipment of lumber at the request of a subpurchaser has been held to constitute a "reshipment" within the meaning of UCC §2-705(2)(c). See *Butts v Glendale Plywood Co*. (9th Cir 1983) 710 F2d 504. As a result, the seller was unable to stop delivery of the lumber when it learned of the purchaser's insolvency. The court reasoned that if the original seller were free to stop delivery after the purchaser redirected the shipment, the subpurchaser could be delayed in receiving the goods and even forced to renegotiate with the original seller at a higher price than was agreed on with the original purchaser. Consequently, the time of redirection or reshipment is a logical point at which to fix the rights of the parties.

NOTE: A seller may negotiate a sale so that the purchaser may not redirect shipment. In *Butts v Glendale Plywood Co.,* the original purchaser was able to redirect shipment because it was the consignee of the goods. If a seller suspects that a buyer has financial problems, the seller may consign the goods to itself or to its agent, at the buyer's location. When the goods arrive, payment can be collected and the goods turned over to the buyer. In the meantime, the buyer who has not been identified on the bill of lading will not be able to effect a reshipment of the goods. The seller or its agent will retain the goods until payment is received.

A negotiable document of title covering the goods is negotiated to the buyer. A document of title symbolizes the goods. The receipt of a document of title is equivalent to receipt of the goods. The buyer's receipt of the goods

serves to terminate the seller's right to stop the goods in transit. The negotiation of documents of title covering the goods to the buyer also serves to terminate the seller's right to stop goods in transit. Com C §2705(2)(d).

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§17.17 d. Shipments Under Negotiable Documents

If a negotiable document covering the goods has been negotiated to the buyer, the seller can no longer stop delivery. Com C §2705(2)(d). A carrier or other bailee need not obey a stop order after a negotiable document has been issued (even if it has not yet been negotiated to the buyer) until possession or control of the document is surrendered. Com C §2705(3)(c). Many rail carriers honor stop orders supported by a cashier's check in the amount of 150 percent of the invoice value or an equivalent surety bond, even though original order bills of lading are not surrendered. Their right to do so against the buyer is protected. See Official Comment 2 to UCC §2-705.

A carrier that has issued a nonnegotiable bill of lading is not obliged to obey a stop order from anyone other than the consignor. Com C §§2705(3)(d), 7102(a)(4).

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§17.18 e. Who May Stop Delivery of Goods?

In addition to the seller, two other parties have the right to stop delivery of the goods:

- A "financing agency," *e.g.,* a bank, finance company, or person who in the ordinary course of business makes advances against goods or documents of title. Com C §§2104(2), 2506(1).
- A "person in the position of a seller," *i.e.,* anyone who holds a security interest or other right in goods similar to that of a seller, or as against a principal, an agent who has paid or become responsible for the price of goods on behalf of the principal. Com C §2707.

Because both of these parties are strangers to the shipment contract, the carrier need not honor their notification to stop delivery. Official Comment 4 to UCC §2-506; Com C §2705(3)(d); Official Comment 2 to UCC §2-705. To avoid this scenario, the financing agency may (1) arrange for the consignor to issue the stop order, (2) make general arrangements with the carrier beforehand or (3) present negotiable documents.

A seller that has goods shipped from some other consignor may also have to work through the consignor to stop the goods, assuming the carrier elects not to obey the seller's notification.

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§17.19 f. Procedure for Stopping Delivery

The seller must notify the carrier or other bailee regarding the stoppage so the bailee, with reasonable diligence, can stop or prevent delivery of the goods. Com C §2705(3)(a). A reasonable time may be a number of days if the goods are in small shipments that are difficult to locate.

The carrier or bailee must comply with the notification when it is properly given by the seller. Com C §2705(3)(b). The carrier or bailee may, but need not, recognize the notification if it is given by someone other than the seller (*e.g.,* by a seller's lender that may be asserting a security interest in the goods). Com C §2705(3)(d); Official Comment 4 to UCC §2-506; Official Comment 2 to UCC §2-705.

The carrier must hold the goods at the direction of the seller if the carrier receives a stop notification that it must obey or elects to obey. Com C §2705(3)(b). See *Petroleum Prod., Inc. v Mid-America Pipeline Co.* (D Kan 1993) 815 F Supp 1421 (carrier was not entitled to demand irrevocable letter of credit from seller to ensure that seller would indemnify carrier for damages arising from stopped delivery).

Procedures for stopping goods in transit are generally informal. The starting point is usually the freight agent who initially handled the shipment. The seller will need to know the names of the shipper and consignee, the routing, the car number, and the shipping and destination points. This information is usually on the bill of lading. The person seeking to stop goods may need to explain to the carrier that this stoppage is not for the common, temporary purpose of doing additional work on the goods. Some carriers route the request through an "LCL ('less-than-carload') clerk" if less-than-carload shipments are being stopped.

In any event, the seller is liable to the carrier for any charges or damages that result from an unjustified stoppage. Com C §2705(3)(b). See Official Comment 2 to UCC §2-705.

It is usually in the seller's interest to notify the buyer that the goods are being stopped, but such notification is not required.

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§17.20 g. Rights of Carrier or Bailee

A carrier may safely divert a shipment at the instructions of the holder of a negotiable bill of lading. Com C §7303(1)(a). If the bill is nonnegotiable, the carrier can usually rely on the consignor's instructions, but it runs the risk of liability if the consignee has the right to dispose of the goods. Com C §7303(1)(b), (d). The carrier may, but need not, obey the directions of a nonconsigning seller. Com C §§2705(3)(d), 7403(a)(4). The seller is liable to the carrier for any losses, charges, or damages that the carrier incurs in following the seller's directions, whether or not the carrier was obligated to follow them. Com C §§2705(3)(b), 7504(d); Official Comment 4 to UCC §7-504; Official Comment 5 to UCC §2-705.

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§17.21 h. Effect of Buyer's Bankruptcy

Although the Bankruptcy Code does not mention the seller's right to stop delivery of goods in transit to the debtor, that right should typically take precedence over rights and powers granted to the trustee in bankruptcy. According to 11 USC §546(c), the rights and powers of a trustee under 11 USC §§544(a) (as a judicial lien creditor), 545 (power to avoid a statutory lien), 547 (right to recover a preference), and 549 (right to recover certain postpetition transfers) are all subject to any statutory or common law reclamation right of a seller who sold goods to the debtor in the ordinary course of seller's business, if the debtor received those goods while insolvent.

The stoppage of goods in transit is essentially the reclamation right exercised at an earlier stage. Consequently, the same principle should apply that establishes the priority of the seller's rights over the rights of the bankruptcy trustee. See *In re Fabric Buys* (Bankr SD NY 1983) 34 BR 471; *National Sugar Ref. Co. v C. Czarnikow, Inc.* (*In re National Sugar Ref. Co*.) (Bankr SD NY 1983) 27 BR 565.

In contrast to reclamation, notice to the buyer is not required by the Commercial Code when goods are stopped in transit. *Indussa Corp. v Reliable Stainless Steel Supply Co*. (ED Pa 1974) 369 F Supp 976. See §§17.22-17.29 for discussion of the seller's right of reclamation.

The stoppage of goods after the buyer files a bankruptcy petition does not violate the automatic stay provisions of 11 USC §362(a). Requiring the seller to first obtain relief from the automatic stay would effectively deny the seller the right of stoppage because the right must be exercised in the short period of time between the filing of the petition and the actual or constructive delivery of the goods. See *National Sugar Ref. Co. v C. Czarnikow, Inc.* (*In re National Sugar Ref. Co*.) (Bankr SD NY 1983) 27 BR 565, 572.

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§17.22 i. Relationship to Division 9

Commercial Code §9110 specifically identifies the security interests under Division 2 to which it applies. Those include security interests arising under Com C §§2401, 2505, 2711, and 10508, but not a security interest arising under Com C §2705 (seller's stoppage of delivery in transit).

In addition, Com C §9109 does not state that Com C §2705 falls within its scope, nor does the definition of "secured party" under Com C §9102(72) reference persons asserting rights under Com C §2705. Furthermore, Com C §9322(f)(4) specifically makes the priority rules of Com C §9322 subject to the provisions of Com C §9110.

A problem for the seller may arise from Com C §9320, which provides that a buyer in the ordinary course of business (Com C §1201(b)(9)) takes free of even a perfected security interest created by its seller. See *Tanbro Fabrics Corp. v Deering Milliken, Inc*. (1976) 385 NYS2d 260, 350 NE2d 590 (which construed former UCC §9-307). In that case, a manufacturer sold goods to a processor on a "bill and hold" basis, under which the manufacturer retained possession pending shipping instructions and was granted a security interest in all retained goods. The processor resold the goods to a second processor that paid the first processor for them. When the manufacturer learned that the first processor was insolvent, it refused to deliver the goods to the second processor. The court, however, held in favor of the second processor. Following the logic of *Tanbro,* the seller's right to stop delivery could be cut off by the buyer's sale of the goods to a third party qualifying as a "buyer in the ordinary course of business." On "buyer in the ordinary course of business" status, see §§12.20-12.26. See also Secured Transactions in California Commercial Law Practice §§4.64-4.67 (2d ed Cal CEB 2001).

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§17.23 4. Buyer's Forfeiture of Its Deposit

Although California law generally prohibits forfeitures and penalties, the Commercial Code permits the limited forfeiture of a buyer's deposit or prepayment. After a seller has justifiably withheld delivery because of a buyer's breach, the buyer may be compelled to forfeit 20 percent of the total value of its performance under the contract or $500, whichever is smaller. Com C §2718(2)(b). The buyer's right to restitution, however, is subject to setoff if the seller has a right to damages. The 20-percent forfeiture may be modified by a provision in the sales contract for liquidated damages, provided that it conforms to the restrictions of Com C §2718(1), which requires compliance with CC §1671. See §18.51. The forfeiture provisions of Com C §2718 apply whether the prepayment is to be applied on the price or is merely intended as security for performance. See Com C §2718(4); Official Comment 2 to UCC §2-718. This should be distinguished, however, from common law or contractual rights of setoff to recover damages.

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Source: Business Law/California UCC Sales and Leases/17 Prelitigation Remedies/ 5. Reclaiming Goods/§17.24 a. Reclamation Under California UCC

5. Reclaiming Goods

§17.24 a. Reclamation Under California UCC

Reclamation is the right of a seller under Com C §2702 to recover possession of goods delivered to an insolvent buyer, on demand made within 10 days after the buyer's receipt of the goods. See §17.27 for further discussion of the 10-day demand requirement.

Reclamation is useful if an unpaid and unsecured seller of goods is unable to retrieve the goods or stop them in transit. The seller need not prove fraud, although underpinning Com C §2702(2) is the proposition that receipt of goods on credit by an insolvent buyer is equivalent to a tacit misrepresentation of solvency and is therefore fraudulent. UCC Comment 2 to Com C §2702. Commercial Code §2702 reads as follows:

> §2702. Seller's Remedies on Discovery of Buyer's Insolvency.
> (1) Where the seller discovers the buyer to be insolvent he may refuse delivery except for cash including payment for all goods theretofore delivered under the contract, and stop delivery under this division ([Com C §2705]).
> (2) Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within 10 days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the 10-day limitation does not apply. Except as provided in this subdivision the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.
> (3) The seller's right to reclaim under subdivision (2) is subject to the rights of a buyer in ordinary course or other good faith purchaser under this division ([Com C §2403]). Successful reclamation of goods excludes all other remedies with respect to them.

The definition of insolvency usually applied under §2702 is the inability of the debtor to meet its financial obligations as they come due in the ordinary course of business. UCC Comment 4 to Com C §2702. Under bankruptcy law, the definition is different. See §17.25.

Some limitations on the seller's reclamation rights should be noted. As the statute is phrased, reclamation is not available if the seller *knew* that the buyer was insolvent before delivery was made but chose to deliver the goods anyway. See Com C §2702(2).

Further, the rights of a good faith purchaser or holder of a perfected security interest are senior to the rights of the reclaiming seller. Com C §2702(3).

Also important is that goods delivered must remain "identifiable," *i.e.,* they must remain separate and distinct from other property of the buyer to be subject to reclamation. See *Conoco, Inc. v Braniff, Inc. (In re Braniff, Inc.)* (Bankr MD Fla 1990) 113 BR 745. Whether a demand letter is sufficient for purposes of identifying the goods at the time of the demand is a facts-and-circumstances determination, including what information the buyer has regarding the identification of the goods and the extent to which that information can reasonably be provided or accessed. *Scotts Co. v Hechinger Co. (In re Hechinger Inv. Co.)* (Bankr D Del 2001) 274 BR 402. See chap 8 on the identification of goods.

Until the buyer files for bankruptcy, a reclamation demand may be written or oral. See *Farmers Rice Milling Co. v Hawkins* (*In re Bearhouse, Inc.)* (Bankr WD Ark 1988) 84 BR 552; *United Beef Packers v Lee* (*In re A.G.S. Food Sys.)* (Bankr D SC 1980) 14 BR 27. The Bankruptcy Code, however, requires that the reclamation demand be in writing. 11 USC §546(c)(1); *Ray-O-Vac, Inc. v Daylin, Inc.* (*In re Daylin, Inc*.) (9th Cir 1979) 596 F2d 853; *Barry v Shrader Holding Co. (In re M.P.G., Inc.)* (Bankr WD Ark 1998) 222 BR 862.

The demand should specifically refer to the fact that the seller is exercising the right of reclamation. See *Montello Oil Corp. Cities Serv. Co. v Marin Motor Oil, Inc. (In re Marin Motor Oil, Inc*.) (3d Cir 1984) 740 F2d 220 (seller's complaint seeking attachment, injunction, and other relief did not constitute demand, because it did not mention reclamation).

Reclamation is a useful remedy. If the buyer goes into bankruptcy, however, the seller must be mindful that the Bankruptcy Code's requirements are slightly different from those of California's Commercial Code. To be prudent, the seller should observe the more stringent Bankruptcy Code requirements. See 11 USC §546(c). If the seller recovers the goods during the 90-day preference period, and for some reason did not observe all the reclamation requirements,

a preference action by the trustee is a possibility. See 11 USC §547.

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§17.25 b. Reclamation Following Commencement of Bankruptcy Case

Demands for reclamation are not subject to the automatic stay. 11 USC §362(b)(3). Thus, if the buyer files bankruptcy, a reclamation demand can still be made by the seller and honored by the debtor-buyer. However, the Bankruptcy Code allows the debtor-buyer to keep the goods if the seller fails to comply with 11 USC §546(c)(1). Under 11 USC §546(c), as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) (Pub L 109-8, 119 Stat 100), a seller, acting in the ordinary course of its business, may reclaim goods received by the debtor while insolvent, subject to the following conditions:

- The seller must make its reclamation demand in writing; and
- The demand must be made either within 45 days (under former law, the period was 10 days, like California's Commercial Code) after receipt of the goods by the debtor, or no later than 20 days after commencement of the case, if the 45-day period expires after commencement of the case. 11 USC §546(c)(1).

A letter demand need not be sent by registered or certified mail. *In re Flagstaff Foodservice Corp*. (Bankr SD NY 1986) 56 BR 910.

A telephone call followed by a letter is sufficient to constitute a demand. *U.S. Billiards Co. v Greenberger* (*In re Bensar Co.*) (Bankr SD Ohio 1984) 36 BR 699.

Written demand is effective on dispatch, not receipt. See *Montello Oil Corp. Cities Serv. Co. v Marin Motor Oil, Inc., supra* (telex sent on tenth day but received the following morning when recipient turned on telex machine was valid demand).

Demand may be made on the buyer's attorneys. *In re Flagstaff Foodservice Corp., supra*.

The BAPCPA has significantly improved the seller's position. Under former 11 USC §546(c), if the debtor asked the bankruptcy court to deny the seller's reclamation right, the court could do so if it granted the seller's claim priority as an administrative expense or secured the seller's claim with a lien. Now, under 11 USC §546(c) as amended by the BAPCPA, even if the creditor fails to make a timely written demand or if the creditor's claim is otherwise denied, the creditor is still entitled to an administrative claim for the value of any goods received by the debtor in the ordinary course of the debtor's business within 20 days before the petition date. 11 USC §§503(b)(9), 546(c)(2). The BAPCPA also added to the list of administrative expenses in 11 USC §503(b) a new category for goods sold on credit and received by the debtor within 20 days of the filing of the case. 11 USC §503(b)(9). For such an administrative claim, there are no requirements of insolvency, written reclamation demand, or goods remaining on hand. Thus, BAPCPA offers the seller another avenue for being made whole in addition to the right of reclamation.

PRACTICE TIP: In spite of the BAPCPA amendments, creditors' counsel should not assume that a creditor with a Chapter 11 "administrative" claim is fully protected. If the debtor's Chapter 11 case fails and is converted to Chapter 7, the administrative claim will be junior to all of the Chapter 7 administrative expenses and may never be paid. Counsel should seek to protect the client by timely sending a written demand for reclamation.

Despite the best efforts of the seller and its counsel, a senior secured creditor with a blanket lien on the debtor's assets may be able to trump unsecured reclamation claims in goods. See, *e.g., In re Dairy Mart Convenience Stores, Inc.* (Bankr SD NY 2003) 302 BR 128. Thus, the new administrative claim status under the BAPCPA should go a long way in protecting suppliers, but sellers wishing more protection from the risk of a buyer's insolvency should obtain a letter of credit from the buyer or a purchase money security interest in the goods sold.

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§17.26 c. Other Remedies Excluded

A seller that successfully reclaims its goods may *not* invoke any contract damages. Com C §2702(3). See Official Comment 3 to UCC §2-702. Because of the harshness of this rule, courts have construed the limitation narrowly to permit other remedies, including non-Code remedies in certain cases.

If the buyer does not relinquish the goods on demand, the seller may institute a claim and delivery action under CCP §§511.010-516.050. See Debt Collection Practice in California §§6.111-6.166 (2d ed Cal CEB 1999) for procedures for prejudgment remedies.

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§17.27 d. 10-Day Limitation and Exception Under Commercial Code

Normally, under the Commercial Code, the seller must demand the goods within 10 days after the buyer has received them. Com C §2702(2). "Receipt" means actual physical possession, not delivery to a carrier or mere passage of title. Com C §2103(1)(c); *Conveyco, Inc. v First Software Corp.* (*In re First Software Corp*.) (Bankr D Mass 1987) 72 BR 403; *Aventura Sportswear, Ltd. v Maloney Enters.* (*In re Maloney Enters*.) (Bankr ED Ky 1983) 37 BR 290.

A seller's reclamation right extends to the goods in the debtor's possession at the time notice of the demand was received. *In re Flagstaff Foodservice Corp*. (Bankr SD NY 1986) 56 BR 910.

If the buyer has misrepresented its solvency in writing to the seller within 3 months before delivery of the goods, the 10-day limitation does not apply. Com C §2702(2). For purposes of measuring the 3-month period, the date on which the writing is presented to the seller, rather than the date of the writing itself, controls. *Potts v Mand Carpet Mills* (*In re Bel Air Carpets)* (9th Cir 1971) 452 F2d 1210 (buyer stated within 3 months of delivery date of goods that 1-year-old financial reports still accurately reflected buyer's financial position).

NOTE: In the bankruptcy setting, 11 USC §546(c), unlike Com C §2702(2), does not have a special rule for written misrepresentations of solvency made within 3 months of delivery.

It is not clear how explicit the misrepresentation of solvency must be before the 10-day requirement becomes inapplicable. Because most credit information is presented in the form of financial statements, the question arises whether entries in such statements (*e.g.,* valuations of assets or collectibility of accounts receivable) can be considered misrepresentations of solvency for purposes of Com C §2702. If the statements are prepared by independent accountants or credit reporting agencies, the additional question arises whether misrepresentations can be attributed to the buyer. There are presently no reported California cases considering these issues. The seller can avoid these problems by obtaining explicit statements of solvency from the buyer on a regular 3-month basis. For a form statement, see form 17.28-1.

The tendering of a check that is subsequently dishonored may constitute a written misrepresentation of solvency for purposes of Com C §2702(2). See *Amoco Pipeline Co. v Admiral Crude Oil Corp*. (10th Cir 1974) 490 F2d 114; *In re Fairfield Elevator Co*. (Bankr SD Iowa 1973) 14 UCC Rep Serv 96.

NOTE: The 10-day demand requirement applies only to sellers who provided the goods on credit. When a seller accepts a check as payment and the check is later dishonored, the 10-day requirement does not play a role. The seller in that situation has a *reasonable* time to reclaim the goods after discovering that the check has been dishonored. (In many instances, a "cash" seller will not learn that the check has been dishonored until the buyer has had the goods for more than 10 days.) See *Citizens Bank v Taggart* (1983) 143 CA3d 318, 191 CR 729.

Although Com C §2702 does not expressly state that the seller must have relied on the misrepresentation, that requirement is implicit in the notion of misrepresentation. *Potts v Mand Carpet Mills* (*In re Bel Air Carpets), supra*; *In re Fairfield Elevator Co., supra*.

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Source: Business Law/California UCC Sales and Leases/17 Prelitigation Remedies/§17.28 e. Form: Buyer's Representation of Solvency

§17.28 e. Form: Buyer's Representation of Solvency

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17.28-1 Buyer's representation of solvency

_ _[*Name*]_ _ **(the buyer) represents and warrants to** _ _[*name*]_ _ **(the seller) that the buyer has during the past 90 days paid its debts in the ordinary course of business, that the buyer can presently pay its debts as they become due, and that the buyer's assets and property, fairly valued, are presently sufficient to pay all its liabilities as they mature. The buyer acknowledges that the seller intends to rely on this representation in entering into a transaction with the buyer for the sale of goods.**

Date: _ _ _ _ _ _ __[*Signature of buyer/duly authorized representative*]__
_ _[*Typed name*]_ _

Comment: This clause incorporates the concept of "insolvency" found in Com C §1201(b)(23).

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§17.29 f. Other Limitations

The right to reclaim goods is narrowed somewhat by the following limitations:

- **Only "sellers" may reclaim.** A person who is not a seller, even if that person is "a person in the position of a seller" (see Com C §2707(1)), does not qualify for the right to reclaim goods under Com C §2702.
- **The seller cannot ordinarily reclaim the proceeds of goods.** *U.S. Billiards Co. v Greenberger (In re Bensar Co.*) (Bankr SD Ohio 1984) 36 BR 699; *In re Kentucky Flush Door Corp*. (Bankr WD Ky 1983) 28 BR 808. See also *Party Packing Corp. v Rosenberg (In re Landy Beef Co.*) (Bankr D Mass 1983) 30 BR 19, in which the court suggested, however, that a seller may "reclaim" proceeds under a trust theory. If the seller retained a security interest in the goods under Commercial Code Division 9, the seller might be entitled to the proceeds on a priority basis. Com C §9315(a)(2).
- **Goods processed into other products most likely cannot be reclaimed, because they are no longer identifiable.** *Party Packing Corp. v Rosenberg (In re Landy Beef Co.*)*, supra*. But see *Eighty-Eight Oil Co. v Charter Crude Oil Co.* (*In re Charter Co.)* (Bankr MD Fla 1985) 54 BR 91 (crude oil mingled in pipeline with other parties' oil subject to reclamation).

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§17.30 g. Rights of Third Parties

An unpaid seller's right of reclamation may be limited by the rights of certain third parties, including the following:

Ordinary course buyer. A buyer in the ordinary course of business or other subsequent good faith purchaser may defeat the seller's right of reclamation. Com C §2702(3); *English v Ralph Williams Ford* (1971) 17 CA3d 1038, 95 CR 501. For the definition of "buyer in ordinary course of business," see Com C §1201(b)(9):

> (9) "Buyer in ordinary course of business" means a person that buys goods in good faith, without knowledge that the sale violates the rights of another person in the goods, and in the ordinary course from a person, other than a pawnbroker, in the business of selling goods of that kind. A person buys goods in the ordinary course if the sale to the person comports with the usual or customary practices in the kind of business in which the seller is engaged or with the seller's own usual or customary practices. A person that sells oil, gas, or other minerals at the wellhead or minehead is a person in the business of selling goods of that kind. A buyer in ordinary course of business may buy for cash, by exchange of other property, or on secured or unsecured credit, and may acquire goods or documents of title under a preexisting contract for sale. Only a buyer that takes possession of the goods or has a right to recover the goods from the seller under Division 2 (commencing with Section 2101) may be a buyer in ordinary course of business. "Buyer in ordinary course of business" does not include a person that acquires goods in a transfer in bulk or as security for or in total or partial satisfaction of a money debt.

Although the Commercial Code does not define the term "good faith purchaser," for the definition of "good faith," see Com C §1201(b)(20):

> (20) "Good faith"… means honesty in fact and the observance of reasonable commercial standards of fair dealing.

Secured creditor. A secured creditor with a perfected security interest in the buyer's inventory and after-acquired property has priority over an unpaid seller that attempts to reclaim goods sold to the buyer under Com C §2702. The secured creditor with such a "floating lien" may be considered to have equal status with a "good faith purchaser for value" and therefore take free of the seller's interest under Com C §§2403 and 2702(3). *Stowers v Mahon* (*In re Samuels & Co*.) (5th Cir 1975) 510 F2d 139, rev'd en banc (1976) 526 F2d 1238.

PRACTICE NOTE: In the case of a sale by a receiver or assignee, the sale may be structured in coordination with the secured party in a manner that defeats the reclamation rights.

If the buyer files a petition in bankruptcy, the secured creditor's position is affected. Property acquired by the debtor after the commencement of its bankruptcy case is not subject to any lien resulting from a security agreement entered into before the commencement of the case. 11 USC §552(a). An important exception to this rule is that if the security agreement extends to "proceeds, product, offspring, rents, or profits" of the property subject to the agreement, then these items continue to be subject to the secured creditor's interest, as provided by the security agreement. That interest, however, might also be limited by applicable state law and the equities of the case. 11 USC §552(b).

The secured creditor should still prevail over the reclaiming seller if (1) the secured creditor has provided postpetition financing and obtained a lien on postpetition collateral to secure that financing, or (2) cash collateral was used to purchase the goods and the secured creditor received, as adequate protection, a replacement lien on postpetition collateral. See 11 USC §546(c). Relief for the seller in this situation may be provided under 11 USC §546(c) by requiring the bankruptcy court to grant a qualifying reclaiming seller an administrative expense priority or a lien subordinate to that of the secured creditor in place of reclamation

Judgment creditor. Unlike a good faith purchaser or secured party, a judgment creditor does not have rights sufficient to defeat a reclaiming seller. *Citizens Bank v Taggart* (1983) 143 CA3d 318, 191 CR 729.

Bankruptcy trustee. Because the right of reclamation does not exist unless the buyer is insolvent, the seller's assertion of its reclamation rights under Com C §2702 frequently brings it into conflict with a trustee in bankruptcy and with other creditors that are seeking to satisfy themselves out of the debtor's assets. Title 11 USC §546(c) partially recognizes the seller's right to reclaim goods sold to a buyer that has filed a petition for relief. Certain of the trustee's rights and avoidance powers are subject to the seller's right to reclaim, *e.g.,* the rights and powers granted to the

trustee by 11 USC §§544(a), 545, 547, and 549. Other rights and powers of the trustee are *not* subordinated to the seller's reclamation right, *e.g.,* those granted by 11 USC §§544(b), 548, and 553. Note that a debtor-in-possession has essentially the same rights, powers, and duties as a bankruptcy trustee. 11 USC §1107(a).

For further discussion of the seller's right to reclaim, and the interplay between 11 USC §546 and Com C §2702, see 5 Collier on Bankruptcy ¶546.04 (15th ed rev 1996).

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§17.31 h. Form: Seller's Demand for Reclaiming Goods

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17.31-1 Seller's demand for reclaiming goods

We have discovered that on _ _[*date*]_ _, _ _[*name of buyer*]_ _ received _ _[*identify and describe goods*]_ _ from us on credit while insolvent within the meaning of

[*Option 1: Buyer has not filed for bankruptcy*]

California Commercial Code §1201(b)(23).

[*Option 2: Buyer has filed for bankruptcy*]

Bankruptcy Code §101(32).

[*Continue*]

By this notice we assert our right to reclaim the goods. We direct you to _ _[*segregate and hold them/return them immediately/ release them to our agent, _ _[name]_ _]_ _.

Comment: The demand for return of the goods should be given to the buyer, trustee, or debtor-in-possession in bankruptcy, or the receiver. Copies or notification should also be given to all interested parties. The demand need not be made in any particular form, but it should be in writing to avoid problems under the Bankruptcy Code.

If the buyer has filed a petition for relief in bankruptcy, the seller will also have to prepare and file a complaint to reclaim the goods. Reclamation is an adversary proceeding under Fed R Bankr P 7001. The complaint should be filed as early as possible and the property to be reclaimed must be positively identified. The burden of proof in reclamation is on the reclaimant to show that the debtor did not have any ownership interest in the property. *Roberts v Geremia* (*In re Roberts, Inc.)* (Bankr D RI 1981) 15 BR 584. The burden is on the trustee to show that the property should remain in the estate once the reclaimant has shown a claim to it. *Jackson Sound Studios, Inc. v Travis* (5th Cir 1973) 473 F2d 503.

The costs in a reclamation proceeding may be imposed on the bankrupt buyer's estate when the reclaimant is successful. Fed R Bankr P 7001, 7054.

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6. Identifying Goods to the Contract

§17.32 a. Effect of Identification

Identifying existing goods as goods to which the sales contract refers affects the rights and remedies of both the seller and the buyer. See Com C §2501.

Identifying the goods after the buyer's default enables the seller to resell them and hold the buyer liable for damages determined by the resale. See Official Comment 1 to UCC §2-704. If the seller cannot resell the goods, or if the circumstances reasonably indicate that any effort to resell would be unavailing, the seller can hold the buyer liable for the contract price. Com C §2709(1)(b).

Identification is usually pursued as a seller's remedy, but it is also a necessary prerequisite to a buyer's recovery of goods from an insolvent seller (Com C §2502; see §§17.75-17.79) and to a buyer's exercise of the right of replevin (Com C §2716; see §18.46).

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§17.33 b. What Constitutes Identification?

Unless the contract explicitly provides for a distinct means of identification, identification occurs as follows:

- If the goods are already in existence, identification takes place when the contract is made. Com C §2501(1)(a).
- If the goods are not yet in existence when the contract is made, identification takes place when the goods are shipped, marked, or otherwise designated by the seller as goods to which the contract refers. Com C §2501(1)(b).

Special rules apply if the goods are unborn animals or future crops. See Com C §2501(1)(c).

For further discussion of identification, see §§8.28-8.29.

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§17.34 c. Grounds

The seller can identify goods to the contract in response to the buyer's wrongful rejection or revocation of acceptance, failure to make a payment due on or before delivery, or repudiation of all or part of the contract. Com C §§2703-2704. In an installment contract, the power to identify may extend to all or only part of the goods, depending on whether the breach is of the whole contract. Com C §§2612, 2703.

The goods identified by the seller must be in its possession or control when the seller learns of the breach. If the goods have not already been identified, they must conform to the contract.

When raw materials are involved, the right of identification applies only to materials that are the property of the aggrieved seller. Unlike a possessory lien, the remedy provided by Com C §2704 does not authorize the seller to identify and appropriate to itself material furnished by the buyer on which no work was performed. *Morton Regent Enters. v Leadtec Cal., Inc*. (1977) 74 CA3d 842, 141 CR 706.

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§17.35 d. Unfinished Goods

A seller who must react to a buyer's breach or repudiation when the goods are not yet finished faces a dilemma. Finishing the goods increases the seller's investment in them. Completion also enhances the value of the goods and may be the only opportunity for making them salable for anything other than scrap.

The Commercial Code gives the seller a variety of choices, placing the risk of a reasonable error on the buyer in breach:

- The seller can simply resell those unfinished goods that "have demonstrably been intended for the particular contract." Com C §2704(1)(b). If the seller does sell the goods in an unfinished state, the costs of manufacture that the seller saves are deducted from its damages. Com C §2706(1).
- The seller may instead choose to finish the goods, if it does so "in the exercise of reasonable commercial judgment for the purposes of avoiding loss and of effective realization." Com C §2704(2). Even if the seller is wrong and finishing the goods results in greater damages, the buyer can avoid liability for the increased costs only if it shows that the seller's judgment was unreasonable. Official Comment 2 to UCC §2-704. The "reasonableness" of the seller's judgment is tested in light of facts apparent to the seller at the time it learned of the buyer's breach. Official Comment 2 to UCC §2-704.
- The seller may cease manufacture and resell the unfinished goods for scrap or "proceed in any other reasonable manner." Com C §2704(2).
- A seller that cannot resell the unfinished goods at a reasonable price may sue for the price. See Com C §2709(1)(b).

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§17.36 e. Goods Being Procured

The identification rights of the seller that is procuring goods are not clearly stated by Com C §2704. It is reasonable to suppose that the purchase of component parts is encompassed by the term "manufacture," which permits the seller not only to make, but also to buy any pieces of a product that the seller is permitted to complete. More difficult problems arise if the seller is procuring the very goods that it is selling to the buyer. The seller may or may not be contractually bound to its supplier. If the seller is bound, those goods may or may not be in a finished state.

If the seller has made no contractual commitments to its supplier, nothing in Com C §2704 permits it to buy goods and then identify them to the contract. If the seller has contracted for existing, conforming goods, it makes sense to treat them as being within its control within the meaning of Com C §2704(1)(a) and therefore subject to identification. If the goods are not finished, however, Com C §2704(1)(a) may not allow identification, if the goods are not "conforming" goods.

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§17.37 f. Seller's Security Interest

If identified goods are shipped under a negotiable bill of lading, the seller reserves a security interest in the goods. The buyer must receive and surrender the bill before it can obtain possession. Thus, the buyer must pay the seller first. Com C §2505(1)(a). The seller's security interest is restricted to securing payment or performance by the buyer. Official Comment 1 to UCC §2-505.

If identified goods are shipped under a nonnegotiable bill of lading naming the seller as consignee, the seller reserves possession of the goods as security and they will not be delivered until the seller so directs. Com C §2505(1)(b). If the buyer is named as consignee, however, the seller has no security interest even though it retains the bill of lading. Com C §2505(1)(b).

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7. Reselling Goods

§17.38 a. Grounds and Purpose

The seller may resell the goods when the buyer (1) repudiates the agreement in whole or in part, (2) fails to make a payment due on or before delivery, (3) wrongfully rejects the goods, or (4) wrongfully revokes its prior acceptance. Com C §2703.

In an installment contract, the right to resell applies only to those goods directly affected by the buyer's breach. The right to resell applies to all the goods covered by the contract only if the breach is of the whole contract. Com C §2612.

A seller that follows the detailed rules of Com C §2706 in reselling the goods will fix its damages, removing from future litigation the issue of market price, which is the basis for measuring damages in the absence of an authorized resale. Com C §2708.

Resale is particularly useful if a market price for the goods is difficult to establish because of fluctuations or lack of any demand for the goods. Some of the difficulties of proving market price are discussed in §18.61.

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§17.39 b. Public or Private Resale?

Although Com C §2706 places some specific restrictions on the manner of resale, "good faith" and "commercial reasonableness" are the standards by which a resale is evaluated. To the unwary seller, failure to observe those standards can mean the difference between substantial recovery and no recovery.

Good faith is defined as "… honesty in fact and the observance of reasonable commercial standards of fair dealing." Com C §1201(b)(20). To the aggrieved merchant-seller, therefore, a good faith resale is one that is in accord with the commercial practices and is objectively honest.

In many instances, sellers may choose between a private and a public sale. The detailed rules for both types of sales are set forth in Com C §2706. The sale must be public if the buyer wishes to buy the goods. Com C §2706(4)(d). The sale also must be public if the goods were purchased primarily for personal, family, or household purposes under a "retail installment contract" (see CC §1802.1-1802.6) and the seller has repossessed them. CC §§1812.2-1812.5.

The sales agreement may indicate both the type of sale that the seller should use and the manner in which it should be conducted. See form 17.40-1 for an example of contract language that may be used. In addition, Official Comment 4 to UCC §2-706 directs that "[i]n choosing between a public and private sale, the character of the goods must be considered and relevant trade practices and usages must be observed."

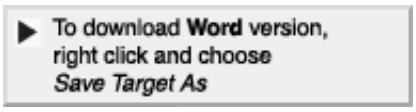
The general requirement that the resale must be conducted in good faith and in a commercially reasonable manner may obligate the seller to choose the type of resale that is most likely to bring the highest price. If there is no market for the goods, a reasonable resale price may in fact be the price of unusable scrap. See *Koppers Co. v Brunswick Corp*. (Pa 1973) 303 A2d 32.

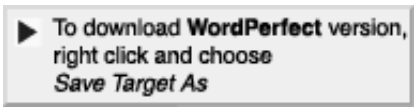
If the seller acts in a manner that prevents a resale at a fair price (*e.g.,* advertises an incorrect date, location, or price, or fails to set a fair minimum price), the sale may not be commercially reasonable. Good faith and commercially reasonable manner are questions of fact that pertain to the difference between the resale price of the goods and the contract price, as well as "every aspect of the sale including the method, manner, time, place and terms." Com C §2706(2); *Coast Trading Co. v Cudahy Co*. (9th Cir 1979) 592 F2d 1074; *Columbia Nitrogen Corp. v Royster Co*. (4th Cir 1971) 451 F2d 3.

PRACTICE TIP: Failure to comply with the requirements of Com C §2706 will prevent recovery of resale damages as a remedy, but, if the sale is otherwise commercially reasonable, the resale still might serve as evidence of market price for purposes of recovering contract damages. See *Sprague v Sumitomo Forestry Co.* (Wash 1985) 709 P2d 1200 (seller failed to give buyer proper notice of resale, but court allowed resale price as evidence of market value, because five separate sales were conducted over one-year period, with resale price remaining at same level).

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§17.40 c. Form: Contract Language Governing Resale





17.40-1 Contractual provision for resale of goods

The seller and buyer agree that, whenever the seller is permitted to resell goods under applicable law, it may do so by either private or public sale. The buyer agrees that _ _[*address*]_ _ is a reasonable place for public sale (but not the only reasonable place), if the seller chooses to use it.

Comment: The parties may agree to any number of variations from the statutory scheme or the one suggested here. For example, they can specify the form or timing of the notice of sale. On contractual modifications of remedies generally, see Com C §2719. See also §§18.53-18.57.

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§17.41 d. Private Sale Procedure

The buyer is given a measure of protection against possible abuse of the sale procedure by the seller under Com C §2706(3). It requires that the seller give the buyer reasonable notification of its intention to resell. The amount of advance notification, however, depends on the urgency of the matter. Notification of the time and place of a sale that must be conducted immediately is not required when the goods are perishable or threaten to decline speedily in value. Official Comment 8 to UCC §2-706.

The statute speaks in terms of the seller "giving" notice rather than the buyer "receiving" it. A person "gives" notice to another by taking steps that are reasonably required to inform the other in the ordinary course whether or not the other actually comes to know of the notice. Com C §1202(d). Any reasonable steps to ensure receipt (*e.g.,* certified mail) should meet the notice requirement even if the buyer never actually receives it. See, *e.g., Steelman v Associates Discount Corp*. (Ga 1970) 175 SE2d 62.

In addition to the requirement that the notice indicate that the seller intends to sell the goods, the only other formal requirement is that the resale be "reasonably identified as referring to the broken contract." Com C §2706(2). For a form of notice, see form 17.42-1.

The timing of a private sale depends on the nature of the goods and market and the acts of the buyer. A falling market (possibly the true reason for a buyer's repudiation) or the perishability of the goods dictates the need for a prompt resale. A buyer that repudiated because of claimed deficiencies in the goods may demand a postrejection inspection that will prevent the seller from going forward with the sale immediately. Official Comment 5 to UCC §2-706.

Almost any sale arrangement is permitted under Com C §2706(1). A sale may be conducted by direct negotiations with prospective purchasers or through brokers. If a broker is employed, the charges incurred constitute incidental damages that the seller can collect under the authority of Com C §§2706(1) and 2710. See *Nobs Chem., U.S.A. v Koppers Co*. (5th Cir 1980) 616 F2d 212, citing *Lee Oldsmobile, Inc. v Kaiden* (Md Ct Spec App 1976) 363 A2d 270, and *Bache & Co. v International Controls Corp*. (SD NY 1972) 339 F Supp 341, aff'd without opinion (2d Cir 1972) 469 F2d 696. The seller may enter into a futures contract if the goods are not yet in existence (forbidden in a public sale except in a recognized futures market; see Com C §2706(4)(a)), or the seller may sell unfinished goods, either in their unfinished condition or after completing their manufacture (Com C §2704).

A resale may be on credit rather than cash terms. The seller's deficiency is fixed by a resale on credit; consequently, the seller assumes the risk of any default by the second buyer. *Elster's Sales v El Bodrero Hotel, Inc.* (1967) 250 CA2d 258, 58 CR 492.

The seller may sell the goods in lots at any place on any terms and may make almost any other arrangement, assuming the seller acts in a commercially reasonable manner and gives proper notice. Com C §2706.

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§17.42 e. Form: Notice to Buyer of Private Resale of Goods

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17.42-1 Notice to buyer of private resale of goods

The seller intends to resell privately the _ _[*describe goods*]_ _ sold to you under _ _[*identify contract*]_ _.

Comment: No particular notification form is required, nor is notice even required to be in writing, but an easily provable notice is useful in litigation. Notice of the time or place of the sale is not required. Official Comment 8 to UCC §2-706. How much advance notice the buyer must receive depends on the circumstances. If the seller must act quickly because the goods are perishable or threaten to decline in value speedily, a shorter period of notice is acceptable. See Official Comment 8 to UCC §2-706.

One function served by notification in anticipatory repudiation situations (see §§16.21-16.34) is to remind the buyer of the opportunity of retraction before the seller materially changes positions. Com C §2611.

If the subject of the sale is a motor vehicle that was purchased primarily for personal or family purposes, the repossessing seller is required to give at least a 15 day written notice "to all persons liable on the contract" of the intent to sell the vehicle. CC §2983.2. Additionally, any cosigner of the motor vehicle credit agreement must be served with a written notice of delinquency before the vehicle is repossessed. CC §2983.35. Additional notice requirements are set forth in CC §§2983.2 and 2983.35.

In *Bank of America v Lallana* (1998) 19 C4th 203, 77 CR2d 910, the California Supreme Court held that a secured creditor who sells a repossessed vehicle must comply not only with the notice provisions of the Rees-Levering Motor Vehicle Sales and Finance Act (CC §§2981-2984.6), but also with the notice requirements of the Commercial Code. In that case, the creditor gave the debtor the notice required for a private sale, but then advertised a public auction of the vehicle and failed to tell the debtor where or when the auction would occur. Because the creditor's notice did not meet the requirements for a public sale notice under former Com C §9504, the creditor could not recover the deficiency from the debtor.

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§17.43 f. Public Sale Procedure

The simplicity and cost-effectiveness of a private sale are compelling; however, one of the principal reasons public sales are performed is to maximize the seller's opportunity of establishing a commercially reasonable sale, particularly with regard to price.

The rules governing public sales are as follows:

- **Only identified goods may be sold.** Com C §2706(4)(a). This rule does not apply, however, if there is an established futures market in goods of the kind. The exception for commodities is set forth in Com C §2706(4)(a). The seller also has a right to either cease or complete manufacture of the goods under certain circumstances. See Com C §2704(2); §17.35.
- **The sale must be conducted "at a usual place or market for public sale if one is reasonably available."** Com C §2706(4)(b); Official Comment 9 to UCC §2-706 (Official Comment 8 to UCC §2-706 (2003)). This requirement is easy to comply with if established auction places exist (although "reasonably available" can refer to time as well as place). An example of such an auction place is the "sales barn" for livestock and machinery in farming areas. Some trades have established public sales that are conducted at scheduled intervals (*e.g.,* the tobacco and used automobile industries). In other trades or with unusual goods, the seller may be required to seek out some kind of public sale likely to attract buyers interested in the goods. See Official Comment 9 to UCC §2-706. The goods may be so unusual (*e.g.,* jumbo frankfurter-making machinery) that a public sale may be commercially unreasonable. See Official Comment 4 to UCC §2-706. The more unusual the goods, the more the seller should advertise their sale. Sometimes trade journals are the only commercially reasonable advertising medium.
- **The seller must give the buyer reasonable notice of the time and place of resale (unless the goods are perishable or threaten to decline speedily in value).** Com C §2706(4)(b); Official Comment 8 to UCC §2-706. The seller's emphasis should be on advising the buyer of the resale, rather than focusing on a particular form of notice. The seller should advise the buyer immediately, even informally, of a public resale to demonstrate fairness and to preclude a challenge over the reasonableness of the notice. Formal notice may be given after the informal notice. For an example of a notice form, see form 17.44-1.
- **The goods must be within the view of those attending the sale, or the notification of sale must state the location of the goods and provide for reasonable inspection.** Com C §2706(4)(c); Official Comment 9 to UCC §2-706 (Official Comment 8 to UCC §2-706 (2003)). This provision specifies that the notification of sale must provide prospective bidders with the opportunity for a reasonable inspection of the goods. Because many sales do not fit the simple model contemplated by this statute, courts are likely to allow the seller flexibility in meeting this requirement if the sale seems otherwise "commercially reasonable." For example, if the goods are perishable and standardized (*e.g.,* a particular grade of tomatoes), there may be neither the time nor the need for presale inspection or viewing. For a form of sale announcement, see form 17.45-1. Similar sale announcements appear frequently in newspapers.
- **The seller may buy the goods.** Com C §2706(4)(d). In the context of an auction sale, the seller must indicate to other bidders that it may participate in the bidding or the buyer may exercise the option to avoid the sale or take the goods at the price of the last good faith bid. Com C §2328(4). It is not clear whether this requirement was intended to apply to nonauction sales under Com C §2706(4)(d).
- **Failure of the seller to comply with the statutory requirements for a resale does not impair the rights of a good faith purchaser.** Com C §2706(5).
- **If the seller can resell the goods at a profit, the seller is not accountable to the buyer for that profit.** Com C §2706(6); Official Comment 11 to UCC §2-706 (Official Comment 10 to UCC §2-706 (2003)). A person in the position of a seller or a buyer with a security interest who resells the goods, however, must account for proceeds in excess of its security interest. Com C §2706(6). On the buyer's right to restitution of amounts that it has already paid on the price, see §§18.48-18.49.

If the goods were originally purchased primarily for personal, family, or household purposes under a "retail installment contract" (see CC §1802.6) and thereafter repossessed by the seller, special sale procedures are prescribed by statute. See CC §§1812.2-1812.5.

For a discussion of the difference between a "private" and "public" sale, see *Bank of America v Lallana* (1998) 19 C4th 203, 77 CR2d 910.

In *Clark v EZN, Inc.* (1997) 57 CA4th 852, 67 CR2d 403, a secured party that complied with the notice requirements of former Com C §9504(2) but failed to conduct a commercially reasonable sale was nevertheless entitled to a deficiency judgment against the debtor. The subject of the sale was a folding ramp for loading goods onto trucks. After the debtor had defaulted on its loan, the secured party obtained possession of the ramps and sold 255 of them in the ordinary course of its business for $450 each. The secured party then conducted an unadvertised auction of the remaining ramps, at which it was the sole bidder, purchasing the ramps for $25 each. Although the court found that the sale was not commercially reasonable because it had not been advertised, it awarded a deficiency judgment to the secured party based on the court's implied finding that the ramps could have sold for $150 each.

For further discussion of "commercial reasonableness," see §17.74.

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§17.44 g. Form: Notice to Buyer of Public Resale of Goods

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17.44-1 Notice to buyer of public resale of goods

We intend to sell the _ _[*describe goods*]_ _ sold to you under _ _[*identify contract*]_ _ on _ _[*date*]_ _, at _ _[*time*]_ _, at _ _[*address*]_ _ in a public sale. In addition to our rights with respect to the sale, we reserve all other rights and remedies we may have under the California Commercial Code or otherwise.

Comment: The notice need not be in any particular form. It may be oral, but a written notice is recommended for evidentiary purposes. A letter identifying the contract, with an attached copy of the public announcement of sale, is a convenient form of notice. See form 17.45-1. The seller is not required to give the buyer reasonable notice of the time and place of resale if the goods are perishable or threaten to decline in value quickly. See Com C §2706(4)(b).

If the subject of the sale is a motor vehicle that was purchased primarily for personal or family purposes, the repossessing seller is required to give at least a 15-day written notice of its intent to sell the vehicle to "all persons liable on the contract." CC §2983.2(a). See CC §2983.2(a)-(d) for additional notice requirements.

If the subject of the sale is goods purchased primarily for personal, family, or household purposes under a "retail installment contract" (see CC §1802.6), the seller is required to give written notice of its intent to sell the goods at public sale within ten days after repossession. The sale must be held no fewer than ten days after the seller gives notice. CC §1812.2. See CC §§1812.2-1812.3 for additional notice requirements.

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§17.45 h. Form: Announcement of Public Sale of Goods

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17.45-1 Announcement of public sale of goods

On _ _[*date*]_ _**, at** _ _[*time*]_ _**, at** _ _[*address*]_ _**,** _ _[*name of seller*]_ _ **will sell** _ _[*describe goods*]_ _ **at public auction. The seller may bid on the goods.**

The goods may be inspected at _ _[*address*]_ _**, on** _ _[*date*]_ _**, at** _ _[*time*]_ _**.**

[*Add if appropriate*]

If you wish to make other arrangements for inspection, please contact _ _[*name of* _ _[*seller/seller's agent*]_ _]_ _ **on or before** _ _[*date*]_ _**.**

Comment: This announcement gives only the essentials. The seller's merchandising method will dictate how the goods are described and the actual form of the announcement. The time for inspection may be at the sale, immediately before the sale, or on weekdays before the sale. The statement that a prospective buyer may contact the seller or its agent to arrange an independent inspection is suggested for commercial reasonableness, but it is not required by the Commercial Code. The statement that the seller may bid at the sale will preclude the buyer from exercising the rights delineated in Com C §2328(4).

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§17.46 i. Sales to Affiliates

Sales to affiliates are not prohibited by the Commercial Code if they are otherwise conducted in good faith and in a commercially reasonable manner. *Allied Grape Growers v Bronco Wine Co*. (1988) 203 CA3d 432, 249 CR 872.

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§17.47 j. Leasing

A seller who is a secured party may apply the proceeds of the sale to the costs of leasing the goods, in addition to its acknowledged right to apply the proceeds to the costs of sale. See Com C §9608(a)(1).

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8. Canceling the Contract

§17.48 a. Grounds and Effect

A seller may exercise several remedies under Com C §2703, including canceling a contract in whole or part, when a buyer wrongfully rejects or revokes acceptance, fails to make a payment due on or before delivery, or repudiates with respect to a part or a whole of the contract. Com C §2703(f). The Commercial Code generally favors the cumulation of remedies as opposed to the election of remedies. Once a party's rights have accrued, they are not to be lightly impaired unless the cancellation of a contract expressly declares that it is "without reservation of rights." Official Comment to UCC §2-720. Consequently, unless the intention is clear, expressions of cancellation or rescission of the contract will not be construed as a renunciation or discharge of any claim in damages for an antecedent breach. Com C §2720.

Breaches of installment contracts permit the seller to cancel the entire contract only when they substantially impair the value of the whole contract. See Com C §2612(3).

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§17.49 b. Limitations on Right to Cancel

A seller's right to cancel is limited to situations when the buyer wrongfully rejects or revokes acceptance of goods, fails to make a payment due on or before delivery, or repudiates the contract. Com C §2703. The seller's right to cancel may be broadened by contractual provisions. Com C §2719(1)(a).

Insolvency is not a specified ground for cancellation, although the buyer's insolvency may give the seller specific rights, *e.g.,* the right to refuse delivery except for cash. See Com C §2702. A buyer's insolvency would, however, give the seller reasonable grounds for demanding adequate assurance of performance. Com C §2609. If the buyer fails to give that assurance, the seller may treat the failure as a repudiation and cancel the contract. Com C §2609(4).

A buyer who has repudiated may retract the repudiation if the seller has not materially changed positions, canceled the agreement, or otherwise indicated that it considers the repudiation to be final. Once the buyer retracts the repudiation, the rights under the contract are reinstated. The seller is given an excuse and allowance for any delay occasioned by the repudiation. The seller may require assurance of performance as a condition of the buyer's retracting the repudiation. Com C §§2609, 2611(2).

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Source: Business Law/California UCC Sales and Leases/17 Prelitigation Remedies/§17.50 c. Form: Notice of Cancellation of Contract

§17.50 c. Form: Notice of Cancellation of Contract

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17.50-1 Notice of cancellation of contract

We hereby cancel our contract with you, _ _[*describe contract*]_ _, effective _ _[*date*]_ _.

[*Add if appropriate*]

Our cancellation is based on _ _[*e.g., your wrongful rejection of goods we shipped to you on _ _[date*]_ _]_ _.

[*Continue*]

Our cancellation is made with full reservation of any other rights or remedies we may have under the California Commercial Code or otherwise.

Comment: The Commercial Code furnishes no procedure for cancellation, but Com C §2612(3) implies that in the case of installment contracts there must be "seasonable" notification. Com C §1205(b). The cancellation notice, if any, need not be in a particular form. The grounds for cancellation need not be itemized. Full disclosure of the reasons for cancellation, however, may lead to a more prompt resolution of the parties' dispute.

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V. BUYER'S REMEDIES

§17.51 A. Selection of Responses

An aggrieved buyer's general prelitigation approach should be to (1) reject and return nonconforming goods to the seller, (2) reasonably dispose of any nonconforming goods in its possession, or (3) procure the type of goods contracted for, or a reasonable substitute, from another seller.

The buyer's attorney should consider the factors discussed in §17.2 to determine which combination of the prelitigation remedies set forth in the Commercial Code are appropriate for the buyer. The buyer should consider the litigation remedies described in chap 18 if no prelitigation remedies appear suitable under the circumstances.

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§17.52 B. Summary of Buyer's Remedies

The buyer's remedies are triggered by actions by the seller that constitute a breach or a default:

- **The seller repudiates or fails to deliver.** Typically the buyer's first decision is to cover (purchase substitute goods) if possible. See §§17.67-17.69. The buyer may or may not want to cancel. See §§17.84-17.86. If the buyer owes the seller money under the contract, the buyer will probably want to deduct damages from the price. See §§17.80-17.83. For discussion of replevin and specific performance, see §§18.46-18.47.
- **The seller delivers conforming goods in a nonconforming manner.** If the goods are late or there is a shortage or overage, the buyer may take advantage of the so-called "perfect tender" rule. (The seller's obligation is to make a "perfect tender"; the buyer may reject if "the goods or the tender of delivery fail *in any respect* to conform to the contract." Com C §2601 (emphasis added). See §17.55 for a list of significant limitations on the perfect tender rule. See also Com C §2503.) The buyer may reject the goods (see §§10.35-10.47, 17.53-17.60) or, if there is a shortage, revoke acceptance of the goods received. See §§10.32-10.34, 17.61-17.66. If the buyer rejects or revokes acceptance, the seller may cover, cancel the contract, and deduct its damages from any part of the price due. If and when the goods arrive, the buyer has an enforceable security interest in the goods. See §§10.45, 17.71-17.74. The buyer may have duties that require their preservation and safekeeping when the buyer is in possession of nonaccepted goods. See §§10.46-10.47, 17.60.
- **The seller delivers nonconforming goods or breaches a warranty.** If the buyer discovers a nonconformity before accepting the goods, the buyer may reject them. If the nonconformity is not discovered until after the buyer accepts the goods, the buyer may be able to revoke the acceptance under limited circumstances. Com C §§2607-2608. See §§10.32-10.34, 17.61-17.66. To obtain proper goods, the buyer can cover, cancel the contract, deduct its damages from amounts owed on the price, and enforce its security interest by selling the goods. If the goods are nonconforming only in part, the buyer may accept the goods that are in conformance and exercise its remedies for the balance of the goods.
- **The seller becomes insolvent.** A seller's insolvency is of greatest importance to a buyer when the buyer has partially or fully paid for goods that are still in the possession or control of the seller. In limited circumstances, the buyer can claim the goods. See §§17.75-17.79. Alternatively, the buyer may cancel the contract and cover by buying the goods elsewhere. The importance of cover as a method of fixing damages is diminished if there are limited assets in an insolvent seller's estate.
- **The seller commits fraud.** The seller's misrepresentation or fraud entitles the buyer to both common law and Commercial Code remedies. See Com C §2721. Consequently, the measure of damages stated in CC §3343 for fraud cases may be liberalized by Com C §2721. Comment to Com C §2721; Official Comment to UCC §2-721.

The attorney should keep in mind that if the parties are operating under an installment contract, the ongoing relationship between them limits the scope of the buyer's remedies to those goods directly affected, unless the breach is of the "whole contract." Com C §2612.

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C. Remedies Available

§17.53 1. Rejecting Goods

Typically, if the buyer discovers before acceptance that either the goods or their tender by the seller are nonconforming, the buyer will want to reject them. Rejection does not limit the remedies that are available to the buyer for the seller's breach of the contract. Although the buyer may accept a nonconforming tender and still exercise appropriate remedies, rejection is generally to the buyer's advantage. See chap 10 for additional discussion of the buyer's right of rejection.

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§17.54 a. Perfect Tender Rule

The buyer has the right to reject whenever the goods or their tender of delivery fails *in any respect* to conform to the contract. Com C §2601. The so-called perfect tender rule has been a matter of some controversy because of the perceived potential for abuse by the buyer. See Lawrence, *The Prematurely Reported Demise of the Perfect Tender Rule*, 35 U Kan L Rev 557 (1987); Schmitt & Frisch, *The Perfect Tender Rule—An Acceptable Interpretation*, 13 U Tol L Rev 1375 (1982). One image that is frequently invoked is the buyer who rejects goods because of a trivial nonconformity in order to take advantage of a rapid falling market price. Such a rejection, however, may be in bad faith. See *Neumiller Farms v Cornett* (Ala 1979) 368 So2d 272.

PRACTICE TIP: The Commercial Code speaks of conformity to the contract and not "perfect tender." Com C §2601. Thus, there may be more latitude for establishing conformity than may appear at first glance, and several sections of the Commercial Code may expressly limit the harshness of the perfect tender rule. See, *e.g.,* Com C §2508 (seller may cure nonconforming tender) and Com C §2612 (effect of Com C §2601 limited with respect to installment contracts). In practice, the application of the perfect tender rule may be substantially limited.

The perfect tender rule has been rejected in international sales. See Article 46(2) of the United Nations Convention on Contracts for the International Sale of Goods (CISG), (sometimes referred to as the Vienna Sales Convention; see 15 USC App).

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§17.55 b. Limitations

The buyer's right of rejection is limited by the following considerations:

Wrongful versus ineffective rejection. There is a distinct difference between a wrongful rejection (one that is improper under Com C §2601) and an ineffective rejection (one that is procedurally defective under the requirements of Com C §2602). A buyer who makes an ineffective rejection is considered to have accepted the goods. See *In re Amica, Inc.* (Bankr ND Ill 1992) 135 BR 534 (buyer's marketing of shipments it received was inconsistent with its articulated rejection; buyer thus considered to have accepted goods). Conversely, a wrongful rejection by the buyer is a breach that entitles the seller to exercise the remedies specified in Com C §2703. See §§18.2-18.19.

Installment contract restrictions. If the nonconformity affects only the delivered installment of an installment contract, the buyer may reject only if (1) the documents are defective, or (2) the nonconformity substantially impairs the value of that installment and cannot be cured. Com C §2612(2). A defect in documents refers to such matters as the absence of insurance documents under a C.I.F. (cost, insurance, and freight) contract or an improper bill of lading (*e.g.,* one that fails to show shipment within the contract period or to the contract destination).

Substantial impairment of the value of an installment may relate to the quality of the goods and to matters such as time, quantity, and assortment. Substantial impairment must be measured in terms of the normal or specifically known purposes of the contract. The parties may stipulate in the contract what they will consider to be a substantial impairment of the value that they regard as impossible to cure. The provision must have some basis in reason, however, and must avoid imposing hardship by surprise. It is also subject to waiver or displacement by practical construction. Official Comment 4 to UCC §2-612.

The buyer's right to reject future deliveries under an installment contract is limited to situations in which the nonconformity of a particular installment "substantially impairs" the value of the whole contract. Com C §2612. The buyer's right to reject may also be limited in this situation by the parties' agreement. Com C §§2718-2719.

Seller's right to cure. If the time for the seller's performance under the agreement has not yet expired, the seller may seasonably notify the buyer of its intention to cure and may then make a conforming delivery within the contract time. Com C §2508(1). When the buyer rejects a nonconforming tender that the seller had reasonable grounds to believe would be acceptable, the seller may have a further reasonable time to substitute a conforming tender if the seller seasonably (Com C §1205(b)) notifies the buyer of its intention. Com C §2508(2). See also Com C §2614 regarding the seller's right to perform by substitute means if the agreed manner of delivery becomes impracticable.

"Material delay or loss" limitation. If the seller is required or authorized to send the goods to the buyer *and* the contract does not require delivery at a particular destination, the seller must (Com C §2504):

- Put the goods in the possession of a carrier and make a reasonable contract for their shipment, having regard for the nature of the goods and other circumstances relevant to shipment;
- Obtain and promptly tender in due form any document necessary to enable the buyer to obtain possession of the goods, or otherwise required by the agreement or by usage of trade; and
- Promptly notify the buyer of the shipment.

The seller's failure to comply with these requirements (with the exception of the tender of a document) is grounds for the buyer's rejection of the goods *only* if material delay or loss ensues. Com C §2504.

Buyer's duty to inspect. At the risk of losing its right to reject, the buyer may have a duty to inspect the goods to identify any defect that an inspection may uncover. *Lockheed Electronics Co. v Keronix, Inc*. (1981) 114 CA3d 304, 170 CR 591.

Federal agricultural products limitations. For federal limitations relating to the rejection of perishable agricultural commodities, see 7 USC §§499a-499s.

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§17.56 c. Effect

Following proper rejection, the buyer may cancel the contract (see §§17.84-17.86), recover any of the purchase price already paid (Com C §2711), cover (see §§17.67-17.69, 18.23-18.24), and recover damages for nondelivery (see §§18.20-18.24, 18.35-18.42). See generally Com C §§2711-2717. The buyer also acquires a security interest in the rejected goods in its possession or control to secure recovery of payments made and certain expenses. See §§10.45, 17.71-17.74.

Consequently, the buyer should retain control or possession of the goods (unless the nature or condition of the goods prevents this) to preserve the buyer's security interest during the time it takes to develop a strategy for dealing with the seller's default.

The buyer's failure to make an "effective" rejection is considered to be an acceptance (Com C §2606(1)(b)), which precludes rejection of accepted goods but does *not* impair other remedies (Com C §2607(2)).

Title to the goods revests in the seller on the buyer's rejection, whether or not the rejection was justified. Com C §2401(4).

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§17.57 d. Partial Acceptance

As an alternative to rejecting the whole delivery, the buyer may accept one or more commercial units and reject the rest without impairing any remedy otherwise available with respect to the rejected portion of the goods. Com C §2601(c). The buyer must act in good faith and with commercial reasonableness to "avoid undue impairment of the value of the remaining portion of the goods." Official Comment 1 to UCC §2-601.

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§17.58 e. Time and Manner of Rejection

The Commercial Code requires only that rejection of the goods be done within a reasonable time after their tender or delivery together with seasonable notification to the seller. Com C §2602(1). A reasonable time for rejection may be stipulated in the agreement, in which case the agreement term controls if it is reasonable within the meaning of Com C §1205(a).

What constitutes a "reasonable time" in a given situation depends on the parties' agreement, their prior course of dealing, the subject matter of the sale, usage of trade, and other relevant circumstances. See, *e.g., Koch Supplies v Farm Fresh Meats, Inc.* (5th Cir 1980) 630 F2d 282 (48 hours for rejection too short because of difficulties of discovery); *Miron v Yonkers Raceway, Inc.* (2d Cir 1968) 400 F2d 112 (shorter time for rejection of live animal than inanimate object); *Don's Marine, Inc. v Haldeman* (Tex Civ App 1977) 557 SW2d 826 (buyer had limited opportunity to test boat; 30 days not unreasonable delay in rejection).

In addition to rejecting the goods within a reasonable time, the buyer is required to give the seller "seasonable" notice of the rejection. Com C §2602(1). An action is taken "seasonably" when it is taken at or within the time agreed, or if no time is agreed, at or within a reasonable time. Com C §1205(b). Although rejection is made within a reasonable time after the delivery or tender of the goods, it is not effective unless the buyer also seasonably notifies the seller.

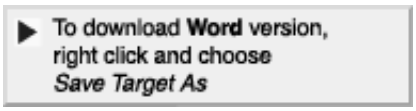
A buyer waives a defective tender under Com C §2605(1) if:

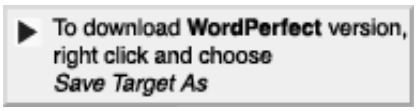
- The buyer fails to particularize the defect in the notice which is ascertainable by a reasonable inspection;
- The defect would be curable if stated seasonably;
- As between merchants, the buyer fails to comply with a seller's written request for a full and final statement of all defects on which the buyer proposes to rely.

The buyer's failure to comply with the above requirements precludes the buyer from relying on an unstated defect to justify rejection or to establish a breach. Com C §2605(1). See *Lockheed Electronics Co. v Keronix, Inc*. (1981) 114 CA3d 304, 170 CR 591.

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§17.59 f. Form: Notice of Rejection





17.59-1 Notice of rejection

This is to notify you that we reject the following goods tendered or delivered by you on _ _[*date*]_ _: _ _[*Describe goods*]_ _.

[*Add if required by Com C §2605 or sales contract*]

The inspection we have been able to make has disclosed the following nonconformities, on which we intend to rely in rejecting the goods: _ _[*List nonconformities*]_ _.

[*Add if appropriate*]

This is not to be construed as a full or final statement of defects. We reserve the right to reject the goods on other grounds. We also reserve all rights and remedies we may have under the California Commercial Code or otherwise.

[*Add if appropriate*]

[*Option 1: Seller to advise on disposition of goods*]

Please send instructions for disposition of the goods.

[*Option 2: Seller to retrieve goods*]

Please pick up the goods at _ _[*address*]_ _ by _ _[*date*]_ _.

Comment: No particular form of notice of rejection is required and it does not need to be in writing. Written notice should be given, however, to avoid evidentiary problems in any ensuing litigation. The buyer should state the grounds of rejection with particularity; otherwise it will be precluded from relying on defects that were not specified. Com C §2605.

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§17.60 g. Duties of Buyer With Respect to Rejected Goods

Certain obligations arise when the buyer rejects goods:

- If the buyer does not have a security interest in the goods (Com C §2711(3)), it has an obligation to hold the goods, with reasonable care, at the seller's disposition for a time sufficient to permit the seller to remove them. Com C §2602(2)(b). See §§10.45, 17.71-17.74.
- The merchant buyer has the additional duties with respect to goods in its possession or control: (1) to follow any reasonable instructions received from the seller with respect to the goods or, in the absence of such instructions, (2) to make reasonable efforts to sell the goods for the seller's account if they are perishable or threaten to decline speedily in value. Com C §2603(1). The seller's instructions to the buyer are not "reasonable" unless the seller, on demand, provides indemnity for the buyer's expenses. Com C §2603(1). If the buyer is required to sell the goods, the buyer is entitled to reimbursement for such expenses and to a commission. Com C §2603(2). For example, if a merchant buyer effectively rejects a shipment of perishable Christmas trees and the seller has no agent or place of business in the vicinity, the buyer must make reasonable efforts to sell the trees for the seller's account, in the absence of instructions from the seller. The buyer may recover the expenses in reselling the trees if the buyer incurs expenses, *e.g.,* rental site costs, wages for salespeople, and costs associated with caring for the trees. Com C §2603(2); *Traynor v Walters* (MD Pa 1972) 342 F Supp 455. The buyer (or merchant buyer) has no resale obligations if the goods are not perishable or will not quickly decline in value.
- If the seller does not give the buyer instructions within a reasonable time after rejection, the buyer may (1) store the goods for the seller's account, (2) reship them to the seller, or (3) resell them in accordance with Com C §2603. These options apply to merchants as well as other buyers, but they do not modify a merchant's duties with respect to perishable goods. Com C §2604.

In performing the above duties, the buyer is held to the standard of good faith conduct. If the buyer's duties are executed in good faith, it will not be considered to have accepted the goods, nor will it be subject to an action for conversion or for damages. Com C §2603(3). Otherwise, an acceptance may occur if the buyer uses the goods in a manner that is "inconsistent with the seller's ownership." Com C §2606(1)(c). If the only "use" of the goods after rejection is to remove them from the buyer's storage area in preparation for their removal by the seller, the rule that any use of the goods waives the buyer's right to reject is not applicable. *Maas v Scoboda* (Neb 1972) 195 NW2d 491. Furthermore, if the buyer's use of rejected goods is the direct result of oppressive conduct on the seller's part in not allowing the buyer to reject the goods when it attempted to do so at delivery, the buyer's continued use of the goods is not inconsistent with the seller's ownership under Com C §2602(2)(a). *Jones v Abriani* (Ind App 1976) 350 NE2d 635. The buyer must be capable of transferring an unencumbered title to the seller on the date on which the goods are returned. A buyer that encumbers title by obtaining a loan from a third party secured by a lien on the goods cannot recover damages relating to the rejection unless the lender releases its lien. See *Moeller Mfg. v Mattis* (Colo App 1974) 519 P2d 1218.

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Source: Business Law/California UCC Sales and Leases/17 Prelitigation Remedies/ 2. Revoking Acceptance/§17.61 a. What Constitutes Acceptance?

2. Revoking Acceptance

§17.61 a. What Constitutes Acceptance?

After a buyer has had a reasonable opportunity to inspect the goods, they are accepted under Com C §2606(1)(a)-(c) when the buyer:

- Fails to make an effective rejection;
- Signifies to the seller that the goods conform or that it will take them despite their nonconformity; or
- When it acts in any way that is "inconsistent" with the seller's ownership.

If the act is "wrongful as against the seller," the seller must ratify it before it will constitute an acceptance. Com C §2606(1)(c). The parties may expressly agree to additional acceptance terms. See Com C §2207(1).

Once it has accepted the goods, the buyer is necessarily precluded from exercising its right of rejection. After acceptance, the buyer may avoid the sale only by an effective revocation. See §§10.32-10.34, 17.61-17.66. Acceptance does not impair any remedy provided by the Commercial Code (other than rejection) when goods are nonconforming. Thus, acceptance of nonconforming goods does not preclude an action for breach, although the burden is on the buyer to establish any breach with respect to the goods accepted. Com C §2607(4). The buyer must notify the seller of any breach within a reasonable time after the breach is discovered or should have been discovered. Com C §2607(3)(A). The acceptance of a nonconforming installment does not affect the buyer's rights in connection with future installments. Official Comment 3 to UCC §2-607.

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§17.62 b. Effect of Revocation of Acceptance

A rightful and procedurally correct revocation of acceptance puts the buyer in the same position it would have occupied if it had rejected the goods. The revoking buyer has the same remedies and duties toward the goods as a rejecting buyer. Com C §2608(3).

On rightful revocation of acceptance, the buyer has a security interest in the goods in its possession or control for any payments made on their price and any expenses reasonably incurred in their inspection, receipt, transportation, care, and custody. The buyer is not required to return or offer to return the goods to the seller but may hold them for resale under terms and conditions similar to those governing an aggrieved seller's resale of goods. Com C §2711(3). See Com C §2706 regarding resale.

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Source: Business Law/California UCC Sales and Leases/17 Prelitigation Remedies/§17.63 c. Circumstances in Which Acceptance May Be Revoked

§17.63 c. Circumstances in Which Acceptance May Be Revoked

The circumstances in which the buyer may revoke acceptance are stated in Com C §§2607(2) and 2608(1). The buyer can revoke acceptance if the nonconformity substantially impairs the value of the goods, and the buyer has accepted the goods under the following circumstances:

- On the reasonable assumption that its nonconformity would be cured and it has not been seasonably cured; or
- Without discovery of the nonconformity, if acceptance was reasonably induced either by the difficulty of discovery before acceptance or by the seller's assurances.

The nonconformity must first substantially impair the value of the goods to the buyer. This standard is considerably more stringent than the standard for rejection. See Official Comment 2 to UCC §2-608.

In deciding whether a nonconformity in accepted goods "substantially impairs" their value to the buyer, courts consider (1) the extent to which the purposes to be served by the goods are frustrated by their defects, and (2) the likelihood that simple repairs could promptly and adequately remedy those defects. See, *e.g., McCormick v Ornstein* (Ariz App 1978) 580 P2d 1206 (substantial impairment found when trailer had major structural defects); *Stofman v Keenan Motors* (Pa Com Pl 1973) 14 UCC Rep Serv 1252 (seller repeatedly but unsuccessfully attempted to cure by repairs); Garland, *Determining Whether a Nonconformity Substantially Impairs the Value of Goods: Some Guidelines*, 26 UCC LJ 129 (Fall 1993).

Although individual defects may not be substantial, their cumulative effect may substantially impair the goods' value to the buyer. *Murray v Holiday Rambler, Inc*. (Wis 1978) 265 NW2d 513.

If there is substantial impairment, the buyer can revoke acceptance in two situations:

Buyer's ignorance of nonconformity due to difficulty of discovery or assurances by seller. Ignorance of a nonconformity at the time of acceptance is no defense unless it is caused by the difficulty of discovery or by the seller's assurances. The buyer has a right to inspect the goods before acceptance. Com C §2513. If a reasonable inspection would have uncovered the nonconformity, the buyer cannot revoke its mistaken acceptance.

In some situations, discovery may be excusably delayed by the latent nature of the defect. For example, a buyer who purchased tulip bulbs initially examined them and found them to be acceptable. The buyer later discovered that the bulbs did not flower properly and revoked its acceptance. *Q. Vandenberg & Sons, N.V. v Siter* (Pa 1964) 204 A2d 494.

If the seller induced the buyer to accept the goods without a proper inspection, it is reasonable to permit the buyer to revoke acceptance once it discovers the goods are not acceptable. For example, if the buyer contacted the seller at the time of shipment to confirm that certain modifications in the goods had been made and the seller falsely assured the buyer that the goods had been modified, the buyer may revoke acceptance when the truth is discovered. Com C §2608(1)(b).

Buyer's reasonable assumption that nonconformity would be cured. The buyer may revoke acceptance if it accepted the goods knowing of their nonconformity, but it reasonably assumed that the seller would seasonably cure the nonconformity. Com C §§2607(2), 2608(1)(a). See *Don's Marine, Inc. v Haldeman* (Tex Civ App 1977) 557 SW2d 826. "Seasonably" means within an agreed time or, if no time for cure is specified, within a reasonable time. Com C §1205(b). This assumption by the buyer could come from previous dealings between the parties, from the buyer's knowledge of the seller's reputation, from usage of trade (Com C §1303), or from a contractual provision.

If the seller gave the buyer assurances knowing that its assurances were false, revocation of acceptance is justified on the grounds of mistake or fraud. Unless otherwise displaced, principles of law and equity may be used to supplement the Commercial Code's remedial provisions. Com C §1103(b).

The buyer cannot revoke acceptance if the goods change substantially in condition while in the buyer's possession, unless the change is inherent in or caused by defects in the goods (*e.g.,* rotting). Com C §2608(2). Use may "substantially change" the condition of the goods, in which case the buyer may waive its right to revoke. *Calvert Knit Corp. v Glendale Textiles* (NY App Div 1987) 3 UCC Rep Serv 2d 585.

NOTE: The replacement/restitution remedy under the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8)

requires only that the defect or defects of a motor vehicle be covered by an express warranty and that there be a failure to repair after a reasonable number of attempts (CC §1793.2(d)). Revocation of acceptance, however, requires more and different actions by the buyer. *Gavaldon v DaimlerChrysler Corp.* (2004) 32 C4th 1246, 1264, 13 CR3d 793. Revocation of acceptance must be done before any substantial change in condition of the goods (Com C §2608(2)); CC §1793.2(d) does not have that requirement. Therefore, a conclusion that a buyer is entitled to a remedy under CC §1793.2(d) does not necessarily mean that he or she is entitled to revoke acceptance of the goods purchased and obtain the corresponding damages remedy. 32 C4th at 1264.

If the buyer discovers a defect when it begins using the goods in production, it may not revoke acceptance of goods that it has already transformed. It may, however, revoke acceptance of commercial units of the remaining goods. Com C §2608(1)-(2). The commercial unit limitation is designed to protect the seller from the buyer's return of less than a commercial unit. See *S & R Metals, Inc. v C. Itoh & Co. (Am.)* (9th Cir 1988) 859 F2d 814.

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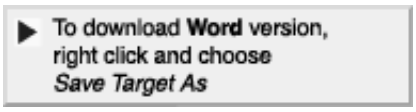
§17.64 d. Time and Manner of Revocation

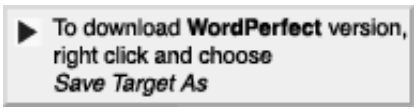
A revocation is not effective until the buyer notifies the seller. Com C §2608(2). The notice must be given within a reasonable time after the buyer actually discovers, or should have discovered, the grounds for revocation. *Albert v Thomas* (D Vt 1986) 643 F Supp 1406. The time for notification may be extended by negotiations or may be specified by the parties' contract within good faith limits. See Official Comment 4 to UCC §2-608.

A buyer has the burden of proving that the revocation was made within a reasonable period of time. *O'Connor v Young* (ND Cal, June 30, 1995, No. C-93-4547) 1995 US Dist Lexis 21111.

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§17.65 e. Form: Notice of Revocation





17.65-1 Notice of revocation

This is to notify you that we revoke our acceptance of _ _[*specify quantity, e.g., all*]_ _ of the _ _[*describe goods*]_ _ delivered under our contract with you dated _ _[*date of contract*]_ _. The goods do not conform to our contract in that _ _[*describe defects*]_ _, and the nonconformity substantially impairs their value to us.

[*Option 1: Acceptance with reliance on seller's cure of defects*]

We accepted these goods on the reasonable assumption that you would cure the defects, which you have failed to do.

[*Option 2: Acceptance without knowledge of defects*]

We reasonably did not know of the defects when we accepted the goods because of the difficulty of discovery at that time.

[*Option 3: Acceptance with reliance on seller's assurances*]

We accepted the goods in reasonable reliance on your assurances that the goods conformed to the contract.

[*Add if appropriate*]

[*Option 1: Seller to advise on disposition of goods*]

Please send instructions for disposition of the goods.

[*Option 2: Seller to retrieve goods*]

Please pick up the goods at _ _[*address*]_ _ by _ _[*date*]_ _.

[*Continue*]

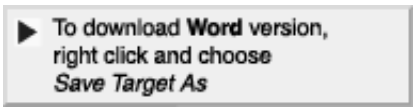
The above is not intended as an exhaustive list of nonconformities. We reserve the right to revoke acceptance of the goods on other grounds. We also reserve all rights and remedies we may have under the California Commercial Code or otherwise.

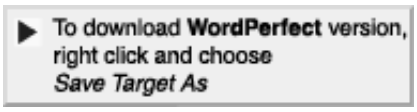
Comment: No particular revocation form is required and the notice does not need to be in writing. Some form of written communication is recommended to document the revocation because litigation often ensues. There is no express statutory requirement that the nonconformities that are the basis for the revocation must be stated. The clause above includes a statement of reasons because Official Comment 5 to UCC §2-608 implies that "good faith" may require it. The description will enable the seller to evaluate the propriety of the revocation and possibly propose an adjustment. Official Comment 5 to UCC §2-608 advocates that the buyer should not be limited only to stated nonconformities. This clause precludes any limitation of the buyer's rights and remedies by explicitly reserving all rights. See Com C §1308.

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Source: Business Law/California UCC Sales and Leases/17 Prelitigation Remedies/§17.66 f. Form: Limitation on Revocation

§17.66 f. Form: Limitation on Revocation





17.66-1 Alternative: Revocation not permitted

The parties agree that acceptance of any goods subject to this agreement will be final and may not be revoked for any reason, known or unknown to the buyer at the time of acceptance.

17.66-2 Alternative: Revocation permitted, but time for notice limited

The parties agree that, to be effective, notification of revocation of acceptance of any goods subject to this agreement must be received by the seller no later than the close of business on the _ _[*e.g., tenth*]_ _ day following delivery of the goods.

Comment: Eliminating the buyer's right to revoke acceptance entirely may be possible as long as the buyer retains some realistic remedy, such as the right to damages. On contractual limitation of remedies, see Com C §2719. If revocation is not eliminated entirely, the manner of notice may be specified. Official Comment 4 to UCC §2-608.

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3. Covering

§17.67 a. Purpose and Consequences

Buyers that receive nonconforming goods or no goods at all usually want what they ordered or a reasonable substitute as close to the scheduled time as possible. If nonconforming goods cannot be used or if the seller has not performed at all and there are no grounds for obtaining specific performance, or if such a remedy would be impractical (see §18.47), the buyer will be forced into the market to buy substitute goods. This process is known as cover, and is the parallel to the seller's right of resale.

Cover enables the buyer to fix the damages caused by the seller's default. The measure of damages is the difference between the cost of cover and the contract price together with any incidental or consequential damages, less expenses saved due to the seller's failure to perform. Com C §2712(2). If the buyer acts reasonably and in good faith, the Commercial Code puts the risk of a fluctuating market on the defaulting seller. The buyer is free to ignore cover and pursue its other remedies (Com C §2712(3)); however, its failure to make a reasonable attempt to cover limits its ability to receive consequential damages. Com C §2715(2)(a). See also *Gerwin v Southeastern Cal. Ass'n of Seventh Day Adventists* (1971) 14 CA3d 209, 92 CR 111. For discussion of consequential damages, see §§18.36-18.42.

Calculation of damages is easy if the buyer is able to purchase similar goods on comparable terms. Damages are more difficult to calculate when the goods differ substantially. For example, if a supplier of promotional items failed to furnish imprinted ballpoint pens, the cost comparison would be relatively easy if the buyer substituted imprinted mechanical pencils. However, if the buyer substituted specially made coffee mugs for the imprinted ballpoint pens, the seller might challenge the fairness of the cost comparison. The seller would likely contend the buyer had actually abandoned its intent to use the seller's goods and had not substituted for those goods but undertaken an entirely different scheme. Similar problems regarding damage calculations will also arise if the buyer must perform work on the substitute goods that would not have been necessary on the goods the buyer contracted to purchase.

Cover does not displace other remedies available to the aggrieved buyer. Com C §2712(3). The buyer may still seek return of the price paid and sue to recover damages for nondelivery. Alternatively, the buyer may cancel the contract and make new arrangements. Com C §2711(1). Cover does not displace the buyer's security interest in rightfully rejected goods or goods whose acceptance was rightfully revoked. See §§10.45, 17.71-17.74.

Cover is available to the buyer whether or not all the goods affected have been identified to the contract. Com C §2711(1)(a). On identification, see §§8.28-8.29, 17.32-17.37.

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§17.68 b. Time and Manner

Cover is available when (1) the seller fails to make delivery, (2) the seller repudiates, (3) the buyer rightfully rejects, or (4) the buyer justifiably revokes acceptance. Com C §2711(1).

The buyer may procure substitute goods at any time and thereby fix its damages. The buyer may cover "by making in good faith and without unreasonable delay" any reasonable purchase of substitute goods or contract for their purchase. Com C §2712(1); Official Comment 2 to UCC §2-712 (Official Comment 4 to UCC §2-712 (2003)). Because the buyer is not required to cover, the good faith requirement will ordinarily be satisfied unless the buyer intentionally chooses a more expensive market over a less expensive one.

Because cover is meant to be flexible, the buyer may obtain nonidentical goods on differing credit and delivery terms. The test of proper cover is whether, at the time and place, the buyer acted in good faith and in a reasonable manner when procuring the substituted goods. It is immaterial that hindsight may prove the method of cover to be neither the cheapest nor the most effective means. Official Comment 2 to UCC §2-712 (Official Comment 4 to UCC §2-712 (2003)). In at least one case, the court held that a buyer may cover by manufacturing the goods itself if it is unable to obtain them on the open market or can do so more economically. See *Cives Corp. v Callier Steel Pipe & Tube, Inc*. (Me 1984) 482 A2d 852. See also *Dura-Wood Treating Co. v Century Forest Indus*. (5th Cir 1982) 675 F2d 745. The decision in *Dura-Wood* suggests that, in a volatile market, a covering buyer may be acting reasonably when it waits to determine whether a decrease in market price might occur. 675 F2d at 754.

The right to cover may, however, be subject to certain limitations:

- It is subject to the seller's right to cure a defective performance. Com C §2508; Official Comment 1 to UCC §2-711.
- In installment contracts, the buyer's cover remedy is confined to the "goods involved" unless the seller's breach affects the whole contract. Com C §2711(1).
- The seller's failure to deliver may be excused because performance has become impracticable. Com C §2615(a).
- The contract itself may also control the buyer's choices. Com C §2719.

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§17.69 c. Effect of Inability or Failure to Cover

In some instances, the buyer no longer needs the goods after the seller's breach. This may occur, for example, if the buyer contracted for the goods to meet a seasonal demand or the seller's failure to provide the goods at the proper time and place caused a sub-buyer to cancel its contract with the buyer, and the goods are no longer required. In these situations, the Commercial Code provides an alternative measure of damages for a buyer that chooses not to cover, *i.e.,* the difference between the contract price and the market price when the buyer learned of the breach. See Com C §2713. See also §§18.20-18.45 regarding measurement of the buyer's damages.

The guiding principle in effecting cover is reasonableness. Cover may be delayed or even excused if the buyer reasonably believes that the seller might eventually perform under the contract. *Huntington Beach Union High Sch. Dist. v Continental Info. Sys. Corp*. (9th Cir 1980) 621 F2d 353.

The buyer has a right of replevin for goods identified in the contract if cover has not been effectuated after reasonable effort, if circumstances show that the effort would be unavailing, or if the goods have been shipped under reservation and satisfaction of the security interest in them has been made or tendered. Com C §2716(3). On replevin, see §18.46.

The buyer may also obtain specific performance "where the goods are unique or in other proper circumstances." Com C §2716(1). "Other proper circumstances" for purposes of granting specific performance may include the buyer's inability to obtain cover. See *Eastern Air Lines, Inc. v Gulf Oil Corp*. (SD Fla 1975) 415 F Supp 429; *Kaiser Trading Co. v Associated Metals & Minerals Corp*. (ND Cal 1970) 321 F Supp 923, aff'd without written opinion (9th Cir 1971) 443 F2d 1364.

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Source: Business Law/California UCC Sales and Leases/17 Prelitigation Remedies/§17.70 4. Repairing or Replacing Nonconforming Goods

§17.70 4. Repairing or Replacing Nonconforming Goods

The Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) requires every manufacturer of consumer goods sold in California to maintain service and repair facilities reasonably close to all areas where those goods are sold, so that the manufacturer can honor the terms of applicable express warranties. The manufacturer may designate independent service and repair facilities to perform warranty work on its behalf. CC §1793.2(a). See CC §1791(a) for a definition of "consumer goods."

The Act does not extend to a vehicle purchased outside the state by a California resident, even if repairs are performed in California. See *Cummins, Inc. v Superior Court* (2005) 36 C4th 478, 30 CR3d 823 (California residents purchased motor home while visiting Idaho); *Davis v Newmar Corp.* (2006) 136 CA4th 275, 38 CR3d 690 (although sale agreement provided that California law applied, motor home was delivered and title passed in Nevada, so Act did not apply); *California State Electronics Ass'n v Zeos Int'l Ltd.* (1996) 41 CA4th 1270, 49 CR2d 127 (Song-Beverly Act did not apply to goods where title passed in Minnesota on shipment of goods from seller to buyer in California).

NOTE: Effective January 1, 2008, the Song-Beverly Act extends to a purchase in the United States of a motor vehicle by a member of the armed forces, regardless of in which state his or her motor vehicle is purchased or registered, if both of the following apply: (1) He or she purchased the motor vehicle from a manufacturer that sells motor vehicles in California or from an agent or representative of that manufacturer; and (2) the member of the armed forces was stationed in or a resident of California at the time he or she purchased the motor vehicle or at the time he or she filed an action under the Act. A "member of the armed forces" means a person on full-time active duty in the army, navy, marine corps, air force, national guard, or coast guard. Full-time active duty includes active military service at a military service school designated by law or the adjutant general of the military department concerned. CC §1795.8.

A buyer of consumer goods has a statutory right to have nonconformities in those goods repaired during their warranty period. Unless the buyer agrees otherwise in writing, service or repair work must be completed within 30 days after its commencement. In addition, the manufacturer is required to commence the work within "a reasonable time." CC §1793.2(b). Delay caused by conditions beyond the manufacturer's control extends the 30-day repair period. Should delay occur, the conforming goods must be returned to the buyer as soon as possible after the delaying condition no longer exists. CC §1793.2(b).

The warranty period is extended by the number of days the goods are out of the buyer's hands for service or repairs. CC §§1793.1(a)(2). If a defect arises during the warranty period, the warranty will not expire until the defect has been remedied. The warranty period will also be extended if the repairs do not remedy the defect and the buyer notifies the manufacturer of the failure of the repairs within 60 days after they were completed. If the defect has not been remedied after a reasonable number of attempts, the buyer may return the product for a replacement or refund, subject in either case to deduction of a reasonable charge for the buyer's use of the goods before the defect was discovered. CC §§1793.1(a)(2), 1793.2(d).

If the defective good is a new motor vehicle (as defined in CC §1793.22(e)(2)) and the manufacturer is unable to make the vehicle conform to applicable express warranties after a reasonable number of repair attempts (CC §1793.22(b)), the manufacturer must promptly replace the vehicle with a "substantially identical" one or make restitution to the buyer. CC §1793.2(d)(2)(A).

A "reasonable number" of repair attempts have been made if, within 18 months from delivery to the buyer or 18,000 miles on the odometer of the vehicle, whichever occurs first, either (1) the same nonconformity results in a condition that is likely to cause death or serious bodily injury if the vehicle is driven and the nonconformity has been subject to repair two or more times by the manufacturer or its agents, and the buyer or lessee has at least once directly notified the manufacturer of the need for the repair of the nonconformity; (2) the same nonconformity has been subject to repair four or more times and the buyer has at least once directly notified the manufacturer of the need for repair of the nonconformity; or (3) the vehicle is out of service for repair of nonconformities for a cumulative total of more than 30

calendar days since delivery of the vehicle to the buyer. CC §1793.22(b). In any event, "reasonable number" means at least two repair attempts. See *Silvio v Ford Motor Co.* (2003) 109 CA4th 1205, 135 CR2d 846 (court granted dealer's motion for nonsuit; buyer demanded repurchase of vehicle after only one repair attempt).

The buyer is free to elect restitution rather than replacement. The buyer is not required to accept a substitute vehicle. CC §1793.2(d)(2). The manufacturer must also pay any sales or use tax, license fees, registration fees, and other official fees that the buyer is obligated to pay in connection with the replacement, plus any incidental damages incurred by the buyer, including reasonable repair, towing, and rental car costs. CC §1793.2(d)(2)(A). The Song-Beverly Consumer Warranty Act, commonly referred to as California's lemon law, contains no time limits for seeking replacement of a defective vehicle. *Krotin v Porsche Cars, Inc.* (1995) 38 CA4th 294, 45 CR2d 10.

Ordinarily, the buyer must deliver the defective or nonconforming goods to the manufacturer's facility for service or repair. If delivery cannot reasonably be accomplished because of size and weight, method of attachment, method of installation, or the nature of the nonconformity, the buyer's written notice of the nonconformity to the manufacturer or its service and repair facility will constitute return of the goods. CC §1793.2(c). The manufacturer then has the option to service or repair the goods at the buyer's residence or to arrange for them to be transported to its facility for service and repair. Expenses of transportation are borne by the manufacturer. If the buyer delivers the goods to the manufacturer's facility, the reasonable expenses of returning them to the buyer are also borne by the manufacturer. CC §1793.2(c).

If the manufacturer does not provide the service or repair facilities required by the statute, the buyer has the following choices:

- **Return the nonconforming goods to the retail seller.** The seller has several options, including (a) service or repair the goods or direct the buyer to someone who can, (b) replace the defective goods, or (c) refund to the buyer the original purchase price, less the amount directly attributable to the buyer's use of the goods before the nonconformity was discovered. CC §1793.3(a).
- **Return the nonconforming goods to any retail seller of like goods of the same manufacturer.** After receipt of the goods, this seller will have the same duties listed above. CC §1793.3(b). The manufacturer is liable to every retail seller of its goods that incurs expenses in honoring the manufacturer's express warranties. CC §1793.5.

If neither of the above courses of action gives the buyer "appropriate relief," it may go to an independent service or repair facility where service or repair of the nonconforming goods can be economically accomplished. CC §1793.3(c). The manufacturer is liable to the buyer (or to the independent service or repair facility, on assignment of the buyer's rights) for the actual and reasonable costs of service and repair, including a reasonable profit. Note that this remedy is not available if the wholesale price of the goods is less than $50. CC §1793.3.

Remedies available under the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312) include repair, replacement, or refund, whichever the warrantor elects. The warrantor may choose refund, however, only if (a) it is unable to provide replacement, and repair is not commercially practicable or cannot be made in a timely manner; or (b) the consumer is willing to accept a refund in place of repair or replacement. 15 USC §2301(10). The Act defines "replacement" as "furnishing a new consumer product which is identical or reasonably equivalent to the warranted consumer product." 15 USC §2301(11). "Refund" is defined as returning the actual purchase price, less reasonable depreciation based on actual use, if permitted by the rules of the Federal Trade Commission in 16 CFR pts 700-703. 15 USC §2301(12).

The Magnuson-Moss Warranty Act requires the warrantor to remedy product defects "within a reasonable time and without charge." 15 USC §2304(a)(1). If the product still contains a defect after a reasonable number of remedy attempts, the warrantor must permit the consumer to elect either a refund or a replacement of the product without charge. 15 USC §2304(a)(4). If the warrantor replaces a component part of a consumer product, replacement includes installing the part in the product without charge. 15 USC §2304(a)(4).

See §§3.94, 18.36-18.41 for discussion of the buyer's right to consequential damages when there is a failure of the "repair or replace" remedy.

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5. Enforcing Buyer's Security Interest

§17.71 a. Purpose of Security Interest

After rightfully rejecting or justifiably revoking acceptance of nonconforming goods, the buyer has a security interest in the goods in its possession or control, to cover payments made on the price and reasonable costs of their inspection, receipt, transportation, care, and custody. Com C §2711(3). The policy reflected in Com C §2711 is one that makes the buyer whole for expenses it necessarily incurs in dealing with an unwanted delivery. Goods in a bailee's possession, to be delivered to the buyer only on payment, are not in the buyer's possession or control for purposes of its security interest under Com C §2711. *Procter & Gamble Distrib. Co. v Lawrence Am. Field Warehousing Corp*. (1965) 266 NYS2d 785, 213 NE2d 873.

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§17.72 b. Extent of Security Interest

The extent of the buyer's security interest is limited to the expenditures listed in Com C §2711(3), payments on the price (including amounts of drafts accepted and negotiable notes signed; see Official Comment 2 to UCC §2-711), and reasonable expenses of transporting, receiving, inspecting, keeping, and caring for the goods. Damages are intentionally left off the list. Official Comment 2 to UCC §2-711.

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§17.73 c. Relation to Division 9

Under Com C §§9102(72)(F) and 9109(a)(5), the buyer's security interest is clearly within the scope of Division 9 of the Commercial Code pertaining to secured transactions. See Com C §§9101-9709. The security interest, however, is exempted from certain formal requirements as long as the debtor (*i.e.,* the seller) does not have lawful possession of the goods under Com C §9110. A buyer who sells goods in enforcement of its security interest is referred by Com C §9110 to Division 2 for guidelines on conducting the sale. For a description of sale procedures, see Com C §2706. See also §17.74.

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Source: Business Law/California UCC Sales and Leases/17 Prelitigation Remedies/§17.74 d. Procedure for Sale

§17.74 d. Procedure for Sale

A sale by a buyer enforcing its security interest is governed by the same principles that apply to a resale by an aggrieved seller. See Com C §2706. See also §§17.38-17.46. There is one difference that distinguishes a buyer's sale to enforce its security interest from a seller's resale of goods. A buyer is required to turn over to the seller any sale proceeds that exceed the buyer's security interest. Official Comment 2 to UCC §2-711. In contrast, a seller is not accountable to the buyer for any profit made on the resale. Com C §2706(6).

Regardless of which party is selling the goods, the sale must be conducted in "good faith" and in a "commercially reasonable" manner. Com C §2706(1); *Allied Grape Growers v Bronco Wine Co.* (1988) 203 CA3d 432, 249 CR 872. Because of the lack of case authority interpreting those requirements under Com C §2706, cases decided under Commercial Code Division 9 and in other jurisdictions may be persuasive. See *Hutchison v Southern Cal. First Nat'l Bank* (1972) 27 CA3d 572, 103 CR 816 (commercially reasonable sale of pledged stock); *U.S. v Terrey* (5th Cir 1977) 554 F2d 685 (commercially unreasonable sale of business assets).

Under Division 9, the disposition of collateral after a default is governed by Com C §9610. Every aspect of the disposition of collateral, including method, manner, time, and place, must be "commercially reasonable." Com C §9610(b). A secured party may dispose of collateral by either public or private proceedings, by one or more contracts, by unit or parcels, at any time and place, and on any terms, as long as all aspects of the disposition are commercially reasonable. Com C §9610(b).

A disposition of collateral is made in a commercially reasonable manner if it satisfies any of the following conditions: (1) it is made in the usual manner on any recognized market; (2) it is made at the price current in any recognized market at the time of the disposition; or (3) it is made otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition. Com C §9627(b). A secured party may establish that a collection, enforcement, disposition, or acceptance was made in a commercially reasonable manner, although a greater amount could have been obtained by the use of a different method. Com C §9627(b).

Although the July 1, 2001, revision of Division 9 addressed the concept of commercially reasonable conduct with greater specificity, the cases that construed the earlier version of Division 9 are helpful in understanding how courts have evaluated different dispositions of collateral. For example, in *General Elec. Credit Corp. v Bo-Mar Constr. Co*. (1977) 72 CA3d 887, 140 CR 417, the court concluded that the sale of repossessed collateral must ordinarily be held (1) in public, (2) during business hours, (3) on adequate notice, (4) within a reasonable time after repossession, and (5) under conditions reasonably calculated to bring a fair price.

A sale may be considered commercially unreasonable if there is insufficient publicity regarding the sale. For example, in *Ford & Vlahos v ITT Commercial Fin. Corp.* (1994) 8 C4th 1220, 36 CR2d 464, the repossessing creditor published a notice of the sale, but the notice omitted information about whom to contact to qualify as a bidder. The notice was corrected and published the day before the sale. The court held the sale was not conducted in good faith and was commercially unreasonable because of insufficient publicity.

Practically speaking, the issue of "commercial reasonableness" tends to dissolve into an issue over price. A debtor is unlikely to complain about the conduct of a sale if a satisfactory sale price is received. A debtor and a court, however, may be alerted to the possibility that a sale was not held in a commercially reasonable manner if a relatively low price is received. For example, a sale in which a repossessed car was sold for less than 50 percent of wholesale book value, without any explanation about the discrepancy, was held to be unreasonable as a matter of law. *Credit Bureau Metro, Inc. v Mims* (1975) 45 CA3d Supp 12, 119 CR 622.

The fact that a higher price could have been obtained at a different time or through a different method of sale, however, will not preclude the secured party from establishing that the disposition was in fact conducted in a commercially reasonable manner. Com C §9627(a). The specific facts of each case regarding the goods and the manner of sale will determine the court's ruling. For example, in *Sierra Fin. Corp. v Brooks-Farrer Co*. (1971) 15 CA3d 698, 93 CR 422, the court held that a sale was conducted in a commercially reasonable manner although it brought only $500 for goods deemed to have a fair market value of $27,616. The determining factors were (1) the goods were in the hands of a party who refused to permit prospective buyers to determine their exact quantity or condition, (2) the

debtor was no longer in business, and (3) the goods were treated as "distressed" merchandise.

Similarly, in *Clark Equip. Co. v Mastelotto, Inc*. (1978) 87 CA3d 88, 150 CR 797, the court held that a sale of equipment for $49,500 met the commercially reasonable standard, considering all the circumstances that existed at the time of the sale. The fact that an expert testified at trial that the equipment was worth $75,000 was not dispositive of the reasonableness issue.

The enforcement of its security interest does not prevent the buyer from also seeking damages. Official Comment 2 to UCC §2-711.

Note that if the seller files for bankruptcy, the buyer must obtain relief from the automatic stay (11 USC §362(a)) before it may proceed with the sale.

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6. Claiming Goods From Seller

a. Grounds

§17.75 (1) Goods Purchased for Personal or Household Use

Commercial Code §2502 permits a buyer to recover goods from the seller when the goods have not yet been shipped under two specific circumstances. The first circumstance involves goods that have been purchased for personal or household use. The buyer must have paid all or a part of the price of the goods in question. The buyer also must have a special property in the goods by identifying them to the contract in accordance with Com C §2501.

NOTE: If the identification creating his or her special property has been made by the buyer, he or she acquires the right to recover the goods only if they conform to the contract for sale. Com C §2502(3).

Finally, the buyer must make and keep good a tender of any unpaid portion of the goods' price. Com C §2502(1). If these conditions are met, the buyer may recover the goods from the seller despite the seller's failure to deliver them or its repudiation of the contract. Com C §2502(1)(a). The seller's right to recover the goods vests on acquisition of a special property, even if the seller had not then repudiated or failed to deliver. Com C §2502(2).

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Source: Business Law/California UCC Sales and Leases/17 Prelitigation Remedies/§17.76 (2) Seller's Insolvency

§17.76 (2) Seller's Insolvency

The second circumstance giving rise to the buyer's right to recover goods it has purchased is the insolvency of the seller. Com C §2502(1)(b). The purpose of this statute is to give the buyer a short-term (10-day) preference over other creditors by treating it similarly to a defrauded party. The statute recognizes that a right to damages is not meaningful if the seller is insolvent.

The seller's insolvency gives the buyer the right to the goods only if all the following conditions exist:

- **The buyer has paid all or part of the price.** Com C §2502(1). By its express terms, Com C §2502 is limited to buyers that have prepaid, in whole or in part, for the goods sought to be recovered. A buyer that purchases on credit may simply cancel the contract if the goods are not forthcoming. Com C §2711(1).
- **The buyer makes and keeps good a tender of any unpaid portion of the price.** Com C §2502(1).
- **The goods have been identified.** See Com C §2501. The buyer is limited to recovering only those identified goods that conform to the contract. Com C §2502(3). This limitation prevents the buyer from obtaining superior goods by identifying those to the contract instead. See Official Comment 3 to UCC §2-502 (Official Comment 4 to UCC §2-502 (2003)).
- **The seller became insolvent within 10 days after receiving the first installment on the price.** Com C §2502(1)(b). This requirement drastically restricts the buyer's right to recover goods when the seller becomes insolvent. See, *e.g., First-Citizens Bank & Trust Co. v Academic Archives, Inc*. (NC App 1971) 179 SE2d 850 (insolvency occurred before payment; no right to obtain goods from seller).

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§17.77 b. Effect

The buyer's right to recover the goods vests on the acquisition of a special property interest even if the seller has not repudiated or failed to deliver the goods at the time. Com C §2502(2). This section became effective on July 1, 2001. This statutory amendment clarified the buyer's interest in the goods in the event the seller became insolvent before the goods were delivered to the buyer.

Before this amendment, the Bankruptcy Court for the Northern District of California held that Com C §2502 gave a buyer an unsecured claim in a bankruptcy case because the buyer's special property interest was more akin to an equitable remedy than a property interest. *Diesel Performance, Inc. v G. Paoletti Co*. (*In re G. Paoletti, Inc.)* (Bankr ND Cal 1997) 205 BR 251. The court also held that once a seller files a bankruptcy petition, a buyer's rights under Com C §2502 were unenforceable because the terms of Com C §2502 were inconsistent with 11 USC §365 regarding executory contracts and unexpired leases.

The court in *Diesel Performance, Inc.* noted in its opinion that federal bankruptcy law generally looks to state law to determine a party's property rights. Because the buyer had not perfected a security interest in the goods under Division 9, the claim was unsecured.

The statutory provision that defines "security interest" for purposes of the Commercial Code is Com C §1201(b)(35). It provides that a seller or lessor may acquire a security interest in goods by complying with Division 9, commencing with Com C §9101, subject to Com C §2505, which pertains to a seller shipping identified goods under reservation.

The effect of Division 9 is to severely restrict the practical significance of Com C §2502. The restrictions arise because the seller must become insolvent almost immediately after payment by the buyer and the goods must be identified within the same time period.

Under the Bankruptcy Code, the buyer's reclamation right depends on whether the buyer has made partial or full payment of the contract price. If the buyer has made partial payment, then the contract for the goods will be categorized as executory under 11 USC §365. The Bankruptcy Code does not contain a precise definition of the term "executory contract." For a discussion of the different definitions applied by a variety of courts, see *Software Customizer, Inc. v Bullet Jet Charter, Inc. (In re Bullet Jet Charter, Inc.)* (Bankr ND Ill 1995) 177 BR 593.

The bankruptcy trustee under 11 USC §365(a) is authorized to assume or reject an executory contract, subject to the court's approval. See *Jenson v Continental Fin. Corp*. (8th Cir 1979) 591 F2d 477. The power to assume or reject an executory contract "is to be exercised in situations where the estate will be benefited." 3 Collier on Bankruptcy ¶365.03 (15th ed rev 1996).

When the buyer has fully paid the contract price, the seller arguably has a possessory interest, but no equitable interest, in the goods. Because of the seller's possessory interest, however, the automatic stay of 11 USC §362(a) would prevent the buyer from exercising its right to obtain the goods.

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§17.78 c. Insolvency

The buyer may claim the goods only "if the seller becomes insolvent within 10 days after receipt of the first installment on their price." Com C §2502(1). A literal reading of this section requires the seller to go from solvency, when the first payment is received, to insolvency within 10 days. See Official Comment 1 to UCC §2-502. It is likely a buyer will encounter significant problems proving the seller's financial condition during this ten-day period, regardless of the size and complexity of the seller's business.

Buyers who deal with financially unstable sellers may choose to avoid the inherent problems associated with Com C §2502 and make a demand for assurances of performance as soon as reasonable grounds for insecurity arise regarding the performance of the contract. Com C §2609. A buyer may also elect to pay for the goods with a letter of credit against delivery of the goods or a negotiable document.

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§17.79 d. Payment

Due to the absence of a definition for "paid" in Com C §2502, questions often arise as to its meaning. When "paid" is used in Com C §2711, the term includes the buyer's execution of a negotiable note and the seller's acceptance of a draft or other time-negotiable instrument. Official Comment 2 to UCC §2-711. Arguably the definition contained in Com C §2711 would also apply to Com C §2502 because both sections are contained in the "performance" chapter of Division 2 (Chapter 5). It is not clear whether the signing of a note by the buyer would be considered the receipt of payment and begin the ten-day period during in which the seller's insolvency must occur under Com C §2502.

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7. Offsetting Buyer's Damages Against Price

§17.80 a. Grounds

If the buyer is damaged by the seller's breach (*e.g.,* the seller delivers nonconforming goods or a short supply of conforming goods), the buyer is permitted to offset all or part of its damages from the price still due on the contract, assuming the buyer has notified the seller. Com C §2717. For a form notice of intention to offset, see form 17.82-1.

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§17.81 b. Effect

A buyer's decision to offset damages under Com C §2717 permits the buyer to retain cash and exercise other remedies, without breaching the contract. For example, if nonconforming goods are received, the buyer may cover, utilize the security interest in the nonconforming goods, and in effect pay for the receipt of conforming goods by offsetting the damages that were fixed by the cover.

The buyer must give notice of the intention to withhold all or part of the price in order to avoid default. See Official Comment 2 to UCC §2-717. If a buyer complies with the notification requirement, the buyer is able to obligate the seller to deliver the goods for their contract price, minus the price offset.

If the buyer's payment is due before the seller has completed performance, and the buyer deducts damages without giving the requisite notice under Com C §2717, the seller may treat the failure to pay as a breach of contract. The seller may elect to pursue the remedies specified in Com C §2703 with respect to undelivered goods.

In *AmerisourceBergen Corp. v Dialysist W., Inc.* (9th Cir 2006) 465 F3d 946, the Ninth Circuit Court of Appeals held that UCC §2-717 did not permit a buyer to deduct damages arising from the breach of one contract from debt owed by the buyer to the seller on another contract.

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§17.82 c. Form: Notice of Intention to Deduct Damages

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17.82-1 Notice of intention to deduct damages

Please take notice that we intend to deduct damages of _ _[*dollar amount*]**_ _ from the price payable to you under our contract dated _ _**[*date*]**_ _, _ _**[*e.g., because the goods you shipped to us under the contract could not be used and we were forced to cover them at higher prices*]**_ _. In addition, we reserve all rights and remedies available to us under the California Commercial Code or otherwise.**

[*Add if appropriate*]

We demand that you make available to us the next shipment of goods for their purchase price less the above amount.

Comment: The notice should specify the buyer's reason for withholding the payment. Official Comment 2 to UCC §2-717. The notice is not required to be in writing or to follow a particular format. *Warren's Kiddie Shoppe, Inc. v Casual Slacks, Inc*. (Ga App 1969) 171 SE2d 643.

The Commercial Code does not specify when the notice must be given to the seller. In most cases, notice is given when the buyer pays the diminished price. If payment is not due until after the goods have been delivered, a buyer may have an enhanced bargaining position if the notice is given after the goods have been received.

A buyer who either wrongfully claims the seller to be in breach or fails to give the requisite notice will itself commit a breach that triggers the seller's remedies.

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Source: Business Law/California UCC Sales and Leases/17 Prelitigation Remedies/§17.83 d. Impact of Accord and Satisfaction Principles

§17.83 d. Impact of Accord and Satisfaction Principles

The buyer's attempt to pay less than the full price for the goods raises the issue of accord and satisfaction. If the buyer deducts the damages from the price, the buyer places the seller in a position to accept and be satisfied with less than full performance. This section will discuss the seller's rights once a check has been received from the buyer in an amount that reflects a price deduction and bears the notation "payment in full for goods received." This section will also discuss whether a seller's negotiation of a check constitutes accord and satisfaction that will bar the seller from disputing the buyer's offset and proceeding against the buyer for the balance of the price.

The requirements of accord and satisfaction are listed in Com C §3311. Assuming the exceptions noted in Com C §3311(c) do not apply, and the following requirements of Com C §3311(a)-(b) are met, the claim will be discharged.

- The buyer tendered the instrument in good faith as full satisfaction of the obligation;
- The amount of the claim was unliquidated or subject to a bona fide dispute;
- The instrument was negotiated by the seller; and
- The instrument or an accompanying written communication contained a conspicuous statement that the instrument was tendered as full satisfaction of the claim.

The requirement of §3311 should be read in the context of CC §1526, which permits the creditor to strike out the accommodation language or accept the check under protest and thereby not be subject to the accord. The Commercial Code does not offer the creditor this option.

NOTE: *Directors Guild v Harmony Pictures* (CD Cal 1998) 32 F Supp 2d 1184 held that Com C §3311 supersedes CC §1526 because the two statutes are irreconcilable, and Com C §3311 was enacted later. See also *Woolridge v J.F.L. Elec., Inc.* (2002) 96 CA4th Supp 52, 60, 117 CR2d 771, reaching the same conclusion.

"Good faith" under the Commercial Code is defined as not only honesty in fact but also the observance of reasonable commercial standards of fair dealing. Com C §1201(b)(20). The meaning of "fair dealing" depends on the facts of the particular case. Official Comment 4 to UCC §3-311.

A statement is conspicuous if it is written so that a reasonable person ought to have noticed it. Com C §1201(b)(10). If the seller can reasonably be expected to examine the check, almost any statement on it should be noticed, particularly a statement that appears above the space where the check is to be endorsed. Official Comment 4 to UCC §3-311.

Accord and satisfaction can be prevented under Com C §3311(c)(1) if the seller is an organization and it is able to prove:

- Within a reasonable time before the check was tendered, the buyer was sent a conspicuous statement that any communication concerning a disputed debt, including a check tendered as full satisfaction of a debt, must be sent to a designated person, office, or place; and
- The person, office, or place designated in the statement did not receive the check.

This requirement is designed to ensure that the customer has reasonable notice that the full satisfaction check must be sent to a particular place. See CC §1526 for further rules and limitations regarding knowledge of the claimant. The reasonable time requirement can be satisfied by a notice on the billing statement sent to the customer. If the full satisfaction check is sent to the designated destination and the check is paid, the obligation is discharged. The claim is not discharged, however, if the seller proves the check was not received at the designated destination, unless the requirements of Com C §3311(d) are met. Official Comment 5 to UCC §3-311.

Whether or not the seller is an organization, it can prevent an accord and satisfaction from occurring if it proves that, within 90 days after payment of the check, it tendered repayment of the full amount to the buyer. Com C §3311(c)(2). This section is designed to prevent inadvertent accord and satisfaction. Official Comment 6 to UCC §3-311.

A discharge will occur if the buyer is able to prove that, within a reasonable time before the check was cashed, the seller or an agent of the seller having direct responsibility for the disputed obligation (*e.g.,* a collection agency) *knew*

that the check was being tendered in full satisfaction of the obligation. Com C §3311(d). If the seller or its agent had this actual knowledge, the accord and satisfaction will occur even though the check was *not* sent to the person designated by the seller and even though the seller tendered repayment of the amount of the check to the buyer. Official Comment 7 to UCC §3-311.

An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routines. There is no failure of "due diligence" if the seller does not require its clerks to look for full satisfaction statements on checks or accompanying communications. Official Comment 7 to UCC §3-311.

A claimant knows that a check was tendered in full satisfaction of a claim when the claimant "has actual knowledge" of the fact. See Com C §1202(a)-(b). An accord and satisfaction will result if a customer asserts a breach of warranty claim for defective goods and delivers a full satisfaction check to the manager of the local outlet of a chain store where the goods were purchased and the check is accepted. Official Comment 7 to UCC §3-311.

An accord and satisfaction will probably not result if the check is mailed to the chief executive officer at the chain store's corporate headquarters. Although the officer may have general responsibility for operations of the company, the officer does not normally have the direct responsibility for resolving a bill dispute with a customer. If the check receives the personal attention of the officer and the officer is aware of the full satisfaction language, an accord and satisfaction will result if the check is cashed. Official Comment 7 to UCC §3-311.

If a full satisfaction check is sent to an office that merely processes checks for the seller, it is irrelevant whether the clerk processing the check did or did not see the statement that the check was tendered as full satisfaction of the buyer's obligation. The clerk's knowledge is *not* imputed to the seller's organization when the clerk has no responsibility with respect to accord and satisfaction. Official Comment 7 to UCC §3-311.

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8. Canceling the Contract

§17.84 a. Grounds

The buyer has the option to cancel the contract whenever the seller fails to deliver or repudiates the contract, or whenever the buyer rightfully rejects or justifiably revokes acceptance of the goods. Com C §2711(1). The buyer may cancel the unperformed part of an installment contract only if the seller's breach is significant enough to impair the value of the whole contract. Com C §2612(3). A buyer's remedies following a breach by the seller may be effectively precluded, with the exception of those associated with the delay, if the seller cures the breach by properly retendering delivery or sending replacement goods under Com C §2508. See Official Comment 1 to UCC §2-711.

The sale of a motor vehicle, bought for personal or family purposes, with a conditional sales contract (see CC §2981(a)), must comply with the Rees-Levering Motor Vehicle Sales and Finance Act (CC §§2981-2984.4). If the conditional sales contract is not enforceable under CC §2983 or §2983.1, the buyer may choose to retain the motor vehicle and continue the contract in force or, with reasonable diligence, rescind the contract and return the vehicle. CC §2983.1. If the vehicle is returned, the value of the vehicle is to be credited as restitution by the buyer without any deduction in the cash price for the passage of time. CC §2983.1.

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§17.85 b. Effect

By canceling, the buyer discharges executory obligations but retains any remedy for past breaches and for breach of the whole contract or unperformed balance of the contract. Com C §2106(4). See also Com C §2720.

The buyer's decision to cancel will depend on whether the buyer considers the value of the contract to sufficiently outweigh the disadvantages of the seller's breach. The buyer may welcome the opportunity to make other contractual arrangements if goods are available elsewhere at comparable prices. The buyer may be willing to accept less than perfect performance if goods are not available or prices of comparable goods have risen.

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Source: Business Law/California UCC Sales and Leases/17 Prelitigation Remedies/§17.86 c. Notification of Cancellation

§17.86 c. Notification of Cancellation

The only express provision regarding a notice of cancellation is set forth in Com C §2612(3), which provides that the contract will be reinstated if the buyer accepts a nonconforming installment without seasonably notifying of the cancellation.

Informal notification is probably required in all cases under the obligations of good faith. See Com C §1304.

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§17.87 d. Contract Reinstatement

In addition to a contract being reinstated when no seasonable notification has been given, Com C §2612(3) also specifies a contract will be reinstated if (1) an action is commenced with respect to only past installments, or (2) performance is demanded for future installments. This section is designed to continue the contract in the absence of an overt cancellation.

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Source: Business Law/California UCC Sales and Leases/17 Prelitigation Remedies/§17.88 VI. CHECKLIST: MATTERS REQUIRING NOTICE BEFORE ACTION BY SELLER OR BUYER

§17.88 VI. CHECKLIST: MATTERS REQUIRING NOTICE BEFORE ACTION BY SELLER OR BUYER

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Notices by the seller:

Merchant's notice of objection when it has received confirmation of sales agreement from other party (otherwise, statute of frauds defense is waived) (Com C §2201(2)) (see §§7.17-7.18)

Notice of objection to buyer's course of performance (Com C §1303(a)(2)) (see §4.97)

Notice of time limit for performance when that term has been left open by the parties (Com C §2309) (see §§4.63, 4.69)

Notice of termination of contract (Com C §2309(3)) (see §4.79)

Notice to other bidders of seller's intention to bid at auction (Com C §2328(4)) (see §2.58)

Notice to buyer of tender of delivery of goods (Com C §2503(1)) (see §§9.45-9.48)

Notice to buyer of shipment by carrier (Com C §2504(c)) (see §9.8)

"Seasonable" notice to buyer of intent to cure improper tender or delivery (Com C §2508(1)-(2)) (see §§9.64-9.65)

Notice to buyer of seller's intent to inspect, test, or sample goods in buyer's possession (Com C §2515(a)) (see §16.80)

Notice to buyer of infringement action filed against seller (Com C §2607(3)(B)) (see §§3.78, 3.82)

Demand to buyer to turn over to seller control of infringement action filed against buyer (Com C §2607(5)(B)) (see §§3.86, 3.88)

"Seasonable" notice to buyer when claiming impracticability of performance, resulting in delay or nondelivery of goods in whole or in part (Com C §2615(c)) (see §16.69)

Notice to bailee to stop delivery when buyer is insolvent or otherwise in breach (Com C §2705(3)) (see §§17.14-17.20)

"Reasonable" notice to buyer of seller's intention to resell goods at private sale; time and place need not be indicated (Com C §2706(3)) (see §§17.41-17.42)

"Reasonable" notice to buyer of seller's intention to resell goods at public sale; time and place must be specified (except in case of goods that are perishable or threaten to speedily decline in value), goods to be sold must be identified (except when there is recognized market for public sale of futures in goods of the kind), and if goods are not to be within view of those attending sale, location of goods must be given and provision made for reasonable inspection (Com C §2706(3)) (see §§17.43-17.45)

Notice of intention to offer evidence of market price in an action based on anticipatory repudiation (Com C §2723(3)) (see §§4.9, 18.61).

Notice by consignor to consignee's secured creditors of consignor's interest in consigned property (Com C §9324(b)) (see §§12.61, 12.63)

Notices by the buyer:

Notice of cancellation of installment contract (Com C §2106(4)) (see §9.58)

Merchant's notice of objection when it has received confirmation of sales agreement from other party (otherwise, statute of frauds defense is waived) (Com C §2201(2)) (see §§7.17-7.18)

Notice of time limit for performance when that term has been left open by the parties (Com C §2309) (see §§4.63, 4.69)

Notice of termination of contract (Com C §2309(3)) (see §4.79)

"Seasonable" notice to seller of buyer's election to return goods sold on approval (Com C 2327(1)(b)) (see §10.25)

Notice to seller of buyer's intent to inspect, test, or sample goods in seller's possession (Com C §2515(a)) (see §16.80)

"Seasonable" notice to seller of rejection of goods (Com C §2602(1)) (see §10.35)

Notice to seller of seller's breach after buyer's acceptance of goods; notice must be within reasonable time after buyer discovers or should have discovered breach (Com C §2607(3)(A)) (see §§18.63-18.67)

Notice to seller of breach of warranty (Com C §2607(3)(A)) (see §§3.73-3.77, 3.81)

Notice to seller of infringement action filed against buyer (Com C §2607(3)(B)) (see §§3.78, 3.82)

Notice to seller of revocation of acceptance of goods, in whole or in part (Com C §2608(2)) (see §§17.64-17.65)

Notice to seller of cancellation of contract (Com C §2612(3)) (see §17.86)

Buyer's response to seller's notice claiming excuse (Com C §2616) (see §§16.72-16.78)

Notice to seller of buyer's intention to deduct damages from any part of the price still due under same contract (Com C §2717) (see §§17.80-17.82)

Notice of intention to offer evidence of market price in an action based on anticipatory repudiation (Com C §2723(3)) (see §§4.9, 18.61)

Notice that buyer is assuming debts to known claimants in purchase of seller's business (Com C §6103(d)) (see §§14.18-14.19, 14.46)

Notice that buyer is assuming all debts in purchase of seller's business (Com C §6103(e)) (see §§14.20-14.21)

Notice by buyer of sale to newly formed organization that will take over and continue seller's business (Com C §6105) (see §14.22)

Notice of bulk sale not by auction or liquidator (Com C §6105(a)-(b)) (see §§14.25-14.27)

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18

Litigation Remedies

Richard J. Maire, Jr.
Ivan L. Kallick
Loyd P. Derby

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§18.1 I. SCOPE OF CHAPTER

This chapter covers litigation remedies provided by the Commercial Code and the following statutory enactments:

- The Consumers Legal Remedies Act (CC §§1750-1784);
- The Song-Beverly Consumer Warranty Act (CC §§1790-1795.8);
- Motor Vehicle Warranty Adjustment Programs (CC §§1795.90-1795.93);
- The Unruh Act governing retail installment sales (CC §§1801-1812.20);
- The Rees-Levering Motor Vehicle Sales and Finance Act (CC §§2981-2984.4); and
- The Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312) with implementing Federal Trade Commission regulations (16 CFR §§700.1-703.8).

The chapter does not discuss remedies available to a buyer or seller at common law.

The remedies provided by the Commercial Code are not exclusive (see Com C §2701), and the attorney should consider which other remedies may be available under the circumstances.

If fraud is present in the transaction, the Code enlarges the remedies available. See Com C §2721, which states that remedies for material misrepresentation or fraud include all remedies available under Division 2 for nonfraudulent breach. See also CC §3343 regarding recovery of damages in fraud actions.

For discussion of Commercial Code remedies available to the buyer or seller short of actual litigation, see chap 17. See also California Breach of Contract Remedies, chap 3 (Cal CEB 1980).

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II. SELLER'S REMEDIES

§18.2 A. Damages

Once the buyer has accepted the goods or is chargeable for their loss, the seller is entitled to recover the contract price. See §§18.17-18.19. If the buyer repudiates, wrongfully rejects, or wrongfully revokes acceptance of the goods, the seller is entitled to recover damages and has several measures of damages from which to choose. Com C §§2703(d)-(e), 2706(1), 2708, 2710.

The basic measure of damages is the difference between the contract price of the goods and their market price. See §§18.3-18.4. By reselling properly (see §§18.5-18.7), the seller can fix its damages and avoid having to prove market price in litigation. In certain circumstances, the seller can recover lost profits. See §§18.10-18.14. Punitive damages are ordinarily not available. See §18.15.

On the seller's right to retain part of the buyer's down payment or deposit, see §17.23. For discussion of liquidated damages, see §§18.51-18.52.

Regarding recovery of damages generally, see California Attorney's Guide to Damages, chap 1 (2d ed Cal CEB 2004); California Law of Contracts, chap 10 (Cal CEB 2007).

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1. Damages Measured by Market Price

§18.3 a. The Rule

The basic measure of damages for the buyer's repudiation, rejection, or wrongful revocation of acceptance of the goods is the difference between the unpaid contract price of the goods and their market price at the time and place for tender, plus any incidental damages sustained and less any expenses saved as a result of the buyer's breach. Com C §2708(1). For the manner of proof of market price, see §18.61. Incidental damages are discussed in §§18.8-18.9.

Where and when the seller is required to tender the goods are governed by Com C §2503 and the contract's shipment terms. Official Comment 1 to UCC §2-708. The attorney should remember that the time for tender may have been (1) changed by express or implied modifications of the contract (see Com C §2209) or (2) delayed by a party's failure to cooperate (see Com C §2311).

With respect to an installment contract, the seller must establish the market price at the time and place for tender of each installment. See Com C §2703.

If the buyer repudiates the contract before the seller's tender and the seller brings an action before the tender date, Com C §2723(1) establishes an alternative time for measuring market price. That alternative is the time when the seller learned of the buyer's repudiation.

If the difference between the market price and unpaid contract price is not enough to put the seller in as good a position as the buyer's performance would have, the measure of damages is the profit that the seller would have made from full performance by the buyer. Com C §2708(2); *National Controls, Inc. v Commodore Bus. Machs., Inc.* (1985) 163 CA3d 688, 209 CR 636. See §§18.10-18.14.

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Source: Business Law/California UCC Sales and Leases/18 Litigation Remedies/§18.4 b. Form: Allegation of Damages Measured by Market Price

§18.4 b. Form: Allegation of Damages Measured by Market Price

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18.4-1 Allegation of damages measured by market price

The unpaid contract price for the goods at the time of defendant's breach was _ _[*dollar amount*]**_ _. The market price of the goods on _ _**[*date*]**_ _ at the time and place for tender of the goods, was _ _**[*dollar amount*]**_ _.**

As a result of defendant's breach, plaintiff was required to and did incur commercially reasonable charges, expenses, or commissions for _ _[*e.g., stopping delivery of, caring for, and returning or reselling the goods*]**_ _. The sum of such incidental expenses was _ _**[*dollar amount*]**_ _.**

Comment: In this clause, use of the term "goods" presumes that they have been described earlier in the complaint and that the specific contract governing their sale has also been adequately identified for pleading purposes.

PRACTICE TIP: The expenses of making the goods marketable should be included, *e.g.,* repackaging, relabeling. As long as such expenses are reasonably calculated to maximize the value of the goods, they should be included.

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2. Damages Measured by Resale

§18.5 a. The Rule

A proper resale of the goods fixes the seller's damages as the difference between the contract price and the resale price, plus any incidental damages and less any expenses saved as a result of the buyer's breach. Com C §§2703(d), 2706(1). This measure applies whether the resale is public or private. See *Alco Standard Corp. v F&B Mfg. Co.* (Ill 1972) 281 NE2d 652.

The seller is under no duty to resell the goods; nor is it obligated to use the resale price in establishing its loss. Even after a resale, the seller can use the difference between the market price and contract price of the goods as its measure of damages. See, *e.g., Lee Oldsmobile, Inc. v Kaiden* (Md Ct Spec App 1976) 363 A2d 270. However, a seller who fails to observe all the requirements of Com C §2706 (see §§17.41-17.45) in conducting the resale forfeits the right to use the resale measure of damages and is relegated to the market price/contract price formula of Com C §2708. Official Comment 2 to UCC §2-706; *National Controls, Inc. v Commodore Bus. Machs., Inc.* (1985) 163 CA3d 688, 209 CR 636; 4 Witkin, Summary of California Law, *Sales* §189 (10th ed 2005). Even though the seller resells the goods, market price remains relevant. If it is significantly higher than the price obtained by the seller on resale, it is evidence that the resale was not "commercially reasonable." Official Comment 3 to UCC §2-706 (Official Comment 4 to UCC §2-706 (2003)). A low resale price should be acceptable, however, if the seller conducted the sale in a proper manner. See *Allied Grape Growers v Bronco Wine Co.* (1988) 203 CA3d 432, 445, 249 CR 872; *Millick v Peer* (1955) 130 CA2d Supp 894, 279 P2d 212. A recent Michigan case has held that on resale the seller may substitute fungible goods and, under circumstances in which the seller made a good faith effort to locate other purchasers, a three-year delay between breach and resale was not commercially unreasonable. *Firwood Mfg. Co. v General Tire, Inc.* (6th Cir 1996) 96 F3d 163.

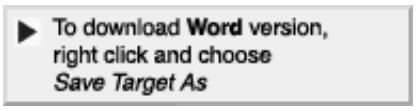
If the seller realizes a profit on the resale, the seller may retain it. Com C §2706(6).

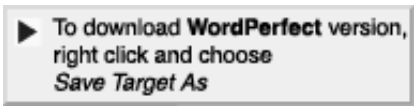
For discussion of the procedures for conducting a resale, see §§17.41-17.45.

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b. Forms

§18.6 (1) Form: Allegation of Damages Measured by Resale (Private Sale)





18.6-1 Allegation of damages measured by resale (private sale)

On _ _[*date*]_ _ at _ _[*time*]_ _, plaintiff resold the goods _ _[*e.g., in a single lot/in lots of ten*]_ _ by private sale at _ _[*e.g., plaintiff's place of business, located at _ _[address*]_ _]_ _.

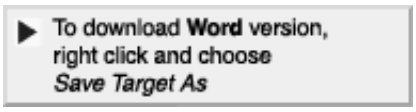
On _ _[*date*]_ _, plaintiff notified defendant that plaintiff intended to resell the goods by private sale. A copy of plaintiff's notice is attached to this complaint as Exhibit _ _[*number*]_ _ and incorporated by reference. The resold goods were identified as being subject to the contract between plaintiff and defendant _ _[*e.g., by marking the goods with defendant's invoice number*]_ _.

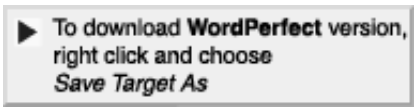
The unpaid contract price for the goods at the time of defendant's breach was _ _[*dollar amount*]_ _. The price obtained by plaintiff for the goods on resale was _ _[*dollar amount*]_ _.

As a result of defendant's breach, plaintiff was required to and did incur commercially reasonable charges, expenses, or commissions for _ _[*e.g., stopping delivery of, caring for, and returning or reselling the goods*]_ _. The sum of these incidental expenses was _ _[*dollar amount*]_ _.

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§18.7 (2) Form: Allegation of Damages Measured by Resale (Public Sale)





18.7-1 Allegation of damages measured by resale (public sale)

On _ _[*date*]_ _ at _ _[*time*]_ _, plaintiff resold the goods _ _[*e.g., in a single lot/in lots of ten*]_ _ by public sale at _ _[*e.g., plaintiff's place of business/public auction facilities located at _ _[address]_ _]_ _.

[*Option 1: If notice is given*]

On _ _[*date*]_ _, plaintiff notified defendant of the time and place of resale. A copy of plaintiff's notice is attached to this complaint as Exhibit _ _[*number*]_ _ and incorporated by reference.

[*Option 2: If notice is not required*]

Plaintiff was reasonably excused from providing notice of the sale to defendant because the goods _ _[*were perishable/threatened to decline in value speedily*]_ _.

[*Continue*]

[*Option 1: Goods available for inspection at sale*]

The goods were within the view of those attending the sale.

[*Option 2: Goods available for inspection at location provided in notice of sale*]

The notice of sale stated where the goods were located and provided for their reasonable inspection by prospective bidders. A copy of the notice of sale is attached to this complaint as Exhibit _ _[*number*]_ _ and incorporated by reference.

[*Continue*]

The unpaid contract price for the goods at the time of defendant's breach was _ _[*dollar amount*]_ _. The price obtained by plaintiff for the goods on resale was _ _[*dollar amount*]_ _.

As a result of defendant's breach, plaintiff was required to and did incur commercially reasonable charges, expenses, or commissions for _ _[*e.g., stopping delivery of, caring for, and returning or reselling the goods*]_ _. The sum of these incidental expenses was _ _[*dollar amount*]_ _.

Comment: In this clause, use of the term "goods" presumes that they have been described earlier in the complaint and that the specific contract governing their sale has also been adequately identified for pleading purposes. On identification of the goods to the contract, see Com C §2501, discussed in §§8.28-8.29, 17.32-17.36. On incidental damages, see §§18.8-18.9.

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3. Incidental and Consequential Damages

§18.8 a. The Rule

The seller is entitled to recover incidental damages in actions based on the buyer's wrongful repudiation of the contract, wrongful rejection of the goods, wrongful revocation of acceptance, or failure to make a payment due on or before delivery. Com C §§2706(1), 2708(1)-(2). Incidental damages consist of all commercially reasonable expenditures that result from the buyer's breach, including the items listed in Com C §2710 (*i.e.,* expenses incurred in stopping delivery, storing or transporting the goods after breach, and returning or reselling the goods). But see *Ballard v Equifax Check Servs., Inc.* (ED Cal 1998) 27 F Supp 2d 1201 (incidental damages do not include costs incurred in collection of underlying debt).

In *Bulk Oil Inc. v Sun Oil Trading Co.* (2d Cir 1983) 697 F2d 481, the buyer defaulted in its agreement to buy oil from the seller. The seller had borrowed money to purchase the oil from a supplier. The court deemed postbreach interest payments on the loan to be commercially reasonable and foreseeable and therefore recoverable as incidental damages. See also *North Am. Foreign Trading Corp. v Direct Mail Specialists* (SD NY 1988) 697 F Supp 163. But see *Firwood Mfg. Co. v General Tire, Inc.* (6th Cir 1996) 96 F3d 163.

Although the seller may recover incidental damages, the seller's recovery should be reduced by expenses saved in consequence of the buyer's breach. Com C §§2706(1), 2708(1). For example, assume that the contract requires the seller to deliver the goods F.O.B. point of shipment (*i.e.,* the seller must deliver the goods at its own expense to the carrier and bear the risk of loss until the carrier has possession). At the time of the buyer's breach, the seller has produced the goods but has neither prepared them for shipment or delivered them to a carrier. If, after the breach, the seller decides not to resell the goods and sues under Com C §2708(1), the expenses saved are the costs not incurred in preparation and shipment. See also *Allsopp Sand & Gravel, Inc. v Lincoln Sand & Gravel Co.* (Ill App 1988) 525 NE2d 1185. In *Allsopp,* sand was purchased by the buyer but never picked up. Its cost included the seller's loading expenses. The seller sued to recover the full price, but the court reduced the seller's recovery by the amount of the loading expenses.

The seller may not recover "consequential or special," damages unless they are allowed in specific provisions of the Commercial Code or available under some other rule of law. Com C §1305(a). No Code provision gives sellers the right to recover consequential damages. On buyers' entitlement to consequential damages, see §§18.36-18.41. Commercial Code §2715(2) describes consequential damages of the buyer as any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know, and which could not reasonably be prevented by cover or otherwise.

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Source: Business Law/California UCC Sales and Leases/18 Litigation Remedies/§18.9 b. Form: Allegation of Incidental Damages

§18.9 b. Form: Allegation of Incidental Damages

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18.9-1 Allegation of incidental damages

As a result of defendant's breach, plaintiff was required to and did incur commercially reasonable charges, expenses, or commissions for _ _[*e.g., stopping delivery of, caring for, and returning or reselling the goods*]**_ _. The sum of these incidental expenses was _ _**[*dollar amount*]**_ _.**

Comment: Incidental damages are collectible (1) in an action for breach following the buyer's wrongful repudiation, rejection, revocation of acceptance, or failure to make a payment due on or before delivery (Com C §2708(1)); (2) for the seller's lost profits (Com C §2708(2)); (3) in a suit for the contract price (Com C §2709(1)); or (4) after resale (Com C §2706(1)).

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§18.10 4. Lost Profits

If the difference between the contract price and the market price or resale price does not adequately compensate the seller for its losses, Com C §2708(2) provides an alternative measure of damages. It entitles the seller to recover the profits (including reasonable overhead) that the seller would have made from the buyer's full performance, together with incidental damages, due allowance for costs reasonably incurred, and due credit for the buyer's payments or proceeds of the resale.

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§18.11 a. Lost Volume Seller

The lost profits measure of damages is most often useful to the "lost volume" seller (*i.e.,* a seller who proves that, even though it resold the contract goods, a sale to some third party would have been made regardless of the buyer's breach, so that the seller would have realized profits from two sales rather than one).

In *National Controls, Inc. v Commodore Bus. Machs., Inc.* (1985) 163 CA3d 688, 209 CR 636, the seller sued the buyer for breach of contract after the buyer ordered 900 scales but accepted and paid for only 50. The seller's damages award was the profit that it would have made on the sale of the remaining 850 scales to the buyer, notwithstanding the seller's resale of the scales to a different customer. The seller established itself as a lost volume seller because its manufacturing plant was operating at 40-percent capacity at the time of the breach and it could have easily filled both orders. See also *Rodriguez v Learjet, Inc.* (Kan Ct App 1997) 946 P2d 1010 (applying criteria in determining whether seller was lost volume dealer).

With a lost volume seller, there should be no credit against recovery of the "proceeds of resale." Applying Com C §2708(2)'s "due credit" provision in that situation would result in the seller's recovering only the profit made on the resale plus the difference between the resale price and the contract price, an almost identical measure to Com C §2708(1). Because, in theory, the seller would have made the resale to the third party anyway, the seller should receive the profit that it would have made from both sales.

The provision in Com C §2708(2) that lost profit should include the seller's reasonable overhead is intended to allow the seller to recover that portion of overhead costs that the broken contract would have borne if the buyer had performed. Otherwise, overhead costs, which are fixed, would be borne by the seller's other sales, reducing the seller's profit from them. See *Scullin Steel Co. v Paccar, Inc.* (Mo Ct App 1988) 748 SW2d 910 (court allowed overhead recovery representing 30 percent of seller's total overhead costs).

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§18.12 b. Component Seller

Another type of seller who benefits from Com C §2708(2)'s "lost profits" measure of damages is the "component" seller who contracts with the buyer to sell an assembled product. For example, assume that the buyer breaches the contract before final assembly and that the seller decides to stop the assembly process. The decision to complete assembly or not must be made in the exercise of reasonable commercial judgment. Com C §2704(2). Whether the seller's judgment is reasonable depends in part on whether a market exists for the finished product. *Detroit Power Screwdriver Co. v Ladney* (Mich Ct App 1972) 197 NW2d 857.

When the seller stops production in mid-process, recovery under Com C §§2706 and 2708(1) is not available because both of those sections contemplate a market for the completed product. The Commercial Code therefore permits the seller to compute its damages by (1) adding expenses already incurred in the assembly process to the profit that it would have made if it had completed and sold the goods and then (2) subtracting the salvage value of any unfinished goods. Com C §2708(2).

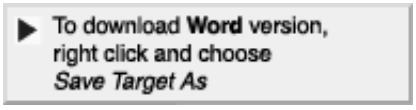
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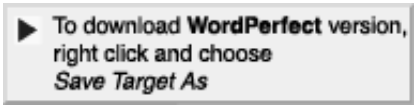
§18.13 c. Jobber or Middleman

A third type of seller who typically would not be adequately compensated under Com C §2708(1) is the "jobber" or middleman, who only acts as an intermediary in the sale of the goods. When the buyer breaches the contract, the middleman may not have any goods on hand to sell to fix its damages. Therefore, it may instead recover the profit lost by the buyer's breach. See, *e.g., Distribu-Dor, Inc. v Karadanis* (1970) 11 CA3d 463, 90 CR 231; *Blair Int'l v LaBarge, Inc.* (8th Cir 1982) 675 F2d 954.

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§18.14 d. Form: Allegation of Damages Measured by Lost Profits





18.14-1 Allegation of damages measured by lost profits

The goods that were the subject of the contract between plaintiff and defendant were not unique or in limited supply and were routinely sold by plaintiff to another customer. As a consequence, plaintiff lost the benefit of the bargain with defendant, and damages based on the difference between the contract price and the market price will not put plaintiff in as good a position as defendant's performance would have. Plaintiff would have realized a net profit of _ _[*dollar amount*]_ _ on the sale to defendant. A reasonable amount of overhead attributable to the contract with defendant is _ _[*dollar amount*]_ _. Plaintiff's lost profit, including reasonable overhead, is _ _[*dollar amount*]_ _.

[*Add if appropriate*]

In addition, plaintiff has incurred the reasonable sum of _ _[*dollar amount*]_ _ in expenses as described in paragraph _ _[*number*]_ _. _ _[*Defendant should be credited _ _[dollar amount]_ _ for payments already made on the contract price.*]_ _ Accordingly, plaintiff has been damaged in the amount of _ _[*dollar amount*]_ _.

Comment: This clause alleges damages recoverable by a "lost volume" seller under Com C §2708(2). Use of the term "goods" presumes that they have been described earlier in the complaint and that the specific contract governing their sale has also been adequately identified for pleading purposes. For an allegation of incidental damages, see §18.9.

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§18.15 5. Punitive or Exemplary Damages

The Commercial Code prohibits recovery of punitive or exemplary damages unless they are available to an aggrieved party under some other body of law. Com C §1305(a). Punitive damages can clearly be awarded in a Uniform Commercial Code suit in which an independent tort is also proven. See, *e.g., Cantrell v Amarillo Hardware Co.* (Kan 1979) 602 P2d 1326 (punitive damages awarded against seller who continued to manufacture ladder after knowing it to be unsafe); *Fousel v Ted Walker Mobile Homes* (Ariz Ct App 1979) 602 P2d 507 (fraud).

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§18.16 6. Attorney Fees and Costs

Division 2 of the Commercial Code contains no provision for the recovery of attorney fees in actions between sellers and buyers; accordingly, unless attorney fees are specifically provided for by statute, their recovery in any action is left to the express or implied agreement of the parties. CCP §1021. If the agreement provides for recovery of attorney fees by one party, they are also recoverable by the other party. CC §1717(a).

If the sale involves consumer goods, attorney fees may be available. See CC §§1780(e) (part of the Consumers Legal Remedies Act), 1794(d) (part of the Song-Beverly Consumer Warranty Act), and 1811.1 (part of the Unruh Act governing retail installment sales). Attorney fees may also be recoverable in a contract action based on a book account. CC §1717.5. See also *Brown v West Covina Toyota* (1994) 26 CA4th 555, 32 CR2d 85 (attorney fees under Song-Beverly Consumer Warranty Act available only to prevailing buyer).

NOTE: *Brown v West Covina Toyota, supra,* was disapproved by the California Supreme Court in *Murillo v Fleetwood Enters., Inc.* (1998) 17 C4th 985, 995, 73 CR2d 682, to the extent that it prohibits a prevailing seller from recovering its cost of suit in an action brought under the Song-Beverly Consumer Warranty Act. The court reasoned that CC §1794(d) creates no *express* exception to the general rule permitting a seller, as a prevailing party, to recover its costs under CCP §1032(b). The court also allowed the prevailing seller in *Murillo* to recover its expert witness fees under CC §998.

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B. Contract Price Recovery

§18.17 1. When Available

When the buyer fails to pay the price as it falls due, the seller can recover the full contract price for the goods in three situations:

(1) When the buyer has accepted the goods. Com C §2709(1)(a). "Acceptance" does not include an acceptance that has been justifiably revoked. Official Comment 5 to UCC §2-709. A rejection or revocation of acceptance that is improper or ineffective, however, will be considered to be an acceptance, entitling the seller to recover the price of the goods. See Com C §§2606(1)(b), 2608(2).

In situations involving an installment contract, failure of the buyer to pay one or more installments may give the seller the right to accelerate the balance due and seek the price even if the contract does not expressly provide for acceleration. *Gantry Constr. Co. v American Pipe & Constr. Co.* (1975) 49 CA3d 186, 122 CR 834.

See CC §1719 for penalties that may be imposed if the buyer fails to cover a dishonored check within 30 days of the seller's written demand for payment. The penalties include: (a) the amount of the check; (b) a service charge of up to $25 for the first dishonored check and up to $35 for each subsequently dishonored check, payable to the seller; (c) the seller's costs to send, by certified mail, the written demand for payment; and (d) treble damages of at least $100 and no more than $1500. CC §1719(a)(1)-(2). (Once the damages are trebled for the amount of the check, the service charge and mailing costs are not chargeable. CC §1719(a)(2).)

(2) When identified goods cannot be resold. Price recovery is available when the goods have been identified to the contract and the seller is unable, after reasonable effort, to resell them for a reasonable price or the circumstances reasonably indicate that the seller would be unable to do so. Com C §2709(1)(b). The term "reasonable" is used three times in Com C §2709 to emphasize that the drafters of the Code believed that most goods could be sold for an amount above their scrap value. Before using Com C §2709, the seller's attorney should ensure that the client has made all reasonable efforts to resell, including offering the goods at a substantial reduction in price. *Publicker Indus. v Roman Ceramics Corp.* (3d Cir 1981) 652 F2d 340; *Foxco Indus. Ltd. v Fabric World Inc*. (5th Cir 1979) 595 F2d 976. See also *Ultralite Container Corp. v American President Lines, Ltd.* (7th Cir 1999) 170 F3d 784 (applying California law).

The requirement of Com C §2709 that the goods be "identified to the contract" arises from the fact that an action for the price is, in effect, an action for specific performance. The seller is not entitled to make the buyer specifically perform unless the seller is also willing and able to perform. If the seller wants the price, it must be able to deliver the goods. Because unidentified or unfinished goods cannot be delivered, identification is a condition precedent to recovery of the price. See *Gantry Constr. Co. v American Pipe & Constr. Co., supra*.

On identification of goods, see Com C §2501. See also §§8.28-8.29, 17.32-17.37.

(3) When the buyer refuses to pay for conforming goods that have been lost or damaged, if risk of their loss has passed to the buyer, and loss or damage occurs within a commercially reasonable time after buyer's breach. Com C §2709(1)(a). This provision must be construed in light of Com C §§2509-2510 on risk of loss. The practical significance of the passage of risk in sales contracts is that, if the goods are lost or damaged after the risk has passed to the buyer, the buyer must pay the seller the agreed price for them even if the buyer has never received the goods. Under the Commercial Code, when there is no basis for the buyer to reject the goods, the risk of their loss ordinarily passes when the seller performs certain acts of delivery or when the buyer receives the goods, documents of title, or acknowledgment of the buyer's right to the goods. Com C §§2509, 2510(1). See §§8.26-8.27, 16.40-16.50.

Any written agreement should be carefully reviewed because the issue of risk of loss is often addressed by agreement of the parties. If the buyer breaches the contract before the risk passes, the seller nevertheless has a limited right to "treat the risk of loss as resting on the buyer." Com C §2510(3). The limits on this right are:

- If the seller has insurance covering the loss, it must deduct insurance proceeds from its claim against the buyer for the price. Com C §2510(3).

- The risk will be considered to rest on the buyer for only a commercially reasonable time. Com C §2510(3).

It is clear from Official Comment 6 to UCC §2-709 that an action for the price is limited to the above three situations. In other situations, the seller must seek damages.

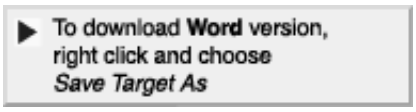
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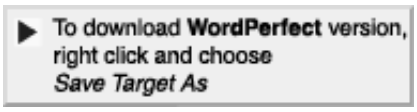
§18.18 2. Procedural Aspects

If the seller is entitled to the price under Com C §2709(1), the buyer may claim the goods intended for the contract or the net proceeds of any of those goods resold by the seller. Com C §2709(2). The seller may have an opportunity to resell the goods before it collects from the defaulting buyer. If so, the seller may, but is not required to, sell them (or part of them) and credit the buyer with the net proceeds. The seller has this option until any judgment against the buyer relating to the goods is satisfied. Com C §2709(2). In effect, resale before judgment transmutes the price action into an action for damages measured by the resale. If the seller can collect a substantial portion of the price by resale, it will be in the seller's interest to do so. If the seller can collect only a small amount for the goods, however, the risk of having the commercial reasonableness of the sale attacked may be too great. On resale, see §§17.38-17.46.

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§18.19 3. Form: Allegations for Recovery of Price





18.19-1 Allegations for recovery of price

[*Alternative 1: Single contract price*]

By the terms of the contract between plaintiff and defendant, defendant agreed to pay the price of _ _[*dollar amount*]_ _ for the goods on or before _ _[*date*]_ _. Defendant has paid no part of this price.

[*Alternative 2: Installment contract*]

By the terms of the contract between plaintiff and defendant, defendant agreed to pay the price in _ _[*number*]_ _ equal installments of _ _[*dollar amount*]_ _, commencing on _ _[*date*]_ _ through _ _[*date*]_ _. Defendant failed to pay the installments due on _ _[*date*]_ _ through _ _[*date*]_ _, as a result of which the value of the contract has been substantially impaired (Commercial Code §2612(3)).

[*Continue*]

[*Option 1: Goods were accepted*]

Defendant accepted the goods on or about _ _[*date*]_ _.

[*Option 2: Risk of loss passed to defendant*]

The goods and plaintiff's performance conformed to the contract in all respects. Risk of loss of the goods passed to defendant on _ _[*date*]_ _, by reason of _ _[*e.g., plaintiff's delivery of the goods to the carrier for shipment/defendant's wrongful repudiation*]_ _. The goods were _ _[*lost/damaged*]_ _ within a commercially reasonable time thereafter, on or about _ _[*date*]_ _.

[*Option 3: Identified goods could not be resold*]

The goods were identified to the contract on or about _ _[*date*]_ _. Plaintiff has made reasonable efforts to resell the goods at a reasonable price but _ _[*has been unable to do so/the circumstances reasonably indicate that any effort to resell the goods will fail*]_ _. Specifically, _ _[*describe efforts to resell the goods/explain why such efforts would be futile*]_ _. Plaintiff is still holding the goods for defendant.

[*Continue*]

As a consequence, plaintiff is entitled to recover the contract price of _ _[*dollar amount*]_ _, together with incidental damages as alleged in paragraph _ _[*number*]_ _.

Comment: Note that if a court holds that the seller is not entitled to the price, the seller may nevertheless be awarded damages for the buyer's nonacceptance of the goods. Com C §2709(3). When the seller brings its action for the price, it should plead a separate cause of action for damages. See Official Comment 7 to UCC §2-709. In this clause, use of the term "goods" presumes that they have been described earlier in the complaint and that the specific contract governing their sale has also been adequately identified for pleading purposes.

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III. BUYER'S REMEDIES

§18.20 A. Damages

If a seller repudiates the contract, fails to deliver, delivers nonconforming goods, or breaches a warranty, several possible remedies for damages are available to the buyer. See Com C §§2711-2715.

Generally, the buyer's damages under Commercial Code Division 2 are the difference between the contract price and either (1) the market price (see §§18.21-18.22) or (2) the cost of cover (see §§18.23-18.24) plus incidental (see §18.35) and consequential (see §§18.36-18.41) damages.

If the seller breaches a warranty after acceptance by the buyer (and when the buyer does not justifiably revoke acceptance), the buyer's basic measure of damages is the difference at the time and place of acceptance between the value of the goods accepted and the value they would have had if they had been as warranted. Com C §2714(2). See §§18.25-18.41.

On recovery of damages generally, see California Attorney's Guide to Damages, chap 1 (2d ed Cal CEB 2004); California Law of Contracts, chap 10 (Cal CEB 2007).

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1. Damages Measured by Market Price

§18.21 a. The Rule

The basic measure of damages for a seller's repudiation or nondelivery is the difference between the market price and the contract price. Com C §2713(1). (The buyer's justified rejection or revocation of acceptance is considered to be nondelivery by the seller. Com C §2711(1)(b).) Market price is measured as of the time the buyer learned of the breach, at the place where the goods were to be tendered or, if the goods have arrived and have been rejected or their acceptance has been revoked, at the arrival point. See Official Comment 1 to UCC §2-713.

In addition to the market price/contract price differential, the buyer can recover incidental and consequential damages to the extent that the consequential damages could not have been avoided by cover. See Com C §§2711, 2713(1), 2715(2)(a). If the buyer saves expenses (*e.g.,* shipping costs) because of the seller's breach, the expenses saved must be deducted from the amount of damages recoverable. Com C §2713(1).

In many instances, determining when the buyer "learned of the breach" will be simple: It is the time when the seller fails to deliver the goods. With a seller's anticipatory repudiation, however, the determination becomes more complicated. The cases and commentators have suggested three different times:

(1) The date on which the buyer learns of the repudiation (see, *e.g., Palmer v Idaho Peterbilt, Inc.* (Idaho Ct App 1982) 641 P2d 346);

(2) A commercially reasonable time after the buyer learns of the repudiation (see, *e.g., First Nat'l Bank v Jefferson Mortgage Co.* (3d Cir 1978) 576 F2d 479); or

(3) The date on which performance was due (see, *e.g.,* White & Summers, Uniform Commercial Code §6-7 (4th ed 1995)).

A majority of courts have adopted the first alternative. See *Trinidad Bean & Elevator Co. v Frosh* (Neb 1992) 494 NW2d 347; *Burgess v Curly Olney's, Inc.* (Neb 1977) 251 NW2d 888. The authors have identified no California authority on this issue. In pre-Code cases, the courts reached differing conclusions. Compare *Eskew v California Fruit Exch.* (1928) 203 C 257, 263 P 804 (damages measured as of date of express repudiation), with *United States Trading Corp. v Newmark Grain Co.* (1922) 56 CA 176, 205 P 29 (damages measured as of date for performance, not date of repudiation).

In an anticipatory breach action that comes to trial before the time for performance, market price will be determined as of the time the aggrieved party learned of the repudiation. Com C §2723.

The measure of damages for the seller's repudiation or nondelivery is the difference between the contract price and market price, with appropriate adjustments for additional incidental and consequential damages and for expenses saved in consequence of the seller's breach. Com C §2713(1). If the market price has risen substantially, this could give the buyer a greater economic benefit than it would have received had the contract been performed.

In *Allied Canners & Packers, Inc. v Victor Packing Co.* (1984) 162 CA3d 905, 209 CR 60, the court refused to allow the buyer to recover damages under Com C §2713 because it would have resulted in a windfall to the buyer. Because of a failure in the raisin crop, at the time of the seller's breach the market price for raisins was three times the contract price. Consequently, under Com C §2713, the buyer would have recovered over $150,000, rather than the $4400 it expected to make on resale of the raisins to another party. Foremost in the court's mind in denying the buyer recovery under Com C §2713 was the Commercial Code policy that its remedies be administered so that the aggrieved party is put in as good a position as if the other party had fully performed. Com C §1305(a). As a result, the court limited the buyer's damages to its actual loss: the amount it expected to make on the transaction. 162 CA3d at 915, 209 CR at 66. (Note that the *Allied Canners* decision has been sharply criticized in numerous law review articles and in at least one sister-state opinion. See *KGM Harvesting Co. v Fresh Network* (1995) 36 CA4th 376, 388, 42 CR2d 286, a cover case under Com C §2712; *Tongish v Thomas* (Kan 1992) 840 P2d 471. See also *Coast Trading Co. v Cudahy Co.* (9th Cir 1979) 592 F2d 1074, in which the court declined to award the seller its full contract price/market price differential under UCC §2-708(1) (ORS §72.7080) because that remedy would have produced a windfall for the seller.

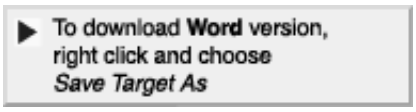
If there is no market or market price for the goods, the measure of damages is the difference between their reasonable or actual value and their contract price. See *Henderson v Otto Goedecke, Inc.* (Tex Ct App 1968) 430 SW2d 120, in which, to determine "reasonable value," the court allowed the introduction of evidence to show the cost of the goods at a point near the place of tender. See also *Cole v Melvin* (D SD 1977) 441 F Supp 193, in which market price was determined by reference to a reasonable substitute market.

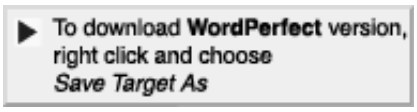
On proof of market price, see §18.61.

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Source: Business Law/California UCC Sales and Leases/18 Litigation Remedies/§18.22 b. Form: Allegation of Damages Measured by Market Price

§18.22 b. Form: Allegation of Damages Measured by Market Price





18.22-1 Allegation of damages measured by market price

Plaintiff learned of defendant's breach on or about _ _[*date*]_ _. The place for _ _[*tender/arrival*]_ _ of the goods was _ _[*address*]_ _. At that time and place, the market price for the goods that defendant was obligated to furnish was _ _[*dollar amount*]_ _. The contract price for the goods was _ _[*dollar amount*]_ _. Accordingly, plaintiff suffered damages as a result of defendant's breach in the amount of _ _[*dollar amount*]_ _.

Comment: In this clause, use of the term "goods" presumes that they have been described earlier in the complaint and that the specific contract governing their sale has also been adequately identified for pleading purposes.

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2. Damages Measured by Cover

§18.23 a. The Rule

Whenever the seller repudiates the contract, fails to make delivery of the goods, or delivers goods that the buyer properly rejects or rightfully revokes acceptance of, the buyer can fix its damages by covering, *i.e.,* by making a substitute contract or purchase. Com C §§2711(1)(a), 2712. For discussion of cover, see §§17.67-17.69.

Although the buyer is free to choose between damages fixed by cover and damages fixed by the market price (Official Comment 3 to UCC §2-712 (Official Comment 6 to UCC §2-712 (2003))), once the buyer covers, it cannot choose to measure its damages by market price (Official Comment 5 to UCC §2-713; *Cosden Oil & Chem. Co. v Karl O. Helm Aktiengesellschaft* (5th Cir 1984) 736 F2d 1064). When the buyer covers by making in good faith and without unreasonable delay any reasonable purchase of goods in substitution for those due from the seller, the buyer may recover from the seller as damages the difference between the cost of cover and the contract price, even though the buyer is able to pass some of its losses on to its customers. *KGM Harvesting Co. v Fresh Network* (1995) 36 CA4th 376, 42 CR2d 286.

Two obvious advantages of obtaining covering goods are:

(1) The buyer then has goods with which to continue its business or fulfill its contractual obligations to other parties; and

(2) The buyer avoids the difficulties of proving market price in subsequent litigation.

Conversely, establishing inability to cover is a prerequisite to the remedy of replevin (see §18.46), is helpful if the buyer seeks specific performance (see §18.47), and is mandatory when the buyer seeks consequential damages that could have been avoided by covering (see §18.36).

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§18.24 b. Form: Allegation of Damages Measured by Cover

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18.24-1 Allegation of damages measured by cover

On or about _ _[*date*]_ _, and without unreasonable delay, plaintiff covered by purchasing, for _ _[*dollar amount*]_ _, _ _[*describe and give quantity of cover goods*]_ _, in substitution for the goods due from defendant. The contract price for the goods was _ _[*dollar amount*]_ _. Accordingly, plaintiff suffered damages as a result of defendant's breach in the amount of _ _[*dollar amount*]_ _.

Comment: Cover must be made "in good faith and without unreasonable delay" for it to be used as a measure of the buyer's damages. Com C §2712. See §17.67-17.69 for discussion of other requirements for a proper cover.

In this clause, use of the term "goods" presumes that they have been described earlier in the complaint and that the specific contract governing their sale has also been adequately identified for pleading purposes.

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Source: Business Law/California UCC Sales and Leases/18 Litigation Remedies/§18.25 3. Damages After Acceptance: Nonconformity and Breach of Warranty

§18.25 3. Damages After Acceptance: Nonconformity and Breach of Warranty

Sometimes the buyer has the opportunity to choose between two courses of action: (1) to reject the goods, procure substitutes, and seek damages, as discussed in §§18.20-18.24; or (2) to accept the goods and seek damages under Com C §2714. The decision inevitably turns on practical considerations. If the buyer has no use for the defective goods or if it can obtain substitute goods easily, it will almost always opt to reject the goods. The buyer may decide to accept the goods, however, if no substitutes are available, the time for rejection or revocation has expired, or the defect does not interfere substantially with the buyer's purposes or expectation of value. Because the buyer can recover incidental and consequential damages in any case (if not disclaimed by contract), the result should theoretically be the same whether the buyer rejects and covers or accepts and claims damages.

To obtain damages under Com C §2714, the buyer must establish that:

- It has accepted the goods;
- The goods are nonconforming;
- Notice of the breach has been given to the seller as required by Com C §2607(3)(A); and
- Damages have been incurred as a result of the breach.

The buyer may recover damages for losses "resulting in the ordinary course of events from the seller's breach." Com C §2714(1). The losses may result from the seller's breach of warranty or any other failure to perform according to its obligations under the contract. The losses may include lost profits, lost use of the goods, loss of customers and goodwill, and expenditures incurred in attempting to make defective goods conform to the condition warranted. Official Comment 2 to UCC §2-714. See 4 Witkin, Summary of California Law, *Sales* §204 (10th ed 2005); *Serian Bros., Inc. v Agri-Sun Nursery* (1994) 25 CA4th 306, 30 CR2d 382.

Damages may be determined "in any manner which is reasonable." Com C §2714(1). Clients are often the best source of methods for valuing the defective goods and otherwise establishing loss. The attorney should question the client carefully about intangible or related losses that may also be recoverable. See Com C §2714(2)-(3).

Breach of warranty claims often arise long after the goods have been accepted and put into use. The measure of damages provided by Com C §2714(2) specifically for breach of warranty is the difference at the time and place of acceptance between the value of the goods accepted and the value they would have had if they had been as warranted. (One modification to this formula is mentioned in Official Comment 3 to UCC §2-714: If the buyer could have revoked acceptance but elected not to, the value of the goods is determined at the time and place at which the buyer elected not to revoke.)

If the goods are "consumer goods," the seller's breach of warranty may entitle the buyer to additional remedies. Civil Code §1794, part of the Song-Beverly Consumer Warranty Act, allows the buyer to recover its reasonable attorney fees and, if the seller's failure to comply with the Act was willful, the judgment may include a civil penalty, not to exceed two times the amount of the buyer's actual damages. See also CC §1791.1(d). The "willful" civil penalty will not be assessed, however, in a class action or when the buyer's action is based solely on breach of an implied warranty. CC §1794(c). Nor will it be assessed when the manufacturer maintains a qualified third party dispute resolution process in conformance with CC §1793.22. CC §1794(3)-(4). (Damages specifically allowed by CC §1794 include the rights of replacement or reimbursement or, if the buyer has accepted the goods, the cost of repairs necessary to make the goods conform. CC §1794(b).)

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a. Determining Value of Goods as Accepted

§18.26 (1) Expert Opinion of Fair Market Value

The value of accepted goods may be determined through the use of expert testimony concerning the goods' fair market value at the time of acceptance. See, *e.g., Soo Line R.R. Co. v Fruehauf Corp.* (8th Cir 1977) 547 F2d 1365 (court allowed testimony of buyer's executive vice president concerning extent to which structural defects in railroad hopper cars diminished their market value).

PRACTICE TIP: Careful consideration must be given to the selection of an expert and the qualifications of that expert.

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§18.27 (2) Resale Price

When available, the resale price of defective goods is also an appropriate measure of the goods' value at the time of acceptance as long as the resale occurs within a reasonable period following acceptance and the buyer knows of the defect. *Lackawanna Leather Co. v Martin & Stewart, Ltd.* (8th Cir 1984) 730 F2d 1197.

PRACTICE TIP: Seasonal consideration must be given to the value, as goods may have different value at different times of any given year.

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b. Determining Value of Goods as Warranted

§18.28 (1) Purchase Price

Many courts consider the price paid by the buyer to be the value of the goods as warranted. See, *e.g., De La Hoya v Slim's Gun Shop* (1978) 80 CA3d Supp 6, 146 CR 68; *Lone Star Ford Inc. v McGlashan* (Tex Ct App 1984) 681 SW2d 720; *Schatz Distrib. Co. v Olivetti Corp. of Am.* (Kan Ct App 1982) 647 P2d 820. Arguably, the purchase price may not provide the proper measure of damages, because it reflects the value of the goods at the time of contracting, not necessarily at the time of the buyer's acceptance. Similarly, the purchase price may differ at given times of the year or under different market conditions.

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§18.29 (2) Repair Costs

If the goods delivered must be repaired to make them conform to the warranty, the cost of repairs is often considered to be the difference between the value of the goods as accepted and as warranted. See, *e.g., Tarter v MonArk Boat Co.* (ED Mo 1977) 430 F Supp 1290, aff'd (8th Cir 1978) 574 F2d 984; *S.H. Nevers Corp. v Husky Hydraulics, Inc.* (Me 1979) 408 A2d 676. Compare *Faultingham v Sea Coast Subaru, Inc.* (Me 1993) 619 A2d 987. If, however, the buyer can establish that the repairs did not restore the goods to the value they would have had in the condition as warranted, the buyer may recover both the cost of repairs and the difference in value between the goods as repaired and as warranted. *Soo Line R.R. Co. v Fruehauf Corp.* (8th Cir 1977) 547 F2d 1365. This is often a very difficult question of fact.

If the defect appears only after the buyer has made significant use of the product, should the seller be required to pay for repairs that would make the product as good as new? See *Community Television Servs., Inc. v Dresser Indus.*, *Inc*. (D SD 1977) 435 F Supp 214 (repair or replacement cost less depreciation is proper measure of damages).

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§18.30 (3) Replacement Price

The cost of replacement of defective parts is normally recoverable as consequential damages for breach of warranty. See *U.S. v Franklin Steel Prods., Inc.* (9th Cir 1973) 482 F2d 400. In some cases, the cost of replacing defective parts has been a conclusive measure of the buyer's damages. See, *e.g., Chrysler Corp. v Wilson Plumbing Co.* (Ga Ct App 1974) 208 SE2d 321 (jury award of $4500 to buyer of defective car was held to be excessive in light of testimony that car could have been restored to good condition by replacing motor at cost of $900).

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Source: Business Law/California UCC Sales and Leases/18 Litigation Remedies/§18.31 (4) Choosing Appropriate Measures of Damages

§18.31 (4) Choosing Appropriate Measures of Damages

A variety of methods may be used to determine the damages resulting from a breach of warranty. The most appropriate method depends on the facts of the case and corresponding problems of proof. As a general proposition, if there is more than one method of estimating damages, that which is most definite and certain should be used. If the facts show that either of two measures of damages will fully compensate the buyer for its loss, the measure that is less expensive to the seller is preferable. *Community Television Servs., Inc. v Dresser Indus., Inc.* (D SD 1977) 435 F Supp 214.

Commercial Code §2714 gives the buyer flexibility in establishing damages:

- Losses resulting from the seller's breach may be determined "in any manner which is reasonable";
- In some cases, the buyer may also recover incidental and consequential damages; and
- The basic formula for breach of warranty damages will be disregarded if "special circumstances show proximate damages of a different amount."

PRACTICE TIP: When considering value, recognize that value in one state may be different than value in another state, *e.g.,* because of costs in labor or environmental laws.

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§18.32 c. Special Circumstances

Typically, courts use the "special circumstances" clause of Com C §2714(2) to measure the buyer's damages at some time after acceptance. See, *e.g., Vista St. Clair, Inc. v Landry's Commercial Furnishings Inc.* (Or Ct App 1982) 643 P2d 1378 (court utilized value of carpeting three and one-half years after defect was discovered, because delay was result of negotiations between parties for carpet's replacement). See also *Intervale Steel Corp. v Borg & Beck Div., Borg-Warner Corp.* (ED Mich 1984) 578 F Supp 1081, in which the buyer cut and stored steel for later use. One month later, the steel was discovered to be unfit for its intended use. Relying on the "special circumstances" clause of Com C §2714(2), the court awarded damages based on the steel's value at the time the buyer discovered the defect. The court noted that, even though the steel was more valuable before the buyer cut it, the buyer could not reasonably have known of the material's defective condition until the steel had been processed. Compare *Electrical Power Sys., Inc. v Argo Int'l Corp*. (ND Okla 1994) 864 F Supp 1080.

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§18.33 d. Injury to Person or Property

Consequential damages include "injury to person or property proximately resulting from any breach of warranty." Com C §2715(2)(b).

If the injury follows use of the goods without discovery of the defect causing the injury, the question of "proximate" cause turns on whether it was reasonable for the buyer to use the goods without an inspection that would have revealed the defect. If it was not reasonable for the buyer to use the goods or if the buyer discovered the defect before use, the injury would not proximately result from the breach of warranty. Official Comment 5 to UCC §2-715.

It is beyond the scope of this book to discuss recovery of damages for injury to person or property under theories of negligence or strict liability. Mention should be made, however, of the distinction that courts have drawn between losses that are "economic" and those that are not. "Economic loss" includes "damages for inadequate value, costs of repair and replacement of the defective product, or consequent loss of profits—without any claim of personal injury or damages to other property." *Sacramento Reg'l Transit Dist. v Grumman Flxible* (1984) 158 CA3d 289, 204 CR 736. Under present California law, damages for economic loss are compensable only under contract, not under tort theories of negligence or strict liability. See *Seely v White Motor Co.* (1965) 63 C2d 9, 18, 45 CR 17; *Frank M. Booth, Inc. v Reynolds Metals Co.* (ED Cal 1991) 754 F Supp 1441. This principle is illustrated in *Sacramento Regional Transit Dist. v Grumman Flxible, supra,* in which the buyer purchased 103 buses from the seller. After the warranty period had expired, the buyer discovered cracked fuel tank supports in some of the buses. Further inspection showed that all the buses might be subject to the same defect. The buyer repaired the damaged buses and did preventative work on the remainder. It sued the seller for the costs of repairs and for loss of use of the buses. Because the buyer admittedly had no cause of action for breach of warranty, it sought to recover those damages under theories of negligence and product liability.

The court held that the buyer's losses were "economic" and not recoverable in tort. The buyer failed to allege physical injury to its property apart from the defect itself. Further damage to the buyer's property caused by the defect may have been recoverable in tort, but, when the defect and damage are the same, recovery is governed by contract law (or, in cases such as this in which the parties are "merchants" and a sale of "goods" is involved, by the Commercial Code).

Note that the plaintiff may recover economic losses for negligence when it has a "special relationship" with the defendant, as determined by a six-part test set forth by the California Supreme Court that considers:

- The extent to which the transaction was intended to affect the plaintiff;
- The foreseeability of harm to the plaintiff;
- The degree of certainty that the plaintiff suffered injury;
- The closeness of the connection between the defendant's conduct and the injury suffered;
- The moral blame attached to the defendant's conduct; and
- The policy of preventing future harm.

The foreseeability of the economic harm to the plaintiff from the defendant's negligent conduct is the critical factor in this determination. *J'Aire Corp. v Gregory* (1979) 24 C3d 799, 804, 157 CR 407 (tenant of commercial building allowed negligence claim against contractor remodeling building for owner). Nevertheless, the majority view in California is that economic losses may not be recovered under theories of negligence or strict liability. See *Zamora v Shell Oil Co.* (1997) 55 CA4th 204, 63 CR2d 762 (plaintiff's claim failed to meet two parts of *J'Aire* test); *LAVWMA v Northwest Pipe & Casing Co.* (ND Cal 1995) 915 F Supp 1066, 1073 (rule in *J'Aire* does not apply in sale of goods context). See also *North Am. Chem. Co. v Superior Court* (1997) 59 CA4th 764, 69 CR2d 466, for an extended discussion of this issue.

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§18.34 e. Notice of Breach

Notice to the seller of the breach is a prerequisite to the buyer's recovery of damages. Com C §§2607(3), 2714(1); *Fieldstone Co. v Briggs Plumbing Prods., Inc.* (1997) 54 CA4th 357, 62 CR2d 701; *Point Adams Packing Co. v Astoria Marine Constr. Co.* (9th Cir 1979) 594 F2d 763. The time for notice is extended, however, if the warranty is prospective and the breach is not reasonably discoverable until the goods fail to perform. *Kaiser Cement & Gypsum Corp. v Allis-Chalmers Mfg. Co.* (1973) 35 CA3d 948, 111 CR 210. If the buyer's claim for defective goods is based on the tort theory of strict liability rather than the contract theory of breach of warranty, no notice is necessary. *Greenman v Yuba Power Prods., Inc.* (1963) 59 C2d 57, 27 CR 697.

For detailed discussion of notice requirements, see §§18.63-18.67.

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§18.35 4. Incidental Damages

Whether the buyer seeks damages based on cover (Com C §2712) or market price (Com C §2713), or claims damages following its acceptance of the goods (Com C §2714), it can recover, as incidental damages, expenses that it reasonably incurred as a result of the seller's breach (Com C §2715(1)).

Incidental damages include "expenses reasonably incurred in inspection, receipt, transportation and care and custody of goods rightfully rejected, any commercially reasonable charges, expenses or commissions in connection with effecting cover and any other reasonable expense incident to the delay or other breach." Com C §2715(1).

Official Comment 1 to UCC §2-715 makes it clear that the above list is "not intended to be exhaustive" but is merely representative of incidental damages that may be recovered under Com C §2715. See also the following cases, which illustrate typical incidental damages that the buyer may recover:

- *S & R Metals, Inc. v C. Itoh & Co. (Am.)* (9th Cir 1988) 859 F2d 814 (costs of transportation, storage, and handling of shipment of steel, acceptance of which was revoked by buyer, plus prejudgment interest on those amounts);
- *Albert v Thomas* (D Vt 1986) 643 F Supp 1406 (buyer who properly revoked acceptance of Arabian stallion for breach of express and implied warranties of breeding soundness was entitled to cancel contract and to return of that part of purchase price already paid plus interest, as well as incidental expenses reasonably incurred in transportation, care, custody, and insurance of stallion from date of delivery to date of judgment);
- *Larsen v A.C. Carpenter, Inc.* (ED NY 1985) 620 F Supp 1084 (unloading fee and letter of credit interest charges);
- *Atlan Indus., Inc. v O.E.M., Inc.* (WD Okla 1983) 555 F Supp 184 (buyer's expenses in inspecting and regrinding nonconforming plastic; court also awarded consequential damages for labor wasted in producing parts from nonconforming plastic, before buyer discovered that it did not conform);
- *Delano Growers' Coop. Winery v Supreme Wine Co.* (Mass 1985) 473 NE2d 1066 (wine bottler revoked acceptance after discovering that wine purchased contained Fresno mold; shipping charges incurred when customers returned contaminated wine, as well as costs of inspecting and reprocessing remaining cases of wine, were recoverable); and
- *Carboline Co. v Oxmoor Center* (Ky App 1985) 40 UCC Rep Serv 1728 (amounts expended for defective roof sealant and labor required to (a) prepare roof for application of product, (b) apply product, and (c) install new roof, which would not have been required if defective product had not been applied, were all reasonable expenses incurred incident to seller's breach of warranty and were recoverable as incidental damages).

If the buyer has possession of the goods, as it often does after a rejection or revocation of acceptance, it has a security interest in them to the extent of its incidental damages as well as payments it has made on the price. Com C §2711(3). See §§10.45, 17.71-17.74.

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§18.36 5. Consequential Damages

Consequential damages are generally prohibited in cases subject to Commercial Code Division 2 unless they are specifically allowed by a particular Commercial Code provision or by non-Code law. Com C §1305(a). The Code does not allow the seller to recover consequential damages. All Code sections relating to the buyer's damages, however, provide for consequential damages, as limited by the definition of "consequential damages" in Com C §2715(2). See Com C §§2712-2714.

The definition of "consequential damages" in Com C §2715 is broad; it includes any loss resulting from the seller's breach, provided that the loss (a) results "from general or particular requirements and needs of which the seller at the time of contracting had reason to know" and (b) "could not reasonably be prevented by cover or otherwise." Com C §2715(2)(a). There is thus a foreseeability requirement (the seller must have reason to know of the buyer's requirements) and a mitigation requirement (only loss not reasonably preventable can be recovered).

These requirements are elaborated on in Official Comments 2, 3, and 6 to UCC §2-715:

- Comment 2 uses as a criterion what the seller "had reason to know" of the buyer's requirements at the time of contracting. See also *Sun-Maid Raisin Growers v Victor Packing Co.* (1983) 146 CA3d 787, 194 CR 612.
- Comment 3 distinguishes between the buyer's "general" and "particular" needs for purposes of deciding whether the seller should have known of them. If the buyer's needs are the usual and predictable ones, the seller is charged with knowledge of them. For example, if the seller knows that the buyer is in the business of reselling goods, the seller is charged with knowledge that resale is one of the buyer's requirements. *Allied Canners & Packers, Inc. v Victor Packing Co.* (1984) 162 CA3d 905, 209 CR 60; *Sun-Maid Raisin Growers v Victor Packing Co., supra*. An unusual, particular need, however, must specifically be made known to the seller. See Official Comment 3 to UCC §2-715. This distinction is apparently predicated on the decision in *Hadley v Baxendale* (1854) 9 Ex 341, 156 Eng Rep 145, which prohibits recovery of contract damages arising from unusual circumstances not known to the defendant at the time of contracting. See *Gerwin v Southeastern Cal. Ass'n of Seventh Day Adventists* (1971) 14 CA3d 209, 92 CR 111 (seller must know of buyer's particular needs at time of contracting; later knowledge (*e.g.,* at breach) is insufficient). The buyer's particular circumstances and the seller's knowledge of them must be specially pleaded. See 5 Witkin, California Procedure, *Pleading* §944 (5th ed 2009).
- Under Comment 6, if the seller knows that the buyer is in the business of selling goods, the seller is charged with the knowledge that the buyer needs the goods for resale. *Sun-Maid Raisin Growers v Victor Packing Co., supra*. Even in the absence of a contractual provision forbidding recovery of consequential damages, a seller in breach will usually be liable for the buyer's resulting loss of profit.

Compensatory damages available to a buyer under the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) are limited to the same categories, and measured in the same manner, as those available to a buyer for a seller's breach of contract for the sale of goods. See CC §1794(b). Such damages do not, in most cases, include recompense for mental suffering independent of physical injury. See, *e.g., Gu v BMW of N. Am.* (2005) 132 CA4th 195, 33 CR3d 617 (owner of vehicle, who was not passenger or witness to accident in which her sister was fatally injured, could not recover for emotional distress from manufacturer; there is no duty to avoid negligently causing emotional distress to another); *Bishop v Hyundai Motor Am.* (1996) 44 CA4th 750, 758, 52 CR2d 134 (no recovery for emotional distress or *nonfinancial* loss of use damages when car was destroyed by fire caused by manufacturing defect); *Kwan v Mercedes-Benz of N. Am., Inc.* (1994) 23 CA4th 174, 188, 28 CR2d 371 (no recovery for emotional distress alleged to have resulted from repeated unsuccessful efforts to have car repaired); compare *Kately v Wilkinson* (1983) 148 CA3d 576, 579, 195 CR 902 (buyer-operator of defective speedboat could recover for emotional trauma caused when boat ran over and killed water skier; plaintiff was not mere bystander, but primary and direct victim of product defect).

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§18.37 a. Lost Profits

Lost profits are probably the most common form of consequential damages sought by the buyer. In general, lost profits may be recovered when a sufficient factual basis for them is shown. See, *e.g., Allied Canners & Packers, Inc. v Victor Packing Co.* (1984) 162 CA3d 905, 209 CR 60. But see *KGM Harvesting Co. v Fresh Network* (1995) 36 CA4th 376, 42 CR2d 286. No recovery for lost profits is allowed, however, if the amount is too speculative to be measured or there is no basis on which lost profits can be computed with reasonable certainty. *Coastal Aviation, Inc. v Commander Aircraft Co.* (SD NY 1996) 937 F Supp 1051; *Autrey v Chemstrust Indus. Corp.* (D Del 1973) 362 F Supp 1085. Even though its business is new, the buyer may be awarded lost profits if the evidence shows with reasonable certainty both their occurrence and their extent. *Gerwin v Southeastern Cal. Ass'n of Seventh Day Adventists* (1971) 14 CA3d 209, 92 CR 111. Compare *Resort Video Ltd. v Lazer Video, Inc.* (1995) 35 CA4th 1679, 42 CR2d 136.

Past profits of an established business may be used to prove loss of prospective profits. *Lewis v Mobil Oil Corp.* (8th Cir 1971) 438 F2d 500. Proof of profits for a new business may be evidenced by the buyer's subsequent profits. See *Cook Assocs. v Warnick* (Utah 1983) 664 P2d 1161.

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§18.38 b. Loss of Goodwill

Goodwill is generally considered a loss too speculative to be compensated, unless the buyer can establish with reasonable certainty that there was such a loss and its dollar value. See, *e.g., R.E.B., Inc. v Ralston Purina Co.* (10th Cir 1975) 525 F2d 749; *Crook Motor Co. v Goolsby* (ND Miss 1988) 703 F Supp 511; *Delano Growers' Coop. Winery v Supreme Wine Co.* (Mass 1985) 473 NE2d 1066.

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§18.39 c. Proof

Although the buyer may not recover damages that are too speculative, it is not required to prove consequential damages with mathematical precision. "Loss may be determined in any manner which is reasonable under the circumstances." Official Comment 4 to UCC §2-715. In addition, almost any injury resulting from defective goods can be compensable as long as the loss can be translated into monetary terms, proven with reasonable certainty, and shown to be reasonably foreseeable. See, *e.g., Hirst v Elgin Metal Casket Co.* (D Mont 1977) 438 F Supp 906 (emotional damages recoverable in breach of warranty case for defective burial casket).

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d. Excluding Consequential Damages

§18.40 (1) The Rule

Courts will uphold a contractual provision that excuses a seller from liability for consequential damages, including lost profits. *J. B. Moore Elec. Contr., Inc. v Westinghouse Elect. Co.* (Va 1981) 273 SE2d 553; *Three-Seventy Leasing Corp. v Ampex Corp.* (5th Cir 1976) 528 F2d 993. See §18.41 for a clause excluding recovery of consequential damages. Such a provision may fail, however, if it is found to be unconscionable. See CC §1670.5; Com C §2719; *A & M Produce Co. v FMC Corp.* (1982) 135 CA3d 473, 186 CR 114. For further discussion of unconscionability, see §§18.69-18.71.

Note that the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312) allows a warrantor to exclude or limit consequential damages for breach of any written or implied warranty of a consumer product, if the exclusion "conspicuously appears on the face of the warranty." 15 USC §2304(a)(3).

A provision that effectively excludes consequential damages does not preclude recovery of incidental damages. *Carbontek Trading Co. v Phibro Energy Inc.* (5th Cir 1990) 910 F2d 302. By agreement, however, the parties may also exclude recovery of incidental damages if the exclusion is not unconscionable or does not deprive a party of all effective remedies. See Official Comment 1 to UCC §2-719.

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§18.41 (2) Form: Recovery of Consequential Damages Excluded

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18.41-1 Recovery of consequential damages excluded

[*Alternative 1: Simple clause*]

The buyer is not entitled to recover consequential damages in connection with any breach of this contract by the seller.

[*Alternative 2: Buyer's remedy limited to repair, replacement, or refund*]

The seller's obligations with respect to goods accepted by the buyer are limited to replacement or repair of defective parts and equipment or, at the seller's option, to refund of the purchase price without further responsibility. The seller is not responsible for consequential damages. This provision will not be affected by the seller's failure to repair any defect or replace defective parts or equipment to the buyer's satisfaction. The buyer has accepted this restriction on its right to recover consequential damages as part of its bargain with the seller. The buyer realizes and acknowledges that the price of the goods would be higher if the seller were required to bear responsibility for the buyer's damages.

Comment: The simple initialing of such a clause by the buyer and seller my aid in a later asserted claim.

See discussion in §§3.92-3.94 on the enforceability of clauses excluding recovery of consequential damages when the "repair or replace" remedy has failed.

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§18.42 e. Mitigation of Damages

For consequential damages to be recoverable, they must not have been reasonably preventable "by cover or otherwise." Com C §2715(2)(a). The Commercial Code defines "cover" as "making in good faith and without unreasonable delay any reasonable purchase of or contract to purchase goods in substitution for those due from the seller." Com C §2712(1). See §§17.67-17.69 for discussion of cover.

The requirement that a buyer cover is not a bar to recovery of all damages; failure to cover or otherwise prevent the loss simply reduces the buyer's recovery by any amount that could have been avoided. Official Comment 3 to UCC §2-712 (Official Comment 6 to UCC §2-712 (2003)).

Under some circumstances, the buyer may be excused from the obligation to mitigate damages. For instance, if the seller has made repeated promises to repair or replace the defective goods, the buyer may be excused from covering. See, *e.g., Cates v Morgan Portable Bldg. Corp.* (7th Cir 1985) 780 F2d 683; *Huntington Beach Union High Sch. Dist. v Continental Info. Sys. Corp.* (9th Cir 1980) 621 F2d 353. In addition, the buyer does not have a duty to cover if doing so is impracticable, unreasonable, or beyond the buyer's financial means. *Kirby v Chrysler Corp.* (D Md 1982) 554 F Supp 743; *Barnard v Compugraphic Corp.* (Wash Ct App 1983) 667 P2d 117.

The breaching party has the burden of proof on the inadequacy of the aggrieved party's efforts to mitigate its consequential damages. *Carnation Co. v Olivet Egg Ranch* (1986) 189 CA3d 809, 229 CR 261.

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§18.43 6. Attorney Fees

Unless attorney fees are specifically provided for by statute, their recovery in any action is left to the parties' express or implied agreement. CCP §1021. If the agreement provides for recovery of attorney fees by one party, they are also recoverable by the other party. CC §1717. Division 2 of the Commercial Code contains no provision for the recovery of attorney fees in actions between sellers and buyers, and they are usually not a proper expense recoverable under Com C §2715. *Equitable Lumber Corp. v I.P.A. Land Dev. Corp.* (1976) 381 NYS2d 459, 344 NE2d 391.

If the sale involves consumer goods, however, attorney fees may be available. See CC §§1780(e) (part of the Consumers Legal Remedies Act), 1794(d) (part of the Song-Beverly Consumer Warranty Act), 1811.1 (part of the Unruh Act governing retail installment sales); 15 USC §2310(d)(2) (part of the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act; *Milicevic v Fletcher Jones Imports, Ltd.* (9th Cir 2005) 402 F3d 912).

See also *De La Hoya v Slim's Gun Shop* (1978) 80 CA3d Supp 6, 146 CR 68, in which the innocent buyer of a handgun brought an action against the seller of the gun for breach of warranty of title. The police determined that the gun was stolen and arrested the buyer for possession of stolen property. The court allowed the buyer to recover the price paid and his attorney fees incurred in defending against the criminal charge.

PRACTICE TIP: In circumstances in which attorney fees are recoverable, the attorney fees of in-house counsel are also recoverable. *PLCM Group, Inc. v Drexler* (2000) 22 C4th 1084, 95 CR2d 198.

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§18.44 7. Punitive or Exemplary Damages

The Commercial Code prohibits recovery of punitive or exemplary damages unless they are available to an aggrieved party under some other body of law. Com C §1305(a). Punitive damages can clearly be awarded in a Uniform Commercial Code suit in which an independent tort is also proven. See, *e.g., Douglas v Ostermeier* (1991) 1 CA4th 729, 2 CR2d 594; *Cantrell v Amarillo Hardware Co.* (Kan 1979) 602 P2d 1326 (punitive damages awarded against seller who continued to manufacture ladder after knowing it to be unsafe); *Fousel v Ted Walker Mobile Homes* (Ariz Ct App 1979) 602 P2d 507 (fraud).

If a sale of consumer goods involves an unfair or deceptive act prohibited by the Consumers Legal Remedies Act (CC §§1750-1784), a consumer harmed by the prohibited act may recover punitive as well as actual damages. See CC §§1770, 1780(a)(4). See also further discussion of the Act in §18.71. A consumer who is a senior citizen or disabled person (defined in CC §1761(f)-(g)) may recover up to $5000 in addition to punitive damages, if the conditions of CC §1780(b) are satisfied.

A willful violation of the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) may entitle an aggrieved buyer of consumer goods to a statutory penalty. The Act limits the penalty to no more than two times the buyer's actual damages. The penalty is not available in class actions or actions based solely on breach of an implied warranty. Nor is the penalty available if the defendant manufacturer maintains a "qualified third-party resolution dispute process" that substantially complies with the Act's requirements. CC §1794(c), (e)(2).

Certain willful violations of the Unruh Act governing retail installment sales (CC §§1801-1812.10) may also entitle an aggrieved buyer to a statutory penalty. If the violation relates to the imposition, computation, or disclosure of finance charges on two or more contracts, the buyer may recover an amount equal to three times the total of the finance charges and any delinquency, collection, extension, deferral, or refinance charges imposed by the seller. CC §1812.9.

If the subject of the sale is a motor vehicle, bought for personal or family use, and the seller or holder of the conditional sales contract violates any provision of CC §2982(*l*) concerning prepayment and permissible charges, the buyer may recover three times the amount of the finance charge paid to that person, unless the violation was accidental or a bona fide error of computation. CC §2983.1.

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§18.45 8. Deduction of Damages From Price

A buyer who has a right to damages under the Commercial Code may deduct them "from any part of the price still due under the same contract." Com C §2717. See *Hughes Tool Co. v Max Hinrichs Seed Co.* (1980) 112 CA3d 194, 169 CR 160. The buyer must give the seller notice of its intention to withhold all or part of the price if the buyer wishes to avoid a default within the meaning of Com C §2609, which deals with insecurity and the right to adequate assurances of performance. Official Comment 2 to UCC §2-717. See §§16.2-16.17 on adequate assurances of performance.

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§18.46 B. Replevin

To accommodate buyers who want and need the goods bargained for rather than damages, the Commercial Code provides the buyer with the remedies of replevin and specific performance. Commercial Code §2716(3) defines the circumstances in which the buyer has a right of replevin. (Despite the Code's retention of the common law term "replevin," the action in California is more properly designated as one for specific recovery of personal property. See 5 Witkin, California Procedure, *Pleading* §§692-693 (5th ed 2009). See also CCP §§512.010-516.050.) Because the action is at law, not in equity, either party is entitled to a jury trial. See 7 Witkin, California Procedure, *Trial* §84 (5th ed 2009).

For the buyer to obtain replevin, the goods must be identified to the contract, and the buyer must be unable to cover after reasonable effort or it must reasonably appear that any effort to cover would be fruitless. See Com C §2716(3). Replevin is available in one additional situation: If the goods have been shipped under reservation (*i.e.,* the seller has retained some right to title or possession of the goods to secure performance by the buyer (see Com C §2505)), the buyer can obtain the goods on satisfying or tendering the amount of the security. With goods purchased for personal, family, or household purposes, the buyer's right of replevin vests on identification of the goods to the contract; the buyer will take the goods free of any security interest that attaches after the goods have been identified. See Official Comment 3 to UCC §2-716.

Replevin is available on the seller's insolvency if the requirements of Com C §2716(3) are otherwise satisfied. See Com C §2502. For discussion of the seller's remedy of reclamation on the buyer's insolvency, see §§17.24-17.31.

In all replevin actions, the buyer must plead and prove its own performance (*e.g.,* that it has made all payments due) to establish its right to immediate possession of the goods. See 6 Witkin, California Procedure, *Provisional Remedies* §§255-256 (5th ed 2009).

The theoretical right of replevin is of little assistance without coercive procedures that actually deliver the goods to the buyer. Claim and delivery (*e.g.,* the request for and issuance of a writ of possession) is a provisional remedy that enables the buyer to obtain immediate but temporary possession of the goods pending a final judgment in the action. The provisional remedy cannot be used independently; it is used in another action (*e.g.,* an action for replevin or specific performance). California claim and delivery practice (CCP §§512.010-516.050) is discussed in 6 Witkin, California Procedure, *Provisional Remedies* §§245-273 and Debt Collection Practice in California §§6.111-6.166 (2d ed Cal CEB 1999).

PRACTICE TIP: The attorney framing pleadings should note Official Comment 5 to UCC §2-716: If the goods are represented by a negotiable document of title, the document is the object of the replevin action, not the goods, which may or may not be in the jurisdiction.

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§18.47 C. Specific Performance

Commercial Code §2716(1) provides for specific performance "where the goods are unique or in other proper circumstances." The decree for specific performance may include terms and conditions regarding payment of the price, damages, or other just relief. Com C §2716(2).

The drafters of the Commercial Code intended to expand the common law remedy of specific performance and make it more available to buyers. The principal way in which the Code does this is through a broadened definition of "unique" goods. Official Comment 2 to UCC §2-716 explains that the test of uniqueness must be made in terms of the total situation that characterizes the contract. Output and requirements contracts involving a particular or peculiarly available source or market present the typical commercial specific performance situation. Whether the goods are "unique" is an issue of fact. See *R.L. Kimsey Cotton Co. v Ferguson* (Ga 1975) 214 SE2d 360 (parties' stipulation that goods were unique was sufficient).

Uniqueness is not the sole basis for specific performance, however, because it may also be granted "in other proper circumstances." Com C §2716(1). Most frequently, other proper circumstances exist when the buyer cannot reasonably cover on the open market. See *Kaiser Trading Co. v Associated Metals & Minerals Corp.* (ND Cal 1970) 321 F Supp 923, aff'd without written opinion (9th Cir 1971) 443 F2d 1364 (specific performance granted when buyer was unable to obtain "cryolite" in sufficient quantities). See also *Magellan Int'l Corp. v Saltzgitter Handel GmbH* (ND Ill 1999) 76 F Supp 2d 919 (allegation of difficulty of covering sufficient to overcome motion to dismiss). Even when the substitute goods are readily available in the market, specific performance may be allowed if the buyer is financially unable to purchase those goods. See *Gerwin v Southeastern Cal. Ass'n of Seventh Day Adventists* (1971) 14 CA3d 209, 92 CR 111. Specific performance may also be granted when substitute goods, though readily available, are inferior to the contract goods. See *Copylease Corp. of Am. v Memorex Corp.* (SD NY 1976) 408 F Supp 758.

Unlike replevin, the remedy of specific performance does not require that the goods first be identified to the contract. In addition, if the buyer wants more than the mere seizure of the goods, it should bring an action for specific performance because the court can order payment of the price, award damages, or provide additional relief that it considers just. Com C §2716(2). If the buyer needs to obtain the goods immediately, pending a judgment in the specific performance action, it may be able to utilize the provisional remedy of claim and delivery. California claim and delivery practice (CCP §§512.010-516.050) is discussed in 6 Witkin, California Procedure, *Provisional Remedies* §§245-273 (5th ed 2009) and Debt Collection Practice in California §§6.111-6.166 (2d ed Cal CEB 1999).

Note that if a buyer is unsuccessful in its attempt to have specific performance ordered, it may still recover damages. *Dexter Bishop Co. v B. Redmond & Son, Inc.* (App Div 1977) 396 NYS2d 652.

For further reading on the remedy of specific performance, see California Breach of Contract Remedies, chap 5 (Cal CEB 1980).

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D. Restitution of Payments

§18.48 1. After Breach by Seller

Whenever the buyer is entitled to pursue any of its remedies (except those when it actually receives the goods), it may also recover any part of the price it has paid. Com C §2711(1); *Music Acceptance Corp. v Lofing* (1995) 32 CA4th 610, 621, 39 CR2d 159. If the buyer has possession of the goods, as it often does when it is rejecting or revoking acceptance, it has a security interest in them for the amount of the price it has paid. Com C §2711(3). See §§10.45, 17.71-17.74 on the buyer's security interest. An award of lost profits and the restitution of sums paid by the buyer for the goods are not necessarily inconsistent. The Commercial Code has not adopted a rule of election of remedies. *Berge v International Harvester Co.* (1983) 142 CA3d 152, 190 CR 815. See also *Allied Semi-Conductors Int'l Ltd. v Pulsar Components Int'l Inc.* (ED NY 1995) 907 F Supp 618.

If the subject of the sale is a motor vehicle bought primarily for personal or family use (see CC §2981(k)), and the seller breaches the conditional sales contract or purchase order, the buyer may recover any motor vehicle it left with the seller as a downpayment. If the seller does not return the vehicle for whatever reason, the buyer may recover either the fair market value of the vehicle or its value as stated in the contract or purchase order, whichever is greater. The vehicle or its value must be tendered to the buyer within five business days after the breach. CC §2982.7.

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§18.49 2. After Breach by Buyer

Occasionally, the buyer has paid all or a portion of the price for the goods and then repudiates the contract or is otherwise in breach. If the seller justifiably withholds delivery, can the buyer recover all or part of the money it has paid?

The seller may be able to retain amounts paid by the buyer as liquidated damages. If the parties have agreed on a reasonable liquidated damages provision, the buyer can recover payments made in excess of the amount set. Com C §2718(2)(a). If the agreement does not contain such a provision (or if the provision is invalid), the seller may keep 20 percent of the value of the total performance for which the buyer is obligated but not more than $500. Com C §2718(2)(b). The seller may also keep any provable damages to which it is entitled and the amount or value of any benefits received by the buyer directly or indirectly by reason of the contract. Com C §2718(3)(b).

Thus, if the buyer pays $1800 toward a total price of $2000 and then wrongfully rejects the goods, and the seller resells them for $1500, the buyer's recovery is calculated as follows:

Sum of buyer's payments	$1800
Less amount under Com C §2718(2)(b) (20 percent of total performance (but not more than $500))	− 400
Buyer's right of restitution under Com C §2718(2)	$1400
Seller's offset under Com C §2718(3)(a):	
Contract price	$2000
Less resale price	− 1500
Seller's damages offset (see Com C §2706(1) on damages)	$500
Buyer's net recovery ($1400 − $500)	$900

In *Neri v Retail Marine Corp.* (1972) 334 NYS2d 165, 285 NE2d 311, however, the court adopted the view that the seller's right of setoff for $500 or 20 percent represents an alternative to actual damages, not a cumulative remedy to which the seller is entitled.

Commercial Code §2718(3)(b), permitting the seller to offset against repayment the amount or value of benefits received either directly or indirectly by the buyer, is arguably punitive unless the courts limit the provision to benefits that have been detrimental to the seller. It is certainly reasonable to give the seller the value of benefits that it has furnished (*e.g.,* the rental value of the seller's goods that were used by the buyer), but it does not seem reasonable to charge the buyer for benefits it has received that have not caused a detriment to the seller (*e.g.,* a profit from the use of the goods greater than their rental value, or a valuable business opportunity obtained because of the existence of the contract).

In summary, Com C §2718 provides that the seller may keep reasonable liquidated damages if the contract provides for them and if the buyer seeks restitution after its own breach. If the contract does not provide for liquidated damages, the seller may keep 20 percent of the value of the buyer's performance (but not more than $500). In either case, the seller may also keep its provable damages (unless California courts follow *Neri v Retail Marine Corp., supra*) and the value of any benefits received by the buyer by reason of the contract. The buyer may recover the remainder.

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§18.50 E. Indemnification

If a sales contract contains an indemnification clause, an independent cause of action arises when a defect in the product sold injures a third party. *Carrier Corp. v Detrex Corp.* (1992) 4 CA4th 1522, 6 CR2d 565. The *Carrier* case involved the sale of a degreasing system. The system leaked, causing solvents to be released. The state ordered that the solvents be cleaned up. The *Carrier* court held that the buyer had a distinct and separate cause of action against the seller based on the indemnity language in the sales contract. 4 CA4th at 1529. It further held that the state order was sufficient to trigger the indemnity claim, even though technically no damages had arisen. 4 CA4th at 1530.

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IV. RESTRICTION, QUALIFICATION, AND ENLARGEMENT OF REMEDIES

A. Liquidated Damages

§18.51 1. Analysis

The validity of a liquidated damages clause is subject both to the requirements of Com C §2718 and CC §1671.

A provision for liquidation of damages must comply with CC §1671, which states that liquidated damages provisions are valid unless unreasonable at the time of contracting. CC §1671(b). (However, CC §1671(d) makes void all provisions allowing recovery of liquidated damages from a consumer in the sale of consumer goods, unless from the nature of the case it would be impracticable or extremely difficult to fix actual damages.)

In deciding whether a liquidated damages provision is unreasonable, courts will consider all the circumstances existing at the time the contract is created, including (Comment to CC §1671):

- The relationship that the damages provided in the contract bear to the range of harm that reasonably could have been anticipated at the time;
- The relative bargaining power of the parties;
- Whether the parties were represented by attorneys;
- Whether the provision is included in a form contract;
- The parties' expectation that proof of actual damages would be costly or inconvenient; and
- The difficulty of proving causation and foreseeability.

With a consumer contract, the amount of liquidated damages selected must represent a reasonable endeavor by the parties to estimate fair compensation for the loss sustained. However, that does not mean both parties to a form contract must expressly negotiate the amount of the liquidated damages. *Utility Consumers' Action Network, Inc. v AT&T Broadband of S. Cal.* (2006) 135 CA4th 1023, 37 CR3d 827. Damages for breach may not be liquidated in an amount unreasonably high or unreasonably low compared to anticipated harm. Official Comment 1 to UCC §2-718 (Official Comment 2 to UCC §2-718 (2003)). If the damages are set too high, the clause is a penalty; if the damages are set too low, the clause may be considered to be unconscionable. Some liquidated damages clauses, masquerading as late charges or provisions for alternative performance, may be void for that reason. See *Sybron Corp. v Clark Hosp. Supply Corp.* (1978) 76 CA3d 896, 143 CR 306 ($28,000 penalty for delay in payment of $30,000 made liquidated damages provision unenforceable; court noted that, because damages for withholding money are easily determinable (*i.e.,* interest at prevailing rates), penal provisions for mere delay in payment of money are not ordinarily enforceable). See also *Hein v Bobbitt (In re Hein)* (Bankr SD Cal 1986) 60 BR 769 (late payment charge amounting to 38 percent of principal amount over 1-year period, included in promissory note specifically and solely to ensure prompt payment and adopted with little discussion between parties of amount of charge or its relationship to anticipated damages, was unenforceable penalty). "[T]he characteristic feature of a penalty is its lack of proportional relation to the damages which may actually flow from failure to perform under a contract." *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 739, 108 CR 845. See *O'Connor v Televideo Sys.* (1990) 218 CA3d 709, 267 CR 237 (1-1/2 percent monthly late charge on invoices for sales of goods held valid under CC §1671).

One industry in which liquidated damages provisions are routinely upheld is burglar alarm services. See *Better Food Mkts. v American Dist. Tel. Co.* (1953) 40 C2d 179, 253 P2d 10 (customer's burglary loss was $36,000; liquidated damages provision limiting burglar alarm service company's liability to $50 upheld); *H.S. Perlin Co. v Morse Signal Devices* (1989) 209 CA3d 1289, 258 CR 1 (customer's loss was $958,000; liquidated damages provision for $250 upheld); *Guthrie v American Protection Indus.* (1984) 160 CA3d 951, 206 CR 834 (customer's burglary loss was $103,000; liquidated damages provision limiting alarm company's liability to $250 upheld). In *H.S. Perlin Co. v Morse Signal Devices* (1989) 209 CA3d 1289, 1298, 258 CR 1, the court noted that the compensation received by the alarm company is nominal in relation to its potential liability. Because most customers are likely to obtain insurance against loss anyway, the shifting of that risk to the customer is considered to be a reasonable industry practice.

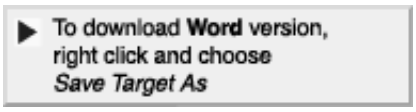
If the liquidated damages provision is invalid, it is void and the parties measure their damages as they would in the absence of the provision. Com C §2719(2). The burden of proof is on the party attempting to establish that the provision is invalid. See *H.S. Perlin Co. v Morse Signal Devices, supra*.

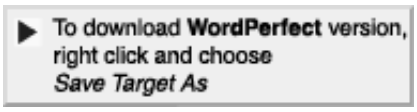
Note that CC §1671 does not apply when the validity of the liquidated damages provision is governed by federal law. CC §1671(a); Official Comment to CC §1671.

On liquidated damages, see 1 Witkin, Summary of California Law, *Contracts* §§533-536 (10th ed 2005).

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§18.52 2. Form: Contract Clause Fixing Liquidated Damages





18.52-1 Contract clause fixing liquidated damages

The parties agree that in litigation or arbitration resulting from either party's breach, the amount of loss would be extremely difficult or impracticable to prove. Accordingly, the parties wish to make a commercially reasonable estimate of the damages they would incur in the event of a breach by the other party and to establish that estimate as liquidated damages.

In the event of a breach by the seller, the buyer will recover as liquidated damages and as the buyer's exclusive remedy for the seller's breach, the amount of _ _[*dollar amount*]_ _. In the event of a breach by the buyer, the seller will recover as liquidated damages and as the seller's exclusive remedy for the buyer's breach, the amount of _ _[*dollar amount*]_ _.

Comment: There are endless possibilities for variation. For example, the parties may want to set different damages for different kinds of breaches, or even do away with monetary damages altogether while retaining specific nonmonetary remedies. Such clauses are usually accompanied by a provision for initialing by the buyer and seller.

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B. Contractual Modification of Remedies

§18.53 1. Power to Modify

Subject to certain limitations (discussed in §18.54), Com C §2719 allows the parties to modify the Commercial Code's scheme of remedies by their contract. Commercial Code §1302(a)-(b) authorizes the parties to vary the effect of Code provisions, except that the obligations of good faith, diligence, reasonableness, and care prescribed by the Code may not be disclaimed by agreement.

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Source: Business Law/California UCC Sales and Leases/18 Litigation Remedies/ 2. Limitations/§18.54 a. Overview

2. Limitations

§18.54 a. Overview

There are several limitations on the parties' right to provide for or modify remedies by contract:

- The contract cannot deprive a party of all effective remedies. See Com C §2719(2); Official Comment 1 to UCC §2-719.
- The limitation or exclusion cannot be unconscionable. See Com C §2719(3); *Nunes Turfgrass, Inc. v Vaughan-Jacklin Seed Co.* (1988) 200 CA3d 1518, 246 CR 823. Note that a limitation of consequential damages for personal injury in the case of consumer goods is invalid unless it is proved that the limitation is not unconscionable. Com C §2719(3). See §§18.69-18.71 for further discussion of unconscionability.
- Under the Airline Deregulation Act of 1978 (49 USC §41713), federal common law governs contractual clauses that limit interstate carriers' liability for damage to goods shipped by air. State law is preempted in this area. *King Jewelry v Federal Express Corp.* (9th Cir 2003) 316 F3d 961, 964; *Wayne v DHL Worldwide Express* (9th Cir 2002) 294 F3d 1179, 1183. The released valuation doctrine, a federal common-law creation, delineates what a carrier must do to limit its liability. Under that doctrine, a carrier may limit its liability if it provides reasonable notice and a fair opportunity to purchase higher liability. The released valuation doctrine requires only a fair opportunity to purchase a higher liability, not necessarily up to the full value of the item. *King Jewelry v Federal Express Corp.* (9th Cir 2003) 316 F3d 961, 966. See also *Read-Rite Corp. v Burlington Air Express, Ltd.* (9th Cir 1999) 186 F3d 1190.

The parties may limit damages or modify remedies. For example, the parties may limit the measure of damages to profits. The seller may require the buyer to measure its damages solely by cover or solely by market price at some fixed time after a breach. The buyer may require the seller to measure its damages solely by resale or solely by market price at some fixed time after a breach.

Does the failure of a "repair or replace" remedy (see below) also nullify a separately stated disclaimer of liability for consequential damages? In *S.M. Wilson & Co. v Smith Int'l* (9th Cir 1978) 587 F2d 1363, the Ninth Circuit Court of Appeals held that the failure of the repair or replace remedy did *not* also cause the disclaimer of consequential damages to fail when:

- The repair or replace remedy and disclaimer of consequential damages were each carefully negotiated at arm's length between commercial equals;
- The machinery sold (a tunnel-boring machine) was so complicated that it was understood to involve risk;
- The parties agreed to allocate that risk to the buyer in the form of the damages disclaimer; and
- The seller did not ignore its obligation to repair but simply was unable to perform it.

In contrast, in *Fiorito Bros., Inc. v Fruehauf Corp.* (9th Cir 1984) 747 F2d 1309, the court found that the failure of the repair or replace remedy nullified the separate disclaimer of consequential damages when the seller arbitrarily declined to repair dump boxes on dump trucks, so that the plaintiff could recover those damages. The court concluded that the question of whether a disclaimer of consequential damages can survive the failure of a repair or replace remedy should be answered on a case-by-case basis. In each case, the four factors mentioned above must be considered to determine whether the damages disclaimer will survive.

In *Milgard Tempering, Inc. v Selas Corp. of Am.* (9th Cir 1990) 902 F2d 703, the Ninth Circuit Court of Appeals suggested that a consequential damages limitation will not be enforced when the seller's failure to repair is "total and fundamental" or when the limitation becomes "oppressive." Although the court acknowledged the four factors discussed in *S.M. Wilson & Co. v Smith Int'l, supra,* it considered its primary inquiry to be whether the seller's default caused a loss that was part of the parties' bargained-for allocation of risk. 902 F2d at 709. The answer to this question depends on whether the repair or replace remedy and the consequential damages limitation are "separable elements of risk allocation" or "inseparable parts of a unitary package of risk allocation."

See also *RRX Indus., Inc. v Lab-Con, Inc.* (9th Cir 1985) 772 F2d 543; *Cooley v Big Horn Harvestore Sys., Inc.*

(Colo 1991) 813 P2d 736.

For further discussion of the repair or replace remedy, see §3.94.

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§18.55 b. Types of Clauses

Clauses limiting the seller's liability to repair or replacement of defective parts may fail of their essential purposes. The Commercial Code allows the seller to limit by contract the seller's warranties and the buyer's remedies. Limiting remedies and limiting warranties are distinct processes, each governed by a different Code provision and body of law. Warranty limitations are governed by Com C §2316; remedy limitations are governed by Com C §2719.

Although remedy and warranty limitations are distinct, they frequently appear together in contracts and can raise intertwined legal issues. Commercial Code §2316 authorizes a buyer of goods to sign a contract in which the seller provides a limited express warranty covering the goods and disclaims all other warranties. The requirements for such a disclaimer are provided in Com C §2316. For forms and a discussion of warranty disclaimers, see §§3.46-3.69. If the seller complies with the requirements specified in Com C §2316, it effectively reduces the necessary standard that its goods must meet.

If the goods do not meet the agreed-on standard (*i.e.,* even when the limited warranty is breached), a contractual remedy limitation may apply to the buyer's recourse against the seller. The buyer and seller can contractually agree that remedies such as cancellation (Com C §2711), cover (Com C §2712), market price damages (Com C §2713), and consequential damages (Com C §2715; see above) will not be available to the buyer and that the buyer's only remedy is the repair or replacement of defective parts. See, *e.g., Rose v Chrysler Motors Corp.* (1963) 212 CA2d 755, 28 CR 185, in which the court held that a warranty to repair or replace must be interpreted to include all parts necessary to remedy a defective condition, regardless of whether an individual part was originally defective.

The Commercial Code creates a presumption in favor of cumulation rather than restriction of remedies. See Official Comment 2 to UCC §2-719. Accordingly, a contractual provision that gives one party a particular remedy is considered to create an optional, rather than a sole, remedy unless the remedy provided "is expressly agreed to be exclusive." Com C §2719(1)(b).

The parties cannot agree to remedies that violate the restrictions of Com C §2718 on liquidated damages. Com C §2719(1). See §§18.51-18.52.

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§18.56 c. Repair Time

If the seller cannot fix the goods, refuses to fix them, or takes so long to fix them that the buyer cannot receive the benefit of its bargain, the buyer may resort to its regular Code remedies because the exclusive or limited remedy "fail[ed] of its essential purpose." Com C §2719(2).

Unfortunately, the Code does not provide a clear guideline for when the seller's allotted time for repair has run out. In one case, the court held that the repair or replace remedy fails of its essential purpose when the breaching seller is unable to make the repairs within a reasonable time period. See *Milgard Tempering, Inc. v Selas Corp. of Am.* (9th Cir 1990) 902 F2d 703. Courts may differ about how much a buyer must endure before the repair or replace remedy is discarded. One Texas court held that the repair remedy had not failed and that the buyer was still bound by it even though the buyer's new car had been in the shop for 45 days to repair 50 different defects during the first 18 months. See *Lankford v Rogers Ford Sales* (Tex Ct App 1972) 478 SW2d 248.

A time limitation fails if latent defects are not discoverable until after the time has expired. See *Held v Mitsubishi Aircraft Int'l* (D Minn 1987) 672 F Supp 369 (design defects in airplane not discovered until after its crash).

The attorney should advise the seller that willfully ignoring its repair obligations could cost more in consequential damages than the savings in repair costs. To preserve the proof that the seller did not purposely avoid its repair obligation, the seller should carefully document all its attempts to repair.

In addition, a clause excluding consequential damages in accordance with Com C §2719(3) should be stated separately in the sales contract. The contract should provide that the disclaimer will not be affected by any failure of the repair or replace remedy. The contract should also state that the buyer has accepted the exclusion of damages as part of the bargain to lower the price of the goods and that the buyer understands that the price of the goods would be higher if the seller were required to bear consequential damages.

See §18.41 for a clause excluding recovery of consequential damages.

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§18.57 d. Consumer Goods

If the sale involves consumer goods, there may be remedies that the seller cannot require the buyer to waive. For instance, there may be statutory prohibitions against waiver of warranty protections and related remedies. See, *e.g.,* CC §§1751 (part of the Consumers Legal Remedies Act), 1792.3 (part of the Song-Beverly Consumer Warranty Act), 1801.1, 1804.1 (part of the Unruh Act governing retail installment sales), 2983.7 (part of the Rees-Levering Motor Vehicle Sales and Finance Act).

Specifically, CC §1790.1 of the Song-Beverly Consumer Warranty Act states that any waiver by the buyer of consumer goods, except as expressly allowed in the statute, shall be deemed contrary to public policy and shall be unenforceable and void. The Song-Beverly Consumer Warranty Act also states that implied warranties of merchantability or implied warranties of fitness are not waived in the sale of consumer goods unless the provisions that affect "as is" or "with all faults" sales have been strictly followed. CC §1792.3.

On disclaimer of warranties generally, see §§3.46-3.69.

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§18.58 C. Cumulation and Election of Remedies

In addition to all available Commercial Code remedies, remedies outside the Code for material misrepresentation or fraud (CC §§1709-1710, 3343) apply to sales contracts. Com C §1103(b). Those remedies are not lost if the buyer makes a claim for rescission or rejects or returns the goods. Com C §2721. The Code rejects any doctrine of election of remedies. Official Comment 1 to UCC §2-703. A party's remedies will be protected even when his or her words or actions might otherwise be held to be an election or waiver of rights. For example, a party's expressions of "cancellation" or "rescission" will not be construed as a renunciation or discharge of any claim unless that intention "clearly appears." Com C §2720. The attorney drafting a cancellation of a contract should include a release of claims under the contract to ensure that cancellation will be given practical effect. See Official Comment to UCC §2-720.

Regardless of the Code's treatment of the cumulation of remedies issue, exercising some non-Code remedy may result in an election by the plaintiff. These remedies include attachment, claim and delivery, and creditors' claims against an estate. Thus, to avoid violating non-Code election-of-remedy principles, the attorney should exercise caution when combining Code and non-Code remedies. For general discussion of this issue, see 3 Witkin, California Procedure, *Actions* §§187-189 (5th ed 2009).

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V. SPECIAL LITIGATION PROBLEMS

§18.59 A. Applicable Law

Parties are generally free to choose the jurisdiction whose law will apply. The transaction, however, must bear a "reasonable relation" to the jurisdiction chosen. Com C §1301(b). The test of "reasonable relation" is similar to that formulated by the Supreme Court in *Seeman v Philadelphia Warehouse Co.* (1927) 274 US 403, 47 S Ct 626, 71 L Ed 1123: Ordinarily, the law chosen must be that of a jurisdiction in which a significant enough portion of the making or performance of the contract occurs. See also CC §1646 (contract is interpreted according to law and usage of place where it is to be performed; or, if it does not indicate place of performance, according to law and usage of place where it is made).

In California, the parties to a transaction involving more than $250,000 (other than those for labor or personal services, consumer contracts, or certain contracts specified in Com C §1301) have a right to select California law to govern their rights and duties whether or not the transaction bears a reasonable relation to the state. CC §1646.5. As noted, under Com C §1301, if one of the following provisions applies to the transaction, that provision governs and a contrary agreement is effective only to the extent permitted by the law so specified (Com C §1301(c)):

- Com C §2402 (rights of creditors against sold goods are governed by law of state where goods are located);
- Com C §4102 (liability of bank with respect to item handled by it for purposes of presentment, payment, or collection is governed by law of place where bank, branch, or separate office is located);
- Com C §5116 (liability of issuer, nominated person, or adviser may be governed by law of that person's location, by agreement, or by rules of custom or practice; jurisdiction whose law is chosen need not bear any relation to transaction);
- Com C §6103 (Division 6 on bulk sales applies California law to sellers whose place of business is in California or whose major executive office in United States is in California);
- Com C §8110 (local law of issuer's jurisdiction governs);
- Com C §§10105-10106 (for leased goods covered by certificate of title, generally applies law of state that issued certificate; choice of law provision in lease agreement subject to Division 10 will only be enforceable if jurisdiction chosen is (1) where lessee resides when lease agreement becomes enforceable or within 30 days thereafter, (2) where lessee executed lease agreement, or (3) where leased goods are to be used; see §§19.23-19.27); and
- Com C §11507 (unless parties agree otherwise, liability with respect to funds transfer is governed by rules set forth in this section).

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Source: Business Law/California UCC Sales and Leases/18 Litigation Remedies/§18.60 B. Choice of Forum

§18.60 B. Choice of Forum

In addition to the points discussed in §17.2, the choice of forum is a strategic issue that will arise when litigation appears inevitable. The attorney must determine whether the causes of action contemplated may be brought only in state court, only in federal court, or in either state or federal court. For example, a breach of warranty action under the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312) may be brought in either state or federal court. For jurisdiction to be brought in federal court, however, the amount in controversy must be at least $50,000. 15 USC §2310(d).

A comparative discussion of state and federal jurisdiction is beyond the scope of this chapter. For a comprehensive treatment of the subject, see California Civil Procedure Before Trial, chaps 6-8 (4th ed Cal CEB 2004). The attorney should consider the following issues in deciding whether to file an action in state or federal court:

- **Geography.** The attorney should weigh the distances that the parties, witnesses, and attorneys must travel to attend trial or pretrial motions and conferences. See Civ Proc Before Trial §§6.43, 22.48.
- **Venue and transfer.** If the attorney decides to file the action in federal court, the case may be transferred to a federal court in any other district in the United States on grounds of convenience (28 USC §1404(a)) or when venue is improper in the district in which the action is brought (28 USC §1406(a)). See Civ Proc Before Trial §§6.44, 22.49.
- **Applicable substantive law.** If there is a state appellate court decision adverse to the client's position, but substantive law applies to the case, it may be advisable for the attorney to file the case in a state court. Although a federal court would be bound to follow the court decision, another state appellate court would not. See Civ Proc Before Trial §6.45.
- **Applicable procedural law.** The attorney should determine whether federal or state procedural law offers the greatest advantage to the client. Federal court affords flexible use of motions for partial summary judgment. See Fed R Civ P 56, which enables litigants to eliminate or narrow issues for trial. In California state courts, however, motions for summary adjudication can no longer resolve facts or issues that do not completely dispose of a cause of action or defense. See CCP §437c(f); Civ Proc Before Trial §22.59.
- **Discovery.** Foreign and out-of-state depositions are more easily conducted in federal court actions. In addition, some attorneys believe that federal court affords greater flexibility in resolving discovery disputes. See Civ Proc Before Trial §22.54.
- **Jury issues.** Before choosing a forum for the case, the attorney should consider several important differences between the jury systems of federal and state courts. A jury in federal district court is usually composed of six persons (see, *e.g.,* Fed R Civ P 48(a)); a jury in state court is composed of 12 persons, unless the parties stipulate to a smaller number (CCP §220). In federal court, the jury verdict must be unanimous (Fed R Civ P 48(b)); in state court, a verdict by three fourths of the jury is sufficient (CCP §§613, 618). In federal court, jury voir dire under Fed R Civ P 47(a) is conducted primarily or entirely by the judge (see, *e.g.,* ND Cal Local R 16-10(b)(9)); in state court, the attorneys have a more active role in asking questions (see CCP §222.5; Cal Rules of Ct 3.1540). Because the jury pool for a federal district court is typically larger than that for a state court, the composition of the jury is less likely to represent the immediate area in which the court sits. See Civ Proc Before Trial §§6.47, 22.50, 22.61-22.62, 22.65.
- **Mandatory arbitration.** Depending on the county in which the action is filed and the amount in controversy, arbitration may be required in state court. See CCP §1141.11. Arbitration may also be required in federal district court. The attorney should consult the local rules of the jurisdiction for applicable requirements. See, *e.g.,* ND Cal Local Rules for Alternative Dispute Resolution 4-2 and 28 USC §654, which may require nonbinding arbitration of certain civil actions when the damages sought do not exceed $150,000.
- **Attorney time.** In certain districts, it may be more time-consuming and demanding for the attorney to litigate the case in federal court than state court because the court's local rules require pretrial meetings, the exchange of documents and lists, the drafting of briefs and a pretrial conference order, and other preparatory work. See Civ Proc Before Trial §22.51.

- **Caliber of federal judiciary and experience of opposing counsel.** See Civ Proc Before Trial §6.49.
- **Disqualification of judge.** Generally, it is easier to disqualify a judge in state court than it is in federal court. See Civ Proc Before Trial §§6.51, 22.57.
- **Registering or entering judgment outside California.** The ability to have judgment easily entered in another state may be an important consideration when the assets of the defendant from whom recovery is expected are located outside the state. If a state court judgment has been entered, the procedure for obtaining its entry in another state may be more cumbersome than the registration procedure provided for federal district court judgments. See Civ Proc Before Trial §22.66.

PRACTICE TIP: Note that some state enactments require the plaintiff to accompany its complaint with an affidavit stating that the action is being filed in the proper county. See, *e.g.,* CC §§1780(d) (part of the Consumers Legal Remedies Act), 2984.4 (part of the Rees-Levering Motor Vehicle Sales and Finance Act). (A verified complaint alleging the required facts would serve as well, but the facts may not be alleged on information or belief. CCP §§2015.5, CC 2984.4(c).) If the plaintiff fails to file the affidavit, the court must dismiss the action without prejudice on its own motion or the motion of any party. CC §§1780(d), 2984.4.

Generally speaking, forum selection clauses in sales agreements are valid and will be given effect in the absence of a showing that enforcement of the clause would be unreasonable. *Bos Material Handling, Inc. v Crown Controls Corp.* (1982) 137 CA3d 99, 186 CR 740. See also *Vimar Seguros y Reaseguros S.A. v M/V Sky Reefer* (1995) 515 US 528, 132 L Ed 2d 462, 115 S Ct 2322 (foreign arbitration clause in maritime bill of lading not nullified by Carriage of Goods by Sea Act); *Richards v Lloyd's of London* (9th Cir 1998) 135 F3d 1289 (choice of forum and choice of law clauses in freely negotiated private international agreements should be enforced unless grounds for repudiation exist; relying on *The Bremen v Zapata Off-Shore Co.* (1972) 407 US 1, 32 L Ed 2d 513, 92 S Ct 1907); *Chateau Des Charmes Wines Ltd. v Sabate USA Inc.* (9th Cir 2003) 328 F3d 528 (under United Nations Convention on Contracts for the International Sale of Goods (CISG), forum selection clause in invoices accompanying shipment of corks did not become part of agreement; parties' oral discussions were sufficient to create oral agreement and choice of forum was not discussed).

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§18.61 C. Evidence of Market Price

To measure the seller's or buyer's damages, the Commercial Code refers to "market price" at particular times and places. See Com C §§2708(1), 2713, 2723(1).

Courts are generally flexible in accepting evidence of market price. See *Harbor Hill Lithographing Corp. v Dittler Bros.* (Sup Ct 1973) 348 NYS2d 920 (price of scarce goods shown by opinion evidence). See also Official Comment 3 to UCC §2-713; *Roth Steel Prods. v Sharon Steel Corp.* (6th Cir 1983) 705 F2d 134 (buyer could have covered only in resale market, as opposed to purchases from manufacturer; market price for purposes of Com C §2713 was price prevailing in resale market); *Kirkwood Agri-Trade v Frosty Land Foods Int'l* (5th Cir 1981) 650 F2d 602 (evidence of spot sales contracts introduced when prevailing market price was unavailable).

If the goods are bought and sold with sufficient regularity to form a market, their market price can be established by reports in official publications, trade journals, newspapers, or periodicals of general circulation published as the reports of such market. Com C §2724. Official Comment to UCC §2-724 states that the Code does not require that the market be closely organized. It is sufficient if transactions in the commodity are frequent and an informed report of the range and trend of prices can be assumed to be reasonably accurate.

If evidence of the price prevailing at the appropriate time or place is not readily available, the price prevailing within a reasonable time before or after, or at a commercially reasonable substitute place, may be used if notice is given to the other party. Com C §2723(2)-(3). The party who wishes to exclude evidence of a substituted price on the grounds that the proper market price is readily available can do so by offering proof of the proper price. The notice required by Com C §2723(3) presumably is waived by failure to object when the evidence of substituted price is introduced. When the notice must be given is not clear, the Code states only that it must be "sufficient to prevent unfair surprise." Com C §2723(3).

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§18.62 D. Burden of Proof

The "burden of establishing" a fact is defined as the burden of persuading the trier of fact that the existence of the fact is more probable than not. Com C §1201(b)(8). In cases arising under the Commercial Code:

- If the buyer has accepted the goods, it bears the burden of establishing the seller's contract breach. Com C §2607(4).
- To justify its revocation of acceptance of the goods, the buyer has the burden of establishing that the goods were nonconforming. *McClure Oil Corp. v Murray Equip., Inc.* (Ind Ct App 1987) 515 NE2d 546.
- Unconscionability is an affirmative defense raised by the party against whom enforcement of the contract is sought; that party has the burden of proving unconscionability. *Earman Oil Co. v Burroughs Corp.* (5th Cir 1980) 625 F2d 1291. See §§18.69-18.71 regarding litigation of the unconscionability claim.
- The breaching party has the burden of proving the inadequacy of the aggrieved party's efforts to mitigate its consequential damages. *Carnation Co. v Olivet Egg Ranch* (1986) 189 CA3d 809, 229 CR 261.

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E. Notice of Breach

§18.63 1. Summary

After tender has been accepted, the buyer must notify the seller of any breach within a reasonable time after it discovers, or should have discovered, the breach. Otherwise, the buyer is barred from any remedy. Com C §2607(3)(A). The purpose of this requirement is to protect the seller from stale claims. *Metowski v Traid Corp.* (1972) 28 CA3d 332, 104 CR 599.

Notice is not required when the seller has failed to deliver the goods. By its terms, Com C §2607 does not apply when there has been no tender or acceptance of the goods.

See §§3.73-3.82 on notice of breach in warranty actions. For a form of notice, see §18.67.

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§18.64 2. Time of Notice

The buyer must provide notice of breach within a "reasonable" time. Com C §2607(3)(A). What is a reasonable time for taking any action depends on the nature, purpose, and circumstances of such action. Com C §1205(a). This time period is measured from the buyer's discovery or imputed discovery of the breach. Com C §2607(3)(A). For a merchant buyer, the time period must be measured by commercial standards. For a retail consumer, the time period "is to be judged by different standards so that in his case it will be extended." Official Comment 4 to UCC §2-607. In fact, the notice requirement is not applicable in actions brought by injured consumers against manufacturers. *Greenman v Yuba Power Prods., Inc.* (1963) 59 C2d 57, 27 CR 697. Although the time period for notice of breach may be fixed by agreement (Com C §1302(b)), the attorney should resist the temptation to make the period so short that the buyer is in effect left without a remedy. The courts may strike such a provision as "manifestly unreasonable." See Com C §1302(b).

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§18.65 3. Particularity of Notice

The content of the notice need merely be sufficient to let the seller know that there may be problems with the seller's performance; the notice need not include a statement of all the objections on which the buyer will rely. Official Comment 4 to UCC §2-607.

Although the Commercial Code does not specifically require *written* notice, the buyer should, of course, be counseled to provide written notice to avoid disputes about whether and when the seller was notified. The seller may wish to include a provision in the sales agreement specifying the manner of giving notice and describing when its receipt will be considered effective. See generally *U.S. v Southern Contracting* (D SC 1994) 862 F Supp 107. The question of whether notice was reasonable is a question of fact unless there is but one inference that can be drawn from the facts, in which case it is a matter of law. *Fieldstone Co. v Briggs Plumbing Prods., Inc.* (1997) 54 CA4th 357, 370, 62 CR2d 701.

PRACTICE TIP: Written notice is recommended and should be drafted in such a way that the seller recognizes the notice as a notice of breach. The seller should not be able to reasonably ask what is meant by the notice.

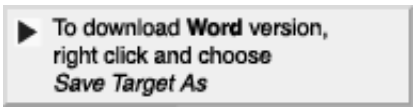
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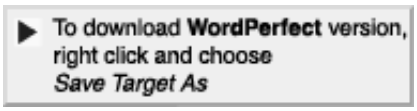
§18.66 4. Notice of Breach by Delayed Delivery or Knowledge of Defects

If the purpose of the notice requirement is to inform the seller of defects in its performance, it might logically be assumed that, because the seller must be aware of delayed delivery, a notice telling the seller that the delay constituted a breach would be superfluous. In *Eastern Air Lines, Inc. v McDonnell Douglas Corp.* (5th Cir 1976) 532 F2d 957, however, the court held that one important purpose of the notice requirement is to protect the seller against stale claims and inform it that its untimely performance may result in a claim for damages. In this case, because the buyer of 99 passenger aircraft had not notified the seller that its delayed deliveries constituted a breach of contract, the court reversed a jury verdict of $25 million. Similarly, in *Aqualon Co. v Mac Equip., Inc.* (4th Cir 1998) 149 F3d 262, the court held that the seller's actual knowledge that its products were inadequate did not obviate the notice requirement.

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§18.67 5. Form: Notice of Breach





18.67-1 Notice of breach

The tender you made under our contract dated _ _[*date*]**_ _, for _ _**[*identify contract*]**_ _, was defective and in breach of that contract because _ _**[*describe defect, e.g., the goods arrived late/there was a shortage*]**_ _.**

Comment: Although even this skeletal form may be more than the Commercial Code requires (see Official Comment 4 to UCC §2-607), the buyer may want to add language inviting inspection, describing injuries that have occurred, claiming damages, suggesting prompt replacement, and so forth. Where the seller is a large entity, every effort should be made to address the notice to a specific person in charge or to a department from where the goods may have emanated.

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Source: Business Law/California UCC Sales and Leases/18 Litigation Remedies/§18.68 F. Statutes of Limitations

§18.68 F. Statutes of Limitations

Actions for the breach of any written or oral sales contract for goods must begin within 4 years after the breach. Com C §2725. By agreement, the parties may reduce the limitations period to 1 year; however, they may not extend it beyond the statutory 4 years. Com C §2725(1). Because the effect of a waiver of the period is to extend it indefinitely, such a waiver is invalid. See *Mysel v Gross* (1977) 70 CA3d Supp 10, 138 CR 873.

In determining the applicability of a particular statute of limitations, courts will look to the nature of the rights sued on rather than to the form of the action. Additionally, a specific statute of limitations will prevail over a more general statute. Under these principles, a breach of contract claim based solely on a breach of warranty is governed by Com C §2725(2). *Cardinal Health 301, Inc. v Tyco Electronics Corp.* (2008) 169 CA4th 116, 134, 87 CR3d 5.

The cause of action accrues on breach, regardless of the aggrieved party's lack of knowledge. A breach of warranty occurs when tender is made, but, when a warranty explicitly extends to future performance of the goods and discovery of the breach cannot occur until then, the cause of action accrues when the breach is or should have been discovered. Com C §2725(2).

Note that if the breach of warranty claim does not arise out of a written contract of sale, the 2-year limitations period of CCP §339 may apply rather than the 4-year period of Com C §2725. See *Fundin v Chicago Pneumatic Tool Co.* (1984) 152 CA3d 951, 199 CR 789 (buyer sued manufacturer for breach of express warranty; demurrer affirmed because no contract of sale existed between parties; 4-year statute of limitations did not apply).

In *Becker v Volkswagen of Am.* (1975) 52 CA3d 794, 125 CR 326, the court ruled that a personal injury claim based on breach of express and implied warranties that the vehicle was safe was a personal injury action and therefore was subject to the (at that time) 1-year limitation of CCP §340(3). The 4-year period of Com C §2725 did not apply even though the complaint was couched in terms of breach of warranty. Note also that Com C §2725(2) does not apply in an action for indemnification based on express or implied warranty. Instead, the traditional time limitations in the Code of Civil Procedure apply. *Carrier Corp. v Detrex Corp.* (1992) 4 CA4th 1522, 6 CR2d 565.

In an action brought under both the Commercial Code and the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8), the code's 4-year statute of limitations applies, rather than the 3-year limitations period prescribed by CCP 338(a) for actions based on statute. *Krieger v Nick Alexander Imports, Inc.* (1991) 234 CA3d 205, 285 CR 717.

In *H. Russell Taylor's Fire Prevention Serv., Inc. v Coca Cola Bottling Corp.* (1979) 99 CA3d 711, 160 CR 411, the buyer failed to return goods at the end of a service contract, and the seller chose to waive the tort of conversion and sue instead on the theory of an implied-in-law contract. The court held that the 4-year limitations period provided by Com C §2725 applied rather than the 3-year statute of limitations for conversion. Commercial Code §2725 also applies to an action by a seller who seeks a deficiency judgment against the buyer after repossession and resale of the goods. The 4-year limitations period runs from the time of the breach of the underlying obligation, not the resale date. *Massey-Ferguson Credit Corp. v Casaulong* (1976) 62 CA3d 1024, 133 CR 497. See also *Jack Haskett Lincoln-Mercury, Inc. v Metcalf* (1984) 158 CA3d 38, 204 CR 355, in which the court held that, because an action for a deficiency judgment following default on a conditional sales contract for goods is not an action for a penalty or forfeiture, CCP §340(1)'s 1-year limitations period for such actions does not apply.

The general law on the tolling of limitations statutes applies to causes of action arising under the Commercial Code. Com C §2725(4). For example, CCP §351 provides that the statute of limitations is tolled when a defendant is out of state. See 3 Witkin, California Procedure, *Actions* §710 (5th ed 2009). In actions under the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8), if the parties resort to a third party dispute resolution process, the limitations period is extended for a period equal to the number of days between the filing of a complaint and the rendering of a decision in that process. If the buyer accepts the decision rendered, the limitations period will be further extended by the period allowed the manufacturer to fulfill the terms of the decision. CC §1793.22(c).

The defendant's failure to plead the correct statutory section as an affirmative defense, or failure to allege all the facts showing that the action is barred, constitutes a waiver of the defense. In *Mysel v Gross* (1977) 70 CA3d Supp 10, 138 CR 873, the defendant had a valid statute of limitations defense under Com C §2725 but an invalid defense under CCP §337. Because the defendant pleaded the defense only under CCP §337, the plaintiff's action was not time-

barred.

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G. Litigating Unconscionability Claim

§18.69 1. Background

Uniform Commercial Code §2-302, relating to the unconscionable contract or clause, was originally not enacted in California as part of Commercial Code Division 2. According to Cal Comment to Com C §2302, the decision to delete that section from California's Code was based on the belief that giving courts unqualified power to strike down terms they might consider "unconscionable" could result in the renegotiation of contracts in every case in which there was a disagreement regarding the fairness of contract provisions.

In 1979, however, the entire text of UCC §2-302 (1962 Official Text) was adopted in California in the form of CC §1670.5. The impetus for its adoption was the legislature's desire "to preserve inviolate the rights of consumers and home owners to remain free from unconscionable, fraudulent and deceptive trade practices" (Historical Note to Bus & P C §17350). See Historical Note to CC §1670.5. Since then, application of CC §1670.5 has not been limited to those contexts. See, *e.g., A & M Produce Co. v FMC Corp.* (1982) 135 CA3d 473, 186 CR 114 (suit by produce company against agricultural equipment company).

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§18.70 2. Meaning of "Unconscionable"

The Commercial Code does not define "unconscionability." The concept has generally been recognized to include an absence of meaningful choice for the party claiming unconscionability, together with contract terms that are unreasonably favorable to the other party. Phrased another way, unconscionability has both a procedural and a substantive element. *Marin Storage & Trucking, Inc. v Benco Contracting & Eng'g* (2001) 89 CA4th 1042, 107 CR2d 645; *A & M Produce Co. v FMC Corp.* (1982) 135 CA3d 473, 186 CR 114.

The procedural element focuses on the factors of "oppression" and "surprise." Oppression arises from an inequality of bargaining power, which results in no real negotiation between the parties and an absence of meaningful choice. Surprise involves the extent to which the supposedly agreed-on terms of the bargain are hidden in a printed form drafted by the party seeking to enforce the disputed terms. *A & M Produce Co. v FMC Corp., supra*.

Of course, the mere fact that a contract term is not read or understood by the nondrafting party or that the drafting party occupies a superior bargaining position will not authorize a court to refuse to enforce the contract. Commercial practicalities dictate that unbargained-for terms will be denied enforcement only when they are also substantively unconscionable. In addition, no precise definition of substantive unconscionability can be given. Courts speak in terms of "overly harsh" or "one-sided" results. See 135 CA3d at 487, 186 CR at 122.

Factors tending to establish substantive unconscionability include:

- **Excessive price.** See, *e.g., Vom Lehn v Astor Art Galleries* (Sup Ct 1976) 380 NYS2d 532, in which $67,000 was charged for jade carvings worth approximately $14,750. The court found the contract to be unconscionable and unenforceable to the extent that it was still executory.
- **Unfair remedies.** See, *e.g., A & M Produce Co. v FMC Corp., supra,* in which a warranty allegedly breached by the defendant applied to basic performance characteristics of the product. The court held that, in attempting to disclaim this and all other warranties, the defendant guaranteed nothing about product performance. In addition, the agreement excluded consequential damages. The court found this treatment of the buyer's remedies to be unconscionable.
- **How the agreement allocates risks between the parties.** In *A & M Produce Co. v FMC Corp., supra,* the defendant was the only party who could prevent the loss that resulted from its selling a machine that was inadequate for the plaintiff's expressed needs. The court commented that special scrutiny should be given to a risk allocation that shifts to one party a risk that *only* the other party can avoid (135 CA3d at 493, 186 CR at 126).

Typically, cases in which contracts are found to be unconscionable in whole or in part involve both procedural and substantive unconscionability. In other words, the contract is likely to have been entered into under questionable circumstances, and the contract or clause is likely to be extremely burdensome or unfair. Therefore, a claim of unconscionability can often be defeated either by a showing that the contract was knowingly and voluntarily entered into or by a showing that the clause complained of is not unduly oppressive. See, *e.g., Fischer v General Elec. Hotpoint* (1981) 438 NYS2d 690 (contract excluded liability for consequential damages caused by faulty refrigerator; buyer prevailed because limitation was onerous and buyer did not understand the significance of the provision); *Walter E. Heller & Co. v Convalescent Home of First Church of Deliverance* (Ill App 1977) 365 NE2d 1285 (notwithstanding presence of apparently unfair provisions in equipment lease, fact that they were agreed to by corporations of "substantially equal bargaining strength" defeated claim of unconscionability).

Given the ambiguous nature of the term "unconscionable," one can expect further attempts at clarification of a standard. The decision in *California Grocers Ass'n v Bank of America* (1994) 22 CA4th 205, 27 CR2d 396, rejects the procedural/substantive approach adopted in *A & M Produce Co. v FMC Corp.*, *supra*. See also *Graham v Scissor-Tail, Inc.* (1981) 28 C3d 807, 820, 171 CR 604 (California Supreme Court defined unconscionable contract as one that "considered in its context, is unduly oppressive"). The *Bank of America* case involved a trade association's challenge of check fees charged to merchants by the defendant bank for customers' checks that were returned for insufficient funds. In the court's view, procedural unconscionability serves merely to identify a contract as adhesive and is not a useful

analysis when adhesiveness is not at issue. To identify a contract as adhesive does not determine its legal effect or enforceability; consequently, "procedural" unconscionability should not be elevated to the same level as "substantive" unconscionability. The core issue is whether a contract is unduly oppressive. 22 CA4th at 214. In addition to questioning *A&M Produce Co. v FMC Corp.*'s procedural/substantive analysis, the court rejected its "unreasonableness" standard for unconscionability. Instead, the court adopted a "shocks the conscience" standard, which it felt was "more specific, more exacting, and more demanding" than the "amorphous" term "unreasonable." 22 CA4th at 215. See also *American Software, Inc. v Ali* (1996) 46 CA4th 1386, 1391, 54 CR2d 477:

> With a concept as nebulous as "unconscionability," it is important that courts not be thrust in the paternalistic role of intervening to change contractual terms that the parties have agreed to merely because the court believes the terms are unreasonable. The terms must shock the conscience.

There is a sliding scale, or a balancing relationship, between the two elements of unconscionability, such that the greater the degree of unfair surprise or unequal bargaining power, the less the degree of substantive unconscionability required to annul the contract and vice versa. *Armendariz v Found. Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 114, 99 CR2d 745.

Analytically, the two approaches used in *California Grocers Ass'n v Bank of America* and *A & M Produce Co. v FMC Corp.* should lead to the same result. See *Perdue v Crocker Nat'l Bank* (1985) 38 C3d 913, 925 n9, 216 CR 345. See also *McCollum v Xcare.net, Inc.* (ND Cal 2002) 212 F Supp 2d 1142. The supreme court endorsed both approaches in *Armendariz*. 24 C4th at 113.

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§18.71 3. Remedies and Proof

The court in its discretion may (a) refuse to enforce the unconscionable contract in its entirety, (b) strike any clause or group of clauses that are unconscionable, or (c) simply limit unconscionable clauses to avoid unconscionable results. Comment 2 to CC §1670.5; *Vance v Villa Park Mobilehome Estates* (1995) 36 CA4th 698, 42 CR2d 723.

Unconscionability is a question of law to be determined by the court; it is not a question that is properly presented to the jury. Comment 3 to CC §1670.5.

When unconscionability is claimed or it appears to the court that the contract or any of its clauses may be unconscionable, the parties may present evidence of the contract's commercial setting, purpose, and effect to aid the court in making the determination. CC §1670.5. The court is given "the widest latitude" in receiving evidence on the issue of commercial setting and unconscionability. *Raybond Elecs. v Glen-Mar Door Mfg. Co.* (Ariz Ct App 1974) 528 P2d 160.

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Source: Business Law/California UCC Sales and Leases/18 Litigation Remedies/§18.72 H. Litigating Claim Under Consumers Legal Remedies Act

§18.72 H. Litigating Claim Under Consumers Legal Remedies Act

The Consumers Legal Remedies Act (CC §§1750-1784) provides damages and injunctive relief to consumers injured by certain deceptive practices in the sale of consumer goods. The prohibited practices are listed in CC §1770(a) and include such things as:

- Representing that goods or services have sponsorship, approval, characteristics, ingredients, uses, benefits, or quantities which they do not have.
- Representing that goods are original or new if they have deteriorated unreasonably or are altered, reconditioned, reclaimed, used, or secondhand.
- Representing that goods or services are of a particular standard, quality, or grade, or that goods are of a particular style or model, if they are of another style or model.
- Disparaging the goods, services, or business of another by false or misleading representation of fact.
- Advertising goods or services with intent not to sell them as advertised.
- Advertising goods or services with intent not to supply reasonably expectable demand, unless the advertisement discloses a limitation of quantity.
- Making false or misleading statements of fact concerning reasons for, existence of, or amounts of price reductions.
- Misrepresenting the authority of a salesperson, representative, or agent to negotiate the final terms of a transaction with a consumer.
- Inserting an unconscionable provision in the contract.
- Selling or leasing goods in violation of Chapter 4 (commencing with CC §1797.8, relating to "grey market" goods).

The Consumers Legal Remedies Act applies to transactions for the sale or lease of goods "primarily for personal, family or household purposes" or for services "for other than a commercial or business use, including services furnished in connection with the sale or repair of goods." CC §1761(a)-(b). A contract is not a prerequisite for bringing an action. CC §1761(e).

The Act was the first to provide injured buyers with a statutory right to bring a class action. See CC §1781. See also Reed, *Legislating for the Consumer: An Insider's Analysis of the Consumers Legal Remedies Act*, 2 Pac LJ 1 (Jan. 1971). The other remedies provided by the Act are additional to those otherwise available at law; nothing in the Act is intended to limit any other rights or remedies possessed by a defrauded consumer. The provisions of the Act cannot be waived. CC §1751. See in this regard, *Nagrampa v MailCoups, Inc.* (2006) 469 F3d 1257, 1289 (burden of proving that CLRA anti-waiver provision was not violated rests with party seeking to enforce provision).

Remedies available under the Act include the following:

- Injunctive relief;
- Restitution of property;
- Actual damages (in a class action, these must total at least $1000);
- Punitive damages;
- Attorney fees (a prevailing defendant can recover its attorney fees if it can show that the plaintiff's prosecution of the action was not in good faith); and
- Any other relief that the court considers proper

If the plaintiff is a senior citizen or disabled person (as defined in CC §1761(f)-(g)), he or she may recover up to $5000 in addition to the remedies noted above. Under CC §1780(a)-(b), for the plaintiff to be entitled to the penalty award:

- The plaintiff must show that he or she suffered substantial physical, emotional, or economic damage resulting from the defendant's conduct; and

- The court must find that one or more special factors are present in the case (see CC §3345(b)) and that an additional award is otherwise appropriate.

Before a consumer may bring an action for damages under the Act, he or she must notify the merchant of the alleged abuse and demand that the merchant "correct, repair, replace or otherwise rectify" the goods or services claimed to be in violation of CC §1780. This notice must be in writing and sent by certified or registered mail to the place where the transaction occurred or to the merchant's principal place of business in California. The merchant has 30 days after receiving the consumer's notice/demand to make the appropriate correction, repair, or replacement; to otherwise remedy the wrong charged; or to at least agree that it will be done within a reasonable time. If the merchant complies with the statute, the consumer may not maintain an action for damages. CC §1782(a)-(b).

Similarly, no class action for damages may be maintained if the merchant can show all the following (CC §1782(c)):

- All consumers similarly situated have been identified or a reasonable effort to identify those consumers has been made;
- The identified consumers have been notified that, on their request, the merchant will make the appropriate correction, repair, replacement, or take other remedial steps necessary;
- The correction, repair, replacement, or other remedy requested by those consumers has been made or will be made in a reasonable time; and
- The merchant has stopped engaging in the prohibited practices or, if immediate cessation is impossible or unreasonably expensive under the circumstances, the merchant will stop within a reasonable time.

If the consumer wishes to file an action for injunctive relief and not seek damages, he or she does not have to notify the merchant of the alleged violation nor demand its correction, because the complaint serves this purpose. The consumer may amend the complaint without leave of court to include a request for damages but must wait at least 30 days after the filing of the complaint to do so and must also comply with the notice requirement of CC §1782. CC §1782(d).

No damages may be awarded to a consumer if the merchant (1) proves that the violation of the Act was unintentional and resulted from a bona fide error, notwithstanding the use of reasonable procedures adopted to avoid such errors, and (2) makes the appropriate correction, repair, or replacement of the goods or takes other remedial action as required by CC §1782. CC §1784.

An action based on the Consumers Legal Remedies Act may be filed in the county in which the defendant resides, has his or her principal place of business, or is doing business, or in the county where the transaction or any substantial part of it occurred. The plaintiff must accompany the complaint with an affidavit stating facts showing that the action was filed in the proper county. CC §1780(d). (A verified complaint alleging the required facts would serve as well. CCP §2015.5.) If the plaintiff fails to file the affidavit, the court must dismiss the action without prejudice on its own motion or the motion of any party. CC §1780(d).

An action based on the Consumers Legal Remedies Act must be commenced within three years after the prohibited act was committed. CC §1783.

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§18.73 I. Persons Answerable

Commercial Code §2607(5) governs the situation in which a buyer is sued for breach of warranty or other obligation for which a seller is answerable. In such a situation, the buyer may give the seller written notice of the litigation, of the opportunity to come in and defend, and of the consequences of not defending (*i.e.,* that the seller will be bound in any action against it by the buyer "by any determination of fact common to the two litigation actions"). Com C §2607(5). Mere notice of the litigation and the opportunity to defend is insufficient unless the seller is also informed of the consequences of its failure to defend. *Bendix-Westinghouse Automotive Air Brake Co. v Swan Rubber Co.* (1976) 55 CA3d 256, 127 CR 571.

If the claim is for infringement (see Com C §2312(3)), the seller may demand in writing that the buyer turn over control of the litigation "or else be barred from any remedy over." Com C §2607(5)(B).

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§18.74 J. Right to Sue Third Parties

If the goods are lost or damaged by a bailee (*e.g.,* a warehouse) during the course of shipment, which party has a right of action against the bailee: the seller or the buyer? Commercial Code §2722 gives the right of action to either party as long as it has title to the goods or a security interest, insurable interest, or other special property interest in them. Com C §2722(a). If the goods are identified to the contract, the buyer obtains a "special property interest" in them. On identification generally, see §§8.28-8.29, 17.32-17.37. Thus, if a creditor of the seller seizes goods that have been identified but not yet delivered, that causes "actionable injury" to the buyer, who may sue the creditor. *Carey Aviation, Inc. v Giles World Mktg., Inc.* (D Mass 1985) 46 BR 458. Before the goods are identified, the right of action belongs to the seller alone. Official Comment to UCC §2-722; *Martin Marietta Corp. v New Jersey Nat'l Bank* (3d Cir 1979) 612 F2d 745. Even after the buyer has accepted the goods, the seller still may have a right of action against a third party if the seller has retained an interest in the goods. Official Comment to UCC §2-722.

Another basis for maintaining an action against a third party is assumption of the risk of loss. If the goods have been destroyed or converted by a third party, the party who assumed the risk of loss either under the original contract or subsequently may sue the third party. Com C §2722(a).

Finally, either party may sue with the consent of the other, even if it lacks the qualifications specified above. Com C §2722(c).

Uniform Commercial Code §2-722 was enacted to liberalize the rule prevailing in some jurisdictions that only the party with title can sue a third party for damage to the goods. Official Comment to UCC §2-722. However, UCC §2-722 does not provide for separate suits by both the buyer and seller. The buyer and seller possess a single, collective cause of action to obtain one recovery—not separate, distinguishable claims. *Mitsui & Co. (USA) v Hudson Tank Terminals Corp.* (2d Cir 1986) 790 F2d 226 (settlement by seller of its damage claim against bailee precluded recovery by buyer for its damages). As between the buyer and seller, if the suing party does not have the risk of loss, it stands as a fiduciary for the other party. Com C §2722(b). See *Ninth St. E., Ltd. v Harrison* (Conn 1968) 259 A2d 772 (goods disappeared while in carrier's custody; risk of loss had passed to buyer; any recovery by seller in suit against carrier would be held as fiduciary for buyer, subject to seller's own interest).

A consignor under a bill of lading was held to have standing to sue the carrier for breach of the terms of the bill of lading in *Lite-On Peripherals, Inc. v Burlington Aire Express, Inc.* (9th Cir 2001) 255 F3d 1189.

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19

Leasing of Goods

William B. Piels

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I. INTRODUCTION

§19.1 A. Overview of Division 10

Division 10 of the Commercial Code, which is based on Article 2A of the Uniform Commercial Code, became operative on January 1, 1990. As originally enacted, Division 10 contained a significant number of deviations from Article 2A. However, Article 2A was amended February 12, 1991, in part to adopt some of California's nonstandard provisions, and Division 10 was amended effective July 15, 1991, to substantially conform California law to amended Article 2A. Article 2A has been adopted in the District of Columbia and every state except Louisiana, thus achieving nearly uniform statutory treatment of personal property leasing transactions in all jurisdictions of the United States. A number of further amendments to Article 2A were proposed in 2001 by the National Conference of Commissioners on Uniform State Laws, and approved by the American Bar Association's House of Delegates in 2004. However, no state has yet enacted the amendments.

The provisions of Division 10 address all major aspects of the relationship between a lessor and lessee, including formation of the lease agreement, obligations of the lessor and lessee, events constituting default under the lease agreement, and remedies of the lessor and lessee.

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§19.2 B. Scope of Division 10

Division 10 applies to any transaction that creates a "lease" of personal property. Com C §10102. The term "lease" is defined to include any transfer of the right to possession and use of goods for a period of time in exchange for consideration. Neither a sale of goods nor the creation of a security interest in goods is governed by Division 10. Com C §10103(a)(10). (On what is encompassed by the term "goods," see §1.5.) It is therefore important to distinguish between a lease transaction and a sale or a creation of a security interest. See §§19.5-19.18 for further discussion.

Although Division 10 is the primary source of personal property leasing law, other statutory provisions may apply to a leasing transaction, including:

- Federal statutes such as the Consumer Leasing Act (15 USC §1667) and its implementing regulation, Regulation M (12 CFR pt 213), which apply to consumer leases;
- Certificate-of-title statutes, including the Vehicle Code with respect to boats and vehicles (see, *e.g.,* Veh C §§9901, 38205) and the Health and Safety Code with respect to mobilehomes and commercial coaches (see *e.g.* Health & S C §18124.5); and
- Certain Civil Code provisions such as CC §§1925-1936 (hiring in general), 1955-1959 (bailments of personal property), and 2985.7-2992 (Vehicle Leasing Act).

Further, although Division 10 contains some specific consumer protection provisions, consumer protection is left primarily to other statutory enactments. See §§19.38-19.40.

Typically, in the event of a conflict with Division 10, certificate-of-title statutes and consumer legislation control. Com C §10104(b).

Division 10 carries forward the Uniform Commercial Code's philosophy of freedom of contract. See Official Comment to UCC §2A-101. In most instances, the provisions of Division 10 apply only when the parties have not otherwise agreed, and the effect of its provisions can be varied by agreement. A well-drafted lease can minimize the impact of Division 10 in many transactions.

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§19.3 C. Relationship of Division 10 to Divisions 2 and 9

Before Division 10 of the Commercial Code was enacted, courts commonly referred to both Division 2 and Division 9 for assistance in analyzing lease transactions. Because a lease transaction has elements of both a sale (*i.e.,* the transfer of possession and use) and the creation of a security interest (*i.e.,* the separation of a right in the goods from possession of the goods), it is easy to understand the rationale for treating Divisions 2 and 9 as a source of rules by analogy. However, the courts have been inconsistent in accepting the argument that these divisions may be applied to leasing transactions. Compare *Westlye v Look Sports, Inc*. (1993) 17 CA4th 1715, 22 CR2d 781 (rejecting argument that Com C §2719 could be applied by analogy to snow ski rental agreement), with *U.S. Roofing, Inc. v Credit Alliance Corp.* (1991) 228 CA3d 1431, 279 CR 533 (applying Com C §2316 in analyzing effectiveness of disclaimer of warranties in lease).

Division 10 represents an attempt to adapt only those provisions of Divisions 2 and 9 that have meaning in the leasing context. As a result, Division 10 should make the law of personal property leasing more predictable and consistent. Because Division 10 is adapted in large part from Division 2, much of the material in this chapter can be supplemented by the discussions of the same topics in chapters of this book that focus on Division 2. In many instances, the rights and remedies of the lessor parallel those of the seller, as do the rights and remedies of the lessee and buyer. Because Division 10 became effective in California only in 1990, there is little case law dealing with its application. Case law interpreting the corresponding provisions of Division 2, however, may still be helpful to the practitioner by analogy. See *Imaging Fin. Servs., Inc. v Graphic Arts Servs., Inc.* (ND Ill 1997) 172 FRD 322 (noting that "Article 2 of the UCC is persuasive, but not controlling" in evaluating lessee's defense of unconscionability in suit by lessor for damages for breach of lease). It is important to recognize, however, that a leasing transaction differs in many material respects from a sale transaction. Thus, a court's interpretation of a Division 2 provision that on its face is substantially the same as a Division 10 provision may not on further analysis be applied to the Division 10 provision.

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§19.4 D. Transition From Prior Law to Division 10

Division 10 does not apply to a lease entered into before January 1, 1990, unless the parties agree in writing to make the lease subject to Division 10. In light of the amount of time that has passed since Division 10 was enacted in California, there should be relatively few instances in which practitioners may be called on to give advice with respect to leases that are not governed by Division 10. However, very little case law exists applying Division 10. See *Harbor Island Holdings, L.L.C. v Kim* (2003) 107 CA4th 790, 132 CR2d 406; *In re Rebel Rents, Inc.* (Bankr CD Cal 2003) 291 BR 520; *In re QDS Components, Inc.* (Bankr SD Ohio 2002) 292 BR 313; *Atel Fin. Corp. v Quaker Coal Co.* (ND Cal 2001) 132 F Supp 2d 1233, aff'd (9th Cir 2003) 321 F3d 924, discussed in §19.113.

As noted in §19.3, in the absence of Division 10 or some other comprehensive personal property leasing law, parties have attempted to apply by analogy the provisions of Divisions 2 and 9 of the Commercial Code, with results that have not always been predictable and consistent. In some jurisdictions that have adopted Article 2A of the Uniform Commercial Code (Division 10 in California), courts have relied on that article's provisions in evaluating the enforceability of a lease entered into before the effective date of the statute. See *American Computer Trust Leasing v Jack Farrell Implement Co*. (D Minn 1991) 763 F Supp 1473, 1484 n 11, aff'd (8th Cir 1992) 967 F2d 1208 (citing Official Comment to UCC §2A-103 as authority for upholding "hell or high water" clause that made lessee's obligation to pay rent independent of lessor's obligations under lease); *Colorado Interstate Corp. v CIT Group/Equip. Fin., Inc.* (10th Cir 1993) 993 F2d 743, 749 n6 (citing UCC §2A-407 as authority for upholding "hell or high water" clause); and *Dudley v Business Express, Inc*. (D NH 1994) 882 F Supp 199 (citing Article 2A as authority for not finding implied warranties by finance lessor). The courts in California that have had occasion to consider leasing transactions after the date of enactment of Division 10, but in situations in which the leases in question were not governed by Division 10, have neglected to make any reference whatsoever to Division 10. The reasoning and conclusions reached in those cases have been consistent with the provisions of Division 10 in some respects and inconsistent in others. See *U.S. Roofing, Inc. v Credit Alliance Corp.* (1991) 228 CA3d 1431, 279 CR 533 (applying finance lease analysis); *Westlye v Look Sports, Inc.* (1993) 17 CA4th 1715, 22 CR2d 781 (finding that limitation on personal injury damages need not pass "unconscionability" test; Com C §10503(c) makes such test applicable to leases subject to Division 10). However, in considering whether a transaction created a true lease or a security interest, one California court applied the amended definition of "security interest" in former Com C §1201(37)(b) (now Com C §1201(b)(35)) that became effective at the same time as Division 10. *Addison v Burnett* (1996) 41 CA4th 1288, 49 CR2d 132. The application of that definition of "security interest" by analogy to pre-January 1, 1990 leases, without applying the substantive provisions of Division 10 to such leases by analogy, may be consistent with decisions in other states that have regarded the definition of "security interest" as a clarification of existing case law while treating the balance of Article 2A as effecting substantive changes in prior law. *Woodson v Ford Motor Credit Co. (In re Cole)* (ND Okla 1990) 114 BR 278; *In re Bumgardner* (Bankr D Idaho 1995) 183 BR 224.

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II. LEASE VERSUS SECURITY INTEREST

A. Reason for Distinction Between Lease and Security Interest

§19.5 1. Overview

For a variety of reasons, including the desire to obtain particular tax and accounting treatment, parties may wish to characterize transactions that are, in substance, secured loans or installment sales as lease transactions. It is easy to see how the distinction between a true lease and an installment sale or a secured loan may become blurred. An installment sale can be documented as a lease, with "rental" payments equaling the purchase price of the property plus some element of interest and the "lease" term coinciding with the useful life of the equipment. Similarly, a secured loan can be cast as a lease in which the rental payments and the term coincide with the payment amounts and the period necessary to fully amortize the loan. To compound the potential for confusion in this area, a transaction may be considered to be a true lease for commercial law purposes but a secured loan for tax or accounting purposes.

DRAFTING CONSIDERATIONS: Even when the parties intend to enter into a lease transaction, the attorney should keep the distinctions drawn by the law in mind when drafting the documents to avoid or minimize the likelihood of commercial law recharacterization after the fact.

A "true lease" transaction involves an economic division of property in which the lessee obtains the right of possession and use for a period of time while the lessor retains the right to a meaningful residual at the conclusion of the lease term. Only by focusing on the economic substance of the transaction is it possible to distinguish between those that may be properly characterized as leases and those that may be properly characterized as installment sales or security interests.

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§19.6 2. Importance of Distinction

The commercial law distinction between a lease and an installment sale or a secured loan is important for the following reasons:

- **Lessor remedies.** If the transaction creates a security interest, the "lessor" must file a financing statement or otherwise perfect an interest in the goods. Division 9 of the Commercial Code, rather than Division 10, sets forth the remedies available on default.

For example, when a debtor defaults under a security agreement, the creditor may be required to sell the equipment (Com C §9610) and to do so in a commercially reasonable manner (Com C §9610). If the sale proceeds exceed the amount that the debtor owes, the surplus cannot be retained by the creditor but must be paid to the debtor. Com C §§9615-9616. See generally Secured Transactions in California Commercial Law Practice, chap 5 (2d ed Cal CEB 2001).

A lessee, on the other hand, has no equity in the goods leased and so is not entitled to any surplus after their disposition. Although the lessor must mitigate damages, the lessor is not required to dispose of repossessed leased goods. See §§19.106-19.112.

PRACTICE TIP: In any situation in which there is a risk that a lease may be recharacterized as a security agreement, the lessor should consider precautionary compliance with Com C §§9610-9614. Otherwise, if the lessee successfully argues that the lease was a security agreement, the lessee may assert noncompliance with that section as a defense to any action by the lessor to recover damages for breach of the lease. See *Addison v Burnett* (1996) 41 CA4th 1288, 49 CR2d 132 (lessee unsuccessfully sought to characterize lease as security agreement in order to avail itself of such a defense).

- **Lessee remedies.** Unlike Division 9, Division 10 specifies the events that constitute defaults by the lessor and the remedies that are available to the lessee following the lessor's default, including the right to recover consequential damages. See §§19.99-19.105.
- **Quiet enjoyment.** Division 10 creates an implied warranty in favor of the lessee that no person has a claim or interest in the leased goods arising through the lessor that will interfere with the lessee's ability to enjoy its leasehold interest. See §19.62. A buyer or debtor is not granted such a warranty under Divisions 2 or 9.
- **Bankruptcy.** Generally, a lessor receives more favorable treatment in a lessee's bankruptcy proceeding than that given to a secured party. For example, if the lease is a true lease, the trustee may either accept or reject the lease agreement in its entirety and, following assumption, must promptly cure prepetition defaults. See §§19.125-19.130. Moreover, if the lessor validly terminates the lease before the lessee's bankruptcy filing or the lease expires before the bankruptcy filing, the lease probably will not be regarded as property of the bankrupt estate. See §19.119.
- If the lease is a security interest, and the lessor failed to perfect its security interest, the lessor's interest would be subordinated to the trustee's. See 11 USC §544(a)(1). Even if the "lessor's" security interest is perfected, the "leased" goods are property of the bankruptcy estate, subject to the perfected security interest, and the "lessor" will be able to repossess the goods only if relief from the automatic stay is granted or the goods are abandoned by the trustee. See 11 USC §§541, 554. Furthermore, the bankruptcy "cram-down" provisions would permit the trustee to keep the goods and pay only their fair value, with any excess amounts owed to the "lessor" under the "lease" being treated as an unsecured claim. See 11 USC §§506, 1129, 1325; *HPSC, Inc. v Wakefield (In re Wakefield)* (Bankr MD Ga 1998) 217 BR 967 (lessee successfully characterized equipment lease as security agreement and reduced secured claim to fair market value of collateral); *In re Yarbrough* (Bankr WD Tenn 1997) 211 BR 654 (lessee unsuccessfully attempted to characterize vehicle lease as security interest in order to allow lessee to pay only fair market value of vehicle); *In re Murray* (Bankr ED Pa 1996) 191 BR 309, aff'd (Bankr ED Pa 1996) 201 BR 381 (lessee unsuccessfully sought to characterize vehicle lease as security agreement in order to reduce "secured obligation" to fair market value of vehicle).

PRACTICE TIP: A lessor may file a financing statement for leased equipment. Such a filing will not be considered evidence that the lease was intended as security, but if the lease is later determined to have been a security transaction, the lessor's interest in the equipment will have been perfected by the filing. Com C §9505(b). As a practical matter, in many instances such a filing will prevent the "lease or security interest" issue from being raised —at least in the context of remedies available to the lessor.

- **Usury.** Usury limitations do not apply to true leases but may apply to a "lease" that is actually a secured loan. See *Burr v Capital Reserve Corp*. (1969) 71 C2d 983, 80 CR 345.
- **Tort liability.** A lessor who is the owner of the goods may be liable for injury to third parties caused by the goods. See §§19.93-19.94. A secured party generally would not be subject to similar liability.

The party seeking to recharacterize a lease has the burden of proving that the lease should be considered a secured loan or installment sale agreement. *In re Rebel Rents, Inc.* (Bankr CD Cal 2003) 291 BR 520; *In re QDS Components, Inc.* (Bankr SD Ohio 2002) 292 BR 313.

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§19.7 3. Taxation and Accounting Issues in General

Although a full discussion of the differences in tax and accounting treatment given to leases versus sales or secured loans is beyond the scope of this chapter, the significance of tax and accounting considerations to all leasing transactions makes a brief summary of the key points necessary.

For federal income tax purposes, if the lease is characterized as a sale or a secured loan, the lessor will not be entitled to claim cost recovery deductions for the leased property, nor will the lessee be entitled to deductions for rentals paid. IRC §162(a)(3). Although the Internal Revenue Code does not set forth a definition of a true lease, the Internal Revenue Service has promulgated guidelines for the issuance of an advance ruling by the IRS that a transaction would constitute a true lease. Rev Proc 2001-28.

Stated briefly, those criteria are:

- The lessor must make an equity investment in the property representing at least 20 percent of the cost of the property. The investment must remain at risk and at the 20-percent level throughout the term of the lease, and the investment commitment must be unconditional when the lease commences. Rev Proc 2001-28 §4.01(1). See also *Estate of Jerry Thomas* (1985) 84 TC 412; *Edward Torres* (1987) 88 TC 702.
- Subject to certain exceptions, the lessee must not have an investment in the property. Rev Proc 2001-28, §4.04.
- The property must have an expected residual value at the end of the lease term (including any renewal terms for which a fixed rental amount is set) of 20 percent or more of the original cost of the property (without regard to inflation or deflation) and a remaining useful life of the longer of one year or 20 percent of the original estimated useful life of the property. Rev Proc 2001-28 §4.01(3). Courts, however, have found transactions to create a true lease notwithstanding violation of this element of the IRS guidelines. *Edward Torres, supra*; *Aditya B. Mukerji* (1986) 87 TC 926.
- The lessee may not hold a purchase option at a price below fair market value. Rev Proc 2001-28 §4.03.
- The lessor must have some expectation of profit totally apart from the tax consequences. Rev Proc 2001-28 §4.06.

In California, leases of tangible personal property are generally treated as "continuing sales" and are subject to generally applicable sales and use tax rules. Rev & T C §§6006(g), 6006.3; California Board of Equalization Rule 1660. Many factors may influence the imposition of the tax (*e.g.,* the type of property, whether the property is located or used in the State of California, and the structure of the transaction as a sale-leaseback or a purchase for lease), and the interpretation of the applicable tax rules for a particular transaction may be complex. Accordingly, parties should be urged to consult their tax advisers at the planning and assessment stage of the transaction and to take into account the tax implications of the transaction in assessing the economics of the deal and in comparing alternative transaction structures.

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§19.8 4. Distinctions Between Operating and Capital Leases

The crucial lease characterization distinction to be made for accounting purposes is between an operating lease and a capital lease. With an operating lease, the lessor shows the leased asset on its balance sheet and records depreciation against, and income from, the asset over time. For the lessee, the lease is an off balance sheet transaction. In contrast, a capital lease results in the disposition of the leased asset by the lessor and the acquisition of the asset by the lessee.

The standards for characterizing a transaction as a lease for accounting purposes differ from both the federal tax guidelines and the commercial law definition discussed in this chapter.

The accounting criteria for distinguishing an operating lease from a capital lease are found in Statement of Financial Accounting Standards (SFAS) 13, which consists of a lengthy set of rules and subrules. The basic elements of those criteria can be summarized in four tests. If any one of the tests is met, the transaction is a capital lease; if none of the tests is met, the transaction is an operating lease. The tests are:

- Does the lease transfer ownership to the lessee by the end of the lease term? See SFAS 13 ¶7A.
- Does the lease contain a bargain purchase option? See SFAS 13 ¶7B.
- Does the lease term equal or exceed 75 percent of the estimated economic life of the leased property? See SFAS 13 ¶7C.
- Is the present value of the rentals under the lease 90 percent or more of the fair market value of the property? See SFAS 13 ¶7D.

The last two tests do not apply to a lease that is entered into during the final 25 percent of the property's economic life.

In addition to meeting one of the foregoing tests, a lessor that wishes to treat the lease as a capital lease must ensure that (1) the collection of minimum rent under the lease is reasonably predictable, and (2) there are no important uncertainties regarding the amount of unreimbursed cost that the lessor will incur under the lease. See SFAS 13 ¶¶8A-8B.

The foregoing tax and accounting criteria for characterizing a transaction as a true lease, a conditional sale, or a security interest are similar to one another and to the criteria used in the commercial law setting. Indeed, some courts have considered the treatment accorded to a transaction for tax or accounting purposes as relevant in determining how the transaction should be treated for commercial law purposes. See, *e.g., Waldoff's Inc. v Orix Credit Alliance, Inc. (In re Waldoff's Inc.)* (Bankr SD Miss 1991) 132 BR 325. As the discussion in §§19.11-19.18 shows, however, the tests also differ in significant ways. Accordingly, a transaction that qualifies as a true lease for commercial law purposes may not qualify as a true lease for tax or accounting purposes.

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§19.9 5. Synthetic Lease or Off Balance Sheet Loan

A once popular form of equipment financing, which takes advantage of the differences between the tax and accounting criteria for characterizing a transaction as a true lease, a conditional sale, or a security interest, is referred to as a "synthetic lease" or "off balance sheet loan." Such a financing uses documentation in the form of a lease. Economically, the transaction represents a loan for approximately the fair market value of the equipment, with a small portion of the loan being nonrecourse to the borrower. Due to the nonrecourse portion of the loan, the "lessor" assumes a portion of the risk of the property having a lower than anticipated residual value at the end of the lease term. For financial accounting purposes, the transaction is arranged so that none of the tests for a capital lease will be met; thus, the transaction will be characterized as an operating lease. As a result, the "lessee/borrower" does not include the value of the equipment or the amount of the debt on its balance sheet. This "off balance sheet" treatment of the transaction may be attractive to some companies. For federal income tax purposes, however, the transaction is structured to avoid meeting the criteria for constituting a true lease, and thus is regarded as a loan. Accordingly, the "borrower/lessee" is treated for tax purposes as the owner of the equipment and is entitled to take depreciation deductions as the owner of the property for tax purposes.

The availability and potential benefits of at least some synthetic lease structures have been limited by recent accounting pronouncements (FASB Interpretations No. 45 and No. 46) and the SEC disclosure obligation of the Sarbanes-Oxley Act of 2002.

PRACTICE TIP: Because an "off balance sheet loan" or "synthetic lease" is given the appearance of a leasing transaction for accounting purposes but economically is much closer to a loan than a lease, it is extremely important for the parties to recognize the potential applicability of Division 9 to the transaction. Thus, UCC financing statements should be filed in accordance with Com C §9505(b) and any exercise of remedies undertaken should be with a view toward compliance with Com C §§9610-9614.

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§19.10 B. Revised Definition of Security Interest

When Division 10 was adopted, the Commercial Code's definition of "security interest" was amended. See Com C §§1201(b)(35), 1203. Before the amendment, whether a transaction created a lease or a security interest depended in part on the parties' intention. In focusing almost exclusively on the intent standard, however, courts had some difficulty in making consistent and rational determinations of whether certain transactions were leases or instead created security interests.

As amended, Com C §1203 dispenses with any inquiry about the intent of the parties and instead focuses on the economic substance of the transaction. Because the revised definition is intended to clarify the law, it may be applied to transactions that precede its effective date (January 1, 1990). See *Addison v Burnett* (1996) 41 CA4th 1288, 1294, 49 CR2d 132.

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C. Two-Part Test for "Security Interest"

§19.11 1. Lessee's Right to Terminate

A transaction creates a security interest if two tests are met. The first test concerns whether the lessee can terminate the lessee's obligation to make payments under the purported lease. (See §19.12 for discussion of the second test.) If the lessee does not have the right to terminate the lease, the "lease" may be characterized as a secured transaction, depending on whether the second part of the test is satisfied. Com C §1203(b). If the lease may be canceled at the option of the lessee, the lease cannot be characterized as a secured transaction, regardless of its other terms. See *In re Arney* (Bankr CD Ill 2004) 54 UCC Rep Serv 2d 1 (tractor lease was true lease when lessee could terminate at any time and residual value of $20,000 was not nominal).

This element of the new definition of security interest reverses certain prior court decisions that recharacterized leases as conditional sales subject to a security interest despite the absence of a purchase obligation for the lessee-purchaser. See *United Rental Equip. Co. v Potts & Callahan Contracting Co*. (Md 1963) 191 A2d 570, 574 (court found rental agreement to be conditional sales contract rather than lease even though agreement contained option to terminate; lessee had option to purchase for little or no additional consideration and rentals were credited towards purchase price).

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§19.12 2. Lessor's Residual Interest

The second test of whether a transaction creates a security interest is met if the purported lease has any one of the following characteristics (Com C §1203(b)):

- The original term of the lease equals or exceeds the remaining economic life of the goods;
- 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;
- The lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration; or
- The lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration.

These statutory factors focus on the economics of the transaction by directing inquiry to the value of the lessor's residual interest. See, *e.g., Addison v Burnett* (1996) 41 CA4th 1288, 49 CR2d 132. Arguably, however, the statutory factors do not direct inquiry to whether it is the lessor or the lessee who assumes the economic risk that the value of the equipment at the end of the lease term will differ from what was anticipated at the inception of the lease, even though this is an extremely important economic consideration. The absence of clear guidance from Com C §1203(b) on this issue may make it difficult in some leasing transactions to determine whether the transaction creates a lease or a security interest.

Furthermore, although the statutory factors set out in Com C §1203(b) draw attention to the issue of whether the lessor retains a meaningful residual interest in the property, they do not purport to provide an exhaustive list of the considerations that may affect the resolution of that issue. It is possible to imagine circumstances where none of the statutory factors are present, and yet the lessor has no meaningful residual interest at the end of the lease term. The Third Circuit Court of Appeals in *In re Pillowtex, Inc*. (3d Cir 2003) 349 F3d 711, evaluated a lease of lighting fixtures in which the lease term was substantially shorter than the economic life of the equipment, and the lessee had no renewal or purchase obligations or options. In other words, none of the statutory factors were present. The lessor in *Pillowtex* was obligated at the end of the lease to choose from among abandoning the property in place, selling to the lessee or renewing at a mutually agreed price, or removing and replacing the equipment with equivalent equipment. The court noted that the replacement alternative was not an economically viable option because the cost of removal and replacement would result in a net loss to the lessor. Because the lease terms put the lessee in a position where it could force the lessor to abandon the property by simply refusing to agree on a purchase or renewal price, the court concluded that the lessor had not retained a meaningful residual interest in the property.

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Source: Business Law/California UCC Sales and Leases/19 Leasing of Goods/§19.13 D. Consideration of Other Factors

§19.13 D. Consideration of Other Factors

Commercial Code §1203(c) expressly identifies certain lease provisions that do not alone create a security interest. Specifically, a transaction does not create a security interest merely because:

- The present value of the aggregate rentals equals or exceeds the fair market value of the goods when the lease is entered into;
- The lessee assumes responsibility for certain incidents of ownership, such as the risk of loss or the obligation to pay taxes, insurance, service or maintenance costs, or similar expenses;
- The lessee holds an option to renew or purchase the goods;
- The lessee holds an option to renew the lease at a fixed rent that is equal to or greater than the reasonably predictable fair-market rent for the term of the renewal at the time the option is exercised;
- The lessee holds an option to purchase the goods for a fixed price that is equal to or greater than their reasonably predictable fair market value at the time the option is exercised; or
- In the case of a motor vehicle that is not to be used primarily for personal, family, or household purposes, the amount of rental payments may be increased or decreased by reference to the amount realized by the lessor on its sale or disposition. See §19.18

Section 1203(c) was designed to undercut prior court decisions in which the existence of such "indicia of ownership" in a lease automatically resulted in a finding of a disguised security interest. In addition, §1203(c) reinforces the focus of Com C §1203(b) on the economics of the transaction.

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E. Application of Revised Definition of Security Interest

1. Lease to End of Economic Life

§19.14 a. Original Lease Term

If the lease term spans the entire useful life of the leased property, and the lease is not terminable by the lessee, then the transaction will create a security interest and not a true lease. See *In re Fleming Cos.* (Bankr D Del 2004) 308 BR 693; *LMV Leasing, Inc. v Conlin* (Utah 1991) 805 P2d 189, 196 n6.

Under Com C §1203(e), the economic life of the leased goods is to be determined as of the time the lease is entered into. Thus, if at the inception of the lease the parties reasonably anticipate that the goods have a remaining life span of 10 years, and they enter into a lease with a term of five years, it will be considered to be a true lease. Even if market conditions change during the term of the lease (including technological developments that render the goods obsolete) so that at the end of five years the lessor is not able to realize any economic value from its reversionary interest, whether through another lease or a sale, the original transaction will not be recharacterized as a disguised sale.

However, if the parties originally anticipated a five-year economic life span for the leased property and enter into a lease with a five-year term, the lease probably will be treated as a secured sale. See, *e.g., In re Hispanic Am. Television Co*. (Bankr ND Ill 1990) 113 BR 453, 461.

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§19.15 b. Options to Renew

Mandatory options to renew a lease are not inconsistent with a true lease transaction. If, however, the original lease term plus the mandatory renewal periods extend the lease to the end of the economic life of the leased goods, then the transaction will be treated as a disguised security interest from the inception of the lease. See Com C §1203(b)(2). The amount of rent or consideration to be paid by the lessee on a *mandatory* renewal has no effect on determining whether the transaction is a true lease.

Options to renew at the election of the lessee result in the creation of a security interest at the outset if:

- The original term plus renewal periods span the entire economic life of the leased goods (Com C §1203(b)(1)); and
- The rental amount on renewal is nominal (Com C §1203(b)(3); see §19.17).

If the renewal rent is not nominal, the transaction is considered to be a true lease at its inception, even though the original term plus the renewal periods would span the entire economic life of the leased goods.

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§19.16 c. Options to Purchase

Although not technically a lease extending to the end of the economic life of an asset, an option to purchase constitutes a transaction that results in the transfer of all residual interest in the leased goods from the lessor to the lessee. Accordingly, a mandatory option to purchase, in combination with a noncancelable lease term, results in the creation of a security interest from the outset of the lease. Com C §1203(b)(2). Similarly, if the option to purchase is not mandatory but the option price is nominal, then the transaction will also be considered a disguised security interest from the very beginning. Com C §1203(b)(3). See also *In re Super Feeders, Inc.* (Bankr D Neb 1999) 236 BR 267 ("lease" was, in reality, secured transaction because it provided lessee with nominal fixed option price of 20 percent of projected fair market value of goods at end of lease term); *In re Kim* (Bankr ED Pa 1999) 232 BR 324 (holding that $1 purchase option, provided in side agreement but not in lease, was part of deal and made lease a secured transaction).

Furthermore, the fact that a lease contains an absolute right to terminate does not preclude it from being a secured transaction if termination would trigger an economic penalty or if the lessee had no choice but to exercise the purchase option. See, *e.g., In re Puckett* (Bankr MD Tenn 1986) 60 BR 223, aff'd (6th Cir 1988) 838 F2d 470. Similarly, an absolute right to terminate does not preclude a lease from being a secured transaction if the lessee is obligated on termination to pay the present value of the remaining rents for the unexpired balance of the term and to purchase the property from the lessor. *In re QDS Components, Inc.* (Bankr SD Ohio 2002) 292 BR 313, applying California law. The provisions of Com C §1203 prevail over any provisions in the lease, which may clearly state that the lease is to be treated as a true lease and not a secured transaction. See *In re Home Place Stores, Inc.* (Bankr D Del 1998) 228 BR 88.

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§19.17 2. Option Consideration

As noted in §§19.15-19.16, whether the presence of a renewal or a purchase option in a lease agreement would cause the transaction to fall within the new definition of a security interest depends in part on whether the consideration to be paid by the lessee in exercising the option is "nominal."

Commercial Code §1203(d) provides that additional consideration to be paid by the lessee on the exercise of an option is *not* "nominal" if:

> (1) when the option to renew the lease is granted to the lessee, the rent is stated to be the fair market rent for the use of the goods for the term of the renewal determined at the time the option is to be performed, or
>
> (2) when the option to become the owner of the goods is granted to the lessee, the price is stated to be the fair market value of the goods determined at the time the option is to be performed.

Thus, if the contract provides for an option price equal to the fair market value of the goods at the time of exercise, the option price is not nominal even if the fair market value at the time of determination is a small dollar amount. A low fair market value at the time of option exercise, however, may indicate either that (a) the original transaction was actually a lease to the end of the economic life of the goods or that (b) the rental payments during the original term compensated the lessor not only for the use and possession of the goods during the term but also for the transfer of its residual interest in the goods. Either (a) or (b) constitutes a separate and distinct ground for finding that the original transaction was not a "true" lease but rather a disguised sale or secured loan.

What if the option price, rather than "being stated to be the fair market value" of the property, is a fixed amount? The better view is that so long as a fixed option price is at least as great as the amount the parties would have reasonably predicted as an end of term fair market value, the option is consistent with characterizing the transaction as a lease. The drafters of Division 10 undoubtedly thought this was clear. To avoid any doubt, they included in the Official Comments a note to the effect that a fixed price option of this type would not (absent other factors) result in recharacterizing a lease as a security interest. However, one bankruptcy court incorrectly has concluded that Com C §1203(d) (former Com C §1201(36)(d)) precluded considering the expected fair value of the property in determining whether or not a fixed price option was nominal. *In re QDS Components, Inc.* (Bankr SD Ohio 2002) 292 BR 313 (applying California law).

PRACTICE TIP: Consider including an acknowledgment by the parties that the fixed option in fact represents what the parties expect the fair market value of the property to be at the end of the lease term. For a court that follows what is clearly the best interpretation of Com C §1203(d), such an acknowledgment will be viewed as evidence that is relevant to the issue of whether the agreed price was nominal.

Section 1203(d) also provides that option consideration is nominal if it is less than "the lessee's reasonably predictable cost of performing under the lease agreement if the option is not exercised." The lessee's "reasonably predictable" cost of performing is determined as of the time the lease is entered into. Com C §1203(d)(1)-(2).

Thus, when a lessee has no economically sensible choice but to exercise the option, the "lease" will be treated as a security interest. An example is the lease of a cellular telephone that is installed in an automobile. If at the end of the lease term it would cost $200 to purchase the equipment, but $300 to remove it and restore the automobile, then the transaction is more properly characterized as a security interest. See *In re Berge* (Bankr WD Wis 1983) 32 BR 370 (court concluded that if cost of reassembly and reshipment of leased equipment to lessor exceeded option price, lessee would have no sensible alternative but to exercise option; transaction characterized as creation of security interest). See also *Jahn v M.W. Kellogg Co. (In re Celeryvale Transp., Inc.)* (6th Cir 1987) 822 F2d 16 (true lease exists when lessee is neither legally obligated nor economically compelled to exercise option and purchase leased equipment).

The right option price would fully compensate the lessor for its ownership of the residual, and in economic terms the transaction would actually be two separate agreements: (1) a lease agreement under which the lessor gives up possession and use of the goods in exchange for the lease payments, and (2) an option agreement under which the lessor agrees to part with the residual interest, for a payment that is equal to, or greater than, its anticipated value at

the time of exercise. Suppose that, due to market conditions at the time a fixed price purchase option becomes exercisable, the option price is significantly less than the fair market value of the property. Can the parties treat the transaction as creating a security interest rather than a lease because the lessee has a purchase option that has become a "bargain"? The answer is no. The issue of whether a fixed price purchase option represents a bargain purchase must be determined from the perspective of the parties at the time the option is granted, and the question is whether the option price viewed from that perspective approximates or represents a discount from the reasonably anticipated value of the property at the time the option will become exercisable. See *In re Zaleha* (Bankr Idaho 1993) 159 BR 581, 585 (rejecting lessee's argument that because current fair market value of leased vehicle exceeded purchase option price, transaction should be characterized as security interest).

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§19.18 3. Risk of Depreciation: Terminal Rental Adjustment Clause (TRAC)

If a lease is structured so that the lessee, rather than the lessor, assumes all the economic risks and benefits attendant to the value of the equipment at the termination of the lease, can the transaction nevertheless be characterized as creating a lease rather than a security interest? This question is posed by the widely used terminal rental adjustment clause (or "TRAC"; see *In re Owen* (Bankr ND NY 1998) 221 BR 56) found in vehicle leases. Such a clause typically specifies a declining schedule of values for the vehicle through the end of the lease. On termination of the lease, at either the scheduled expiration date or earlier on a default by the lessee, the lessee is required to pay the lessor an amount equaling any deficit between the fair market value of the vehicle (determined by either an appraisal or by sale of the vehicle) and the scheduled value. If the vehicle has a fair market value in excess of the scheduled value, the lessee is entitled to receive an amount equal to such difference. Thus, at the inception of the transaction, the lessor knows that it is entitled to receive a fixed stream of payments from the lessee and a fixed value for the vehicle. The lessee, on the other hand, assumes the economic risk and benefit of any deviation in the fair market value of the vehicle from the scheduled value at the end of the lease term. The definition of "security interest," as amended, states that the mere presence of a TRAC provision in the lease of a motor vehicle or trailer should not cause the lease to be regarded as a security interest. Com C §1203(c). Consumer leases, however, are excluded from this provision. In any case, Com C §1203(c) does not preclude a finding that a lease that includes a TRAC provision is a disguised security interest. One still must analyze the economics of the transaction under Com C §1203(b) in order to determine its character.

Viewed from the perspective of the two-part test established by Com C §1203(b) (see §§19.11-19.12), a lease containing a TRAC provision arguably does not create a security interest because:

- The lease term does not extend through the end of the economic life of the vehicle;
- The lessee is not bound to buy the vehicle; and
- The lessee is not entitled to purchase the vehicle or renew the lease to the end of the vehicle's economic life for a nominal payment.

Nevertheless, the economics of the leasing arrangement bear an extremely close resemblance to a loan.

In *Addison v Burnett* (1996) 41 CA4th 1288, 49 CR2d 132, the court of appeal analyzed a vehicle lease containing a TRAC provision. The court held that the transaction constituted a lease rather than a security interest. The court distinguished cases from other jurisdictions that reached contrary holdings on the basis that the lessor in this instance had the exclusive right to choose between selling the vehicle and having it appraised. The court noted that the lessor had a meaningful residual interest in the vehicle, in that the lessor had the right to continue to own the vehicle and, following lease termination, would be responsible for any gain or loss in its value. It is unclear what conclusion the court would have reached if the TRAC provision had required the lessor to sell the vehicle. Courts in other jurisdictions have reached inconsistent results in characterizing leases with TRAC provisions. Recent cases have held that leases containing TRAC provisions are true leases. See *In re Rebel Rents, Inc.* (Bankr CD Cal 2003) 291 BR 520; *In re Owen* (Bankr ND NY 1998) 221 BR 56; *In re Architectural Millwork of Va., Inc.* (Bankr WD Va 1998) 226 BR 551. Older courts have held that purported leases containing TRAC provisions created a security interest. See, *e.g., Bill Swad Leasing Co. v Stikes (In re Tillery)* (5th Cir 1978) 571 F2d 1361; *In re Tulsa Port Warehouse Co.* (10th Cir 1982) 690 F2d 809; *In re Zerkle Trucking Co.* (Bankr SD W Va 1991) 132 BR 316.

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III. CONTRACT FORMALITIES

§19.19 A. Offer and Acceptance

Division 10 adopts the "firm-offer" rule found in Com C §2205. See Com C §10205. This binds a merchant to the offer to lease goods for the period during which the offer is stated to be irrevocable or, if no time is specified, for a reasonable period.

Division 10 contains no provision analogous to Com C §2207 (Additional Terms in Acceptance or Confirmation), which resolves disputes when purchase and acceptance memorandums contain different terms. Such disputes are sometimes characterized as "battles of the forms." See chap 5. Division 10 probably lacks such a provision because these disputes rarely arise in the leasing industry.

As with the Commercial Code's contract formation policy generally (see §2.2), Division 10 recognizes and gives effect to the parties' bargain even though all formalities have not been strictly observed. A lease contract may be found on the basis of conduct between the parties showing that they acknowledge the existence of the lease. Com C §10204(a). The fact that the parties have left some of the terms open will not cause the lease to fail for indefiniteness. Instead, the lease will be enforced if the parties intended to enter into a lease agreement and there is a reasonably certain basis for arriving at an appropriate remedy. Com C §10204(c).

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§19.20 B. Modification and Waiver

A lease contract may be modified without consideration; however, when the lease prohibits modification except by a signed writing, the lease may not be otherwise modified or rescinded. Com C §10208.

Unless the parties are both merchants, a clause in a form supplied by a merchant that prohibits modification except by a signed writing must be separately signed by the other party. Com C §10208(b). Thus, a provision that purports to exclude oral modifications must be initialed by the parties.

DRAFTING CONSIDERATIONS: If a lessor is a "merchant" for purposes of the Commercial Code (see Com C §2104), its form lease agreement should include a space for the lessee to initial, indicating that the lessee has read the integration clause. The logical place for the space to appear is immediately above the signature block.

Even if a lease agreement effectively prohibits a modification that is not written and signed, conduct or oral statements may constitute waivers of lease terms. Com C §10208(c). Once a written provision has been waived, the waiving party has the right to retract the waiver by giving the other party a reasonable notification that strict performance of the waived term will be required in the future. Such a retraction is not permissible if the other party has made a material change of position in reliance on the waiver and the retraction would be unjust as a result. Com C §10208(d).

DRAFTING CONSIDERATIONS: Course of performance and course of dealing between the lessor and lessee are relevant in interpreting the lease or in showing a waiver. Com C §1303(d), (f). For example, acceptance of a late payment may provide the basis for an argument that the time-of-payment provision has been waived. To prevent an unwanted modification such as this from happening, it is advisable to provide that a waiver or failure to enforce a lease provision on one occasion should not be construed as a waiver for future occasions. The attorney should also inform the nonperforming party of this at the time the waiver is granted.

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§19.21 C. Statute of Frauds

The statute of frauds applicable to leases is much like the statute of frauds applicable to sales under Division 2. See Com C §§2201, 10201. To meet the statute of frauds requirement of Division 10, a writing must be signed by the party against whom enforcement is sought (or that party's agent), sufficient to indicate that a lease agreement has been entered into, its term, and the goods to which it relates. Com C §10201(a)(2). A writing is sufficient if it reasonably identifies the goods and the lease term even though it is not specific. Com C §10201(b).

The statute of frauds requirement does not apply unless the aggregate of payments (other than renewal and purchase options) equals or exceeds $1000. Com C §10201(a)(1).

In addition, as in Division 2, Division 10 contains exceptions to the statute of frauds for the following (Com C §10201(d)):

- Goods that are specially manufactured or obtained for the lessee and are not suitable for lease or sale to others in the ordinary course of the lessor's business (provided that, before the lessee repudiates the lease, the lessor has made a substantial start or commitment under circumstances reasonably indicating that the goods are for the lessee);
- Goods that have been received and accepted by the lessee; and
- Instances in which the party against whom enforcement of the lease is sought has admitted that the lease was made.

For the above three items, if no lease term is set out in writing or admitted by the party against whom enforcement of the lease is sought, a "gap-filling" provision in Division 10 makes the lease term equal to a reasonable lease term. Com C §10201(e)(3).

See chap 7 for further discussion of the statute of frauds in the context of a contract for the sale of goods.

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§19.22 D. Parol Evidence Rule

The parol evidence rule for leases parallels Divisions 2's parol evidence rule for sales. See Com C §§2202, 10202. In general, prior oral or written agreements and contemporaneous oral agreements are not permitted to contradict a writing that the parties intend to be their final agreement. Com C §10202. A writing may be supplemented or explained, however, by "course of dealing," "usage of trade," or "course of performance." Com C §10202. See also Com C §1303. If the writing is found not to be a complete and exclusive statement of the parties' agreement, it may also be explained or supplemented by evidence of consistent additional terms.

See chap 7 for further discussion of the parol evidence rule in the context of a contract for the sale of goods.

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IV. CHOICE OF LAW AND FORUM SELECTION

§19.23 A. Choice of Governing Law

As a general matter, parties are permitted to select the law of any jurisdiction to which the transaction bears a reasonable relationship. Com C §1301. See *Mencor Enters. v Hets Equity Corp*. (1987) 190 CA3d 432, 235 CR 464. Subject to the special rules discussed below, even if the transaction does not have a relationship to California, the parties may agree to select California law as the law governing their agreement as long as the transaction involves at least $250,000 in the aggregate. CC §1646.5.

In *Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 11 CR2d 330, the California Supreme Court upheld a choice of law clause in a shareholders' agreement between parties in an international shipping transaction. In analyzing the choice of law issue, the court adopted the approach of Restatement (Second) of Conflict of Laws §187, which strongly favors enforcement of such provisions. The court ruled that unless the law of the selected jurisdiction is contrary to a fundamental policy of the state of California, the law of the selected jurisdiction will be given effect if either (1) the jurisdiction selected has a substantial relationship to the parties or their transaction, or (2) there is a reasonable basis for the parties having chosen the law of such other jurisdiction. The court also noted that in cases involving the Commercial Code the parties may choose the law of a state having a "reasonable relation" to the transaction. Com C §1301. Because it was not at issue, the court did not determine whether and to what extent, if any, the Commercial Code ("reasonable relation") and Restatement (substantial relationship) approaches differed.

NOTE: A couple of special circumstances in the leasing area should be noted:

With respect to goods covered by a certificate of title, compliance and the effect of compliance or noncompliance with a certificate of title statute are governed by the law (including the conflict of laws rules) of the jurisdiction issuing the certificate until the earlier of (1) surrender of the certificate or (2) four months after the goods are removed from that jurisdiction and thereafter until a new certificate of title is issued by another jurisdiction. Com C §10105.

If the law chosen by the parties to a consumer lease is that of a jurisdiction other than a jurisdiction in which the lessee resides at the time the lease agreement becomes enforceable or within 30 days thereafter, in which the goods are to be used, or in which the lease is executed by the lessee, the choice is not enforceable. Com C §10106(a).

If the judicial forum chosen by the parties to a consumer lease is in a county other than the county in which the lessee in fact signed the lease, the county in which the lessee resides at the commencement of the action, the county in which the lessee resided at the time the lease contract became enforceable, or the county in which the goods are permanently stored, the choice is not enforceable. Com C §10106(b).

DRAFTING CONSIDERATIONS: The choice-of-law clause should be conspicuous (*e.g.,* capitalized or in boldface type). Some states (*e.g.,* Texas) will not enforce the clause unless it is both conspicuous and initialed.

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§19.24 B. Forum Selection Clause

A lease not only may set forth the parties' choice of governing law but may also specify a forum in which disputes may or must be adjudicated. In addition, the lease may contain the lessee's consent to the jurisdiction of a specified court. Such clauses are usually upheld in the absence of fraud, overreaching, unfairness, or a strong countervailing public policy of the forum. See *M/S Bremen v Zapata Off-Shore Co.* (1972) 407 US 1, 15, 32 L Ed 2d 513, 92 S Ct 1907; *Argueta v Banco Mexicano* (9th Cir 1996) 87 F3d 320, 325.

In *Cal State Bus. Prod. & Serv., Inc. v Ricoh* (1993) 12 CA4th 1666, 16 CR2d 417, the court of appeal upheld a contract provision designating New York as the exclusive forum for litigating disputes between a party with its principal place of business in California and a party with its principal place of business in New Jersey. The court applied the standard adopted by the California Supreme Court in *Smith, Valentino & Smith, Inc. v Superior Court* (1976) 17 C3d 491, 131 CR 374, that an agreement on forum selection will be given effect unless it is unfair or unreasonable. Thus, the court of appeal found that even though neither party was domiciled in New York, and the contract was not executed in New York, New York was a "reasonable" forum because it is a major commercial center in reasonable physical proximity to one of the parties and the courts of New York could be expected to have expertise in commercial litigation.

In *First Fed. Fin. Serv., Inc. v Derrington's Chevron, Inc.* (Wis App 1999) 602 NW2d 144, however, the court rejected a provision in a surveillance equipment lease, which required all suits to be brought in Wisconsin. The California lessees dealt exclusively with the local California supplier and did not have any contact with the Wisconsin finance lessor, the drafter of the contract. The court held that the lease was unconscionable because the terms of the lease were never read or explained to the lessees and the name of the Wisconsin finance lessor was not conspicuously displayed on the lease.

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§19.25 C. Variations in Commercial Code Provisions and Other Laws

Even though Article 2A of the Uniform Commercial Code has now been adopted in nearly all jurisdictions, the attorney should not assume that another state's version of the Uniform Commercial Code will contain exactly the same provisions as the California Commercial Code. Variations exist from state to state, particularly since a substantial number of jurisdictions have not yet enacted the 1991 amendments to Article 2A, and as states adopt the 2001 amendments to Article 2A, the number of variations from state to state will increase. See §19.1.

Differences from state to state in laws outside of the UCC may well have a significant impact on the parties to a lease transaction. For instance, a lessor may want to avoid the application of Texas law, not only because Texas courts inconsistently apply its usury laws but also because of the possibility that its Deceptive Trade Practices—Consumer Protection Act (Tex Bus & Com C Ann §§17.41-17.63) could be applied to a *commercial* lease transaction. See *Kinerd v Colonial Leasing Co*. (Tex 1990) 800 SW2d 187.

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Source: Business Law/California UCC Sales and Leases/19 Leasing of Goods/§19.26 D. Special Rules for Consumer Leases

§19.26 D. Special Rules for Consumer Leases

The governing law for a consumer lease (discussed in §§19.38-19.40) is limited to the jurisdiction in which (Com C §10106(a)):

- The lessee resides at the time the lease agreement becomes enforceable or within 30 days thereafter;
- The goods are to be used; or
- The lease is executed by the lessee.

Under Com C §10106(b), the judicial forum for resolving consumer lease disputes must be the county in which:

- The lessee signs the lease agreement;
- The lessee resides at the time the agreement becomes enforceable;
- The lessee resides at the time the action is commenced; or
- The goods are permanently stored.

Any choice-of-law or choice-of-forum clause in a consumer lease agreement that provides otherwise is unenforceable. Com C §10106(a)-(b).

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§19.27 E. Special Rules for Goods Covered by Certificate of Title

As in Division 9 (see Com C §§9303(c), 9316(d)-(e)), if the goods are covered by a certificate-of-title statute, the consequences of complying or not complying with that statute are determined under the laws of the issuing jurisdiction until the earlier of either (Com C §10105):

- Surrender of the certificate; or
- Four months following removal of the goods from the issuing jurisdiction.

A significant variety of commonly leased equipment is subject to certificate-of-title statutes. It is beyond the scope of this chapter to outline the steps that should be taken to protect the interests of a lessor and a lessee in each type of equipment. For general discussion see McBain, Aircraft Finance: Registration, Security and Enforcement; Rice, Asset Financing (1989); Ruda, Asset Based Financing: A Transactional Guide (1985); and Dubin & Wong, Equipment Leasing (1995). The following list identifies the most common types of equipment:

- **Aircraft.** The Federal Aviation Administration (FAA) of the Department of Transportation maintains the United States registry for aircraft. See 49 USC §§44101-44113 (registration provisions). The FAA registry reflects both record title to aircraft and liens against aircraft. In addition, the registry includes liens against (but not title to) aircraft engines and propellers rated above a certain power threshold and aircraft parts maintained on behalf of certificated air carriers. 49 USC §44107(a)(2). A lease must be filed with the FAA to be valid against third parties without actual notice of the lease. The relative priority of liens recorded with the FAA, however, is governed by state, not federal, law. It is generally advisable for a lessor to file a precautionary Uniform Commercial Code financing statement in the applicable state in addition to having the lease recorded with the FAA.
- **Motor vehicles.** Title to and security interests in motor vehicles are largely governed by state law. In California, both the lessor and the lessee of a leased vehicle are shown on the registration card and ownership certificate pertaining to the vehicle. See Veh C §4453.5.
- **Vessels.** Two separate bodies of federal statutes govern the recordation of title to vessels and of mortgages against vessels. See 46 USC §§12101-12152 (documentation of title), 31301-31343 (mortgages). Neither, however, contains any provision for the recording of leases or security interests created by conditional sales of vessels. In addition, a California statute governs the numbering of vessels that are not documented at the federal level. See Veh C §§9840-9928. The interests of the vessel lessor and lessee are reflected in the same manner as the interests of the lessor and lessee of motor vehicles.
- **Rolling stock.** The Interstate Commerce Commission (ICC) records documents creating leases of, conditional sales of, and security interests in rolling stock (railroad cars and locomotives). The ICC maintains a grantor-grantee type of index of all such recorded documents, which may be searched by the public. 49 USC §11301. No UCC filing is required to perfect a security interest in rolling stock if documents have been properly submitted to the ICC. Com C §9311(a)-(b); 49 USC §11301(a). See *Drabkin v Continental Ill. Bank & Trust Co. (In re Auto-Train Corp.)* (Bankr DC 1981) 9 BR 207. As a result, lessors generally do not file precautionary UCC financing statements in addition to filing the lease with the ICC.

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V. TYPES OF LEASES

§19.28 A. Introduction

Division 10 establishes three categories of leases to which special rules may apply: finance leases, consumer leases, and installment leases. Sections 19.29-19.43 discuss those three categories of leases and how they are treated differently from other lease agreements.

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B. Finance Leases

§19.29 1. Overview

As the name implies, finance leases arise in circumstances in which the lessor's interest in the transaction is primarily as a source of funds. A finance lease is essentially a three-party transaction involving the financing lessor, a lessee, and a supplier (or seller). (Whether an affiliate of the supplier can qualify as a finance lessor is left to the "facts of each case." Cal Comment (g) to Com C §10103.) Because the finance lessor does not participate in selecting the goods, the Commercial Code largely insulates the lessor from responsibility for matters not related to its role as a financing source. For instance, the finance lessor is not held liable for implied warranties of the goods' fitness or merchantability. See §§19.32-19.33. Nor does it assume the risk of loss, which is transferred to the lessee. See §19.37.

There are no reported cases construing California law with respect to a finance lease under Division 10. However, in *U.S. Roofing, Inc. v Credit Alliance Corp.* (1991) 228 CA3d 1431, 279 CR 533, the court of appeal recognized the general principles that distinguish a finance lease from other types of lease agreements and, without making any reference to Division 10, afforded the same type of special treatment to the finance lease examined there as Division 10 would provide. The *U.S. Roofing* court held that a financing lessor in a commercial transaction can validly disclaim all warranties to the lessee as long as the lessee has an adequate remedy against the manufacturer.

"Finance lease" is a defined term in Division 10. See Com C §10103(a)(7). The following discussion assumes that definition. The term is often used in a different sense by the accounting profession or generally in the leasing market.

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§19.30 2. Definition of Finance Lease

To qualify as a finance lease, the lease must meet the following tests (see Com C §10103(a)(7)):

- The goods must not have been selected, manufactured, or supplied by the lessor.
- The lessor must have acquired the goods in connection with entering into the lease.
- The lessor must have informed the lessee as to the terms of the agreement between the lessor and supplier in one of the following ways:
- Before the lessee signed the lease, the lessee received a copy of the agreement by which the lessor acquired the goods;
- The effectiveness of the lease was conditioned on the lessee's approval of the agreement by which the lessor acquired the goods;
- Before the lessee signed the lease, the lessor gave the lessee an accurate and complete written statement setting out the covenants and warranties, together with any warranty disclaimers or remedy limitations or modifications of remedies, provided to the lessor by the supplier; or
- Before the lessee signed the lease agreement, the lessor informed the lessee in writing (1) of the identity of the supplier (unless the lessee selected the supplier), (2) that the lessee was entitled to the benefit of the promises and warranties provided to the lessor by the supplier, and (3) that the lessee had the right to contact the supplier directly to receive an accurate and complete statement of the promises and warranties.

PRACTICE TIP: If the finance lessor does not want the lessee to see the entire lessor/supplier agreement, the last two methods above provide the option of a statement limited to covenants and warranties, without the disclosure of confidential information.

The lessor benefits from structuring a lease as a finance lease in several ways. First, if benefits are conferred by contract rather than statute, a court may construe the contractual provisions as unconscionable or interpret them narrowly. Second, if the lessor attempts to gain benefits by contract rather than statute, the benefits may be subject to negotiation. By qualifying a lease as a finance lease under Division 10, a lessor will have both contractual and statutory protection.

PRACTICE TIP: In addition to a recital at the beginning of the lease agreement to the effect that "the parties agree that this is a finance lease as defined in California Commercial Code §10103(a)(7)," lessors should consider doing the following to ensure that they obtain finance lease status:

- Have the purchase order delivered to the supplier on a form prepared by the lessor.
- Make sure that the purchase order form has a place for the lessee to indicate its approval of the purchase order and contract. If the supplier's purchase order form must be used, the lessee's approval could be typed across the face of a copy of the purchase order.
- Sign and date the lessee's approval on or before the date on which the lease is executed.
- Include a recital in the lease that the lessee has reviewed and approved the form of the purchase order.
- Ensure that the delivery and installation/acceptance certificate contains a reaffirmation by the lessee of the relevant finance lease criteria.

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§19.31 3. Lessor Who Is Affiliate of Manufacturer or Supplier

Manufacturers commonly provide credit support for the distribution of their products through an affiliate rather than directly. A question is thus presented as to whether an affiliate of a manufacturer is too closely connected to the manufacturer for the transaction to meet the definition of a finance lease. The Official Comment (g) to UCC §2A-103 recognizes that Division 10 contains no special rule to address the case when the lessor is an affiliate of the manufacturer or supplier, and the comment suggests that the characterization issue will be left to the facts of each case.

One court considering the issue of a close connection under Florida law has held that a leasing transaction was within the definition of a finance lease even though the lessor was an affiliate of the manufacturer. *Siemens Credit Corp. v Newlands* (ND Cal 1994) 905 F Supp 757, 763. Similarly, a New Jersey court held that a leasing transaction involving a lessor who was an affiliate of the manufacturer met the requirements for a finance lease, and found the lessee's argument that the "close connection" between the lessor and manufacturer gave the lessee special defenses not otherwise available for a finance lease to be without merit. *AT&T Credit Corp. v Transglobal Telecom Alliance, Inc.* (D NJ 1997) 966 F Supp 299, 303, aff'd without published opinion (3d Cir 2001) 261 F3d 490. See generally Comment, *Brothers at Arm's Length: U.C.C. Article 2A, Captive Finance Companies and the Close-Connection Doctrine*. 1999 Wis L Rev 1051.

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§19.32 4. Lessor's Warranties

A finance lessor receives special benefits relating to warranties. Although the lessor does not escape liability for any express warranties created by the lessor's conduct or representations to the lessee (Com C §10210(a)(2)), a finance lessor will not be held to have made any implied warranties of merchantability (Com C §10212(a)), fitness for a particular purpose (Com C §10213), or freedom from infringement (Com C §10211(b)). This is a logical consequence of the fact that the lessor is fundamentally performing a credit function and has no direct responsibility for the quality of the goods. Therefore, except as to express warranties under Com C §10210(a)(2) and the warranty of quiet enjoyment (Com C §10211(a); see §19.62), the lessee under a finance lease looks to the supplier (seller or lessor) for warranty protection, including warranties or title. *Arriaga v CitiCapital Commercial Corp.* (2008) 167 CA4th 1527, 85 CR3d 143 (employee injured by glue spreader, whose employer had acquired glue spreader from finance lessee, could not sue finance lessor for breach of warranty). See Official Comment 2 to UCC §2A-211.

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§19.33 5. Pass-Through of Supplier Warranties

In a finance lease the benefit of the supplier's promises, even when made to the lessor, extend to the lessee. Com C §10209(a). This provision reflects the expectation that, due to the lessor's passive financing role in a finance lease arrangement, the lessee looks to the supplier of the goods for the representations and warranties that are a necessary inducement to take the goods. See Official Comment 1 (Purposes) to UCC §2A-209.

Thus, despite the fact that the lessee is not in privity of contract with the supplier, the lessee will have a direct right of action against the supplier under any of the supply contract express or implied covenants or warranties. See *Vacation Village, Inc. v Hitachi Am., Ltd.* (Sup Ct Nev 1994) 874 P2d 744, 747. In transactions not involving finance leases, however, privity of contract is still a prerequisite in California for recovery on a theory of breach of warranties. *All W. Electronics, Inc. v M-B-W, Inc.* (1998) 64 CA4th 717, 725, 75 CR2d 509. Thus, while it may seem at first glance that the finance lessor is the party with the stronger interest in ensuring that the transaction meets the statutory requirements for a finance lease, the finance lessee who wishes to have the benefit of manufacturer's warranties has a similarly strong interest in documenting compliance with the finance lease requirements.

The lessee is also protected against any modification or rescission of the supply contract by the supplier and the lessor. If a modification occurs after the supplier has notice that the lessee has entered into a finance lease, the modification or rescission is ineffective. If the modification or rescission occurs before the supplier had notice of the finance lease, the lessor is considered to have assumed responsibility for the promises of the supplier and warranties as they existed before the modification or rescission. Com C §10209(c).

PRACTICE TIP: Particularly in high technology leases, the lessor frequently takes an assignment of the lessee's own purchase order or purchase agreement with the supplier. Although the lessor takes title to the equipment, it typically assigns the rights to any warranties and indemnities back to the lessee and relies on the fact that all issues with respect to acceptability and performance of the equipment are settled entirely between the lessee and the supplier or manufacturer. The assignment will state specifically that it is only an assignment of the right to purchase and obtain title, and that all obligations under the original purchase agreement or purchase order continue to reside with the lessee.

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§19.34 6. Lessee's Obligations Irrevocable

On acceptance of the goods, a lessee's obligations under a finance lease that is not a consumer lease are irrevocable and independent of the lessor's return performance. Com C §10407(a). This is referred to as a "hell or high water" obligation because the lessee is bound to perform come what may. See Official Comment 1 to UCC §2A-407. For example, even if the goods do not conform to a supplier's warranty or if the lessor breaches its obligations under the lease, the lessee is obligated to pay under the lease terms. As with the other benefits available to a finance lessor, this one can be obtained through the parties' agreement, whether or not the lease qualifies for finance lease treatment. See §19.30.

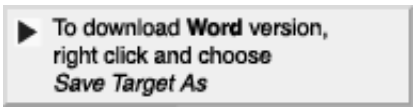
DRAFTING CONSIDERATIONS: A finance lessor may include a hell or high water provision in the lease to attempt to preempt some defenses of the lessee, such as frustration of purpose, which do not appear to be removed by Com C §10407. See form 19.35-1.

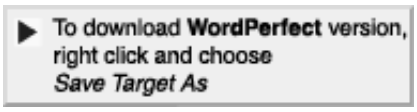
Notwithstanding the lessee's inability to terminate the lease because of the lessor's or supplier's default, the lessee still has the right to bring an action against the lessor or supplier to recover whatever damages may result from the breach.

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Source: Business Law/California UCC Sales and Leases/19 Leasing of Goods/§19.35 7. Form: Hell or High Water Covenant

§19.35 7. Form: Hell or High Water Covenant





19.35-1 Hell or high water covenant

Lessee's obligation to pay all rent will be absolute and unconditional and will not be affected or reduced by any circumstance, including:

(1) Any setoff, counterclaim, recoupment, defense, or other right that Lessee may have for any reason against Lessor, the manufacturer, any seller of the property, or any person providing services with respect to the property;

(2) Any defect in the title, condition, design, operation, or fitness for use of the Property; any damage to, or loss or destruction of, the Property; or any interruption or cessation in its use or possession by Lessee for any reason, whether arising out of or related to an act or omission of Lessor or any other person;

(3) Any liens with respect to the Property;

(4) The invalidity or unenforceability of this Lease or any absence of right, power, or authority of Lessor or Lessee to enter into this Lease;

(5) Any insolvency, bankruptcy, reorganization, or similar proceedings by or against Lessor or Lessee; or

(6) Any other circumstance or occurrence of any nature, whether or not similar to any of the foregoing.

It is the express intention of Lessor and Lessee that all rent payable under this Lease will be payable in all events, unless the obligation to pay is terminated under the express provisions of this Lease.

Lessee hereby waives, to the extent permitted by law, all rights that Lessee may now have or later acquire, by law or otherwise, to terminate this Lease or any obligation imposed on Lessee in relation to this Lease.

Nothing in this Lease may be construed as a waiver of Lessee's right to seek a separate recovery of any payment of rent that is not due and payable under this Lease. Lessee retains the right to seek damages, specific performance, or any other remedy at law or in equity, separately or in combination, against Lessor or any other person, on account of Lessor's or another person's failure to perform under this Lease.

Comment: See §19.34 for related discussion. In actual practice, negotiations between the lessor and the lessee may result in terms less onerous than those reflected in this clause. Courts have upheld the validity of "hell or high water" clauses in leases governed by Article 2A. *Lyon Fin. Servs. v Protech Plumbing & Heating, Inc.* (2004) 2004 Minn App Lexis 191; *Wells Fargo Bank Northwest, N.A. v TACA Int'l Airlines* (SD NY 2002) 247 F Supp 2d 352; *AT&T Credit Corp. v Transglobal Telecom Alliance, Inc.* (D NJ 1997) 966 F Supp 299, aff'd without published opinion (3d Cir 2001) 261 F3d 490; *Imaging Fin. Servs., Inc. v Graphic Arts Servs., Inc.* (ND Ill 1997) 172 FRD 322; *In re First Interregional Advisors Corp*. (Bankr D NJ 1997) 218 BR 722.

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§19.36 8. Revocation of Acceptance of Goods

Any lessee has the right to reject goods that do not conform to the terms of the lease agreement. See Com C §§10509-10510. After a finance lessee (other than a consumer lessee in certain circumstances) has accepted the goods, however, the lessee cannot revoke acceptance for nonconformity if the acceptance was made with knowledge of the nonconformity. Com C §10516(b). This is true even if the finance lessee reasonably believed when the lessee accepted the goods that the nonconformity would be cured. Com C §10517(a). Once the lessee accepts, the lessor will ordinarily become bound to pay the purchase price to the supplier; thus, the lessee should be bound in turn to pay the lessor. Even if the goods were accepted because the nonconformity could not be discovered before acceptance, a finance lessee still is not permitted to revoke acceptance. Com C §10517(a)(2).

The "nonconformity" referred to in the Commercial Code is the goods' nonconformity with the lease agreement, not the supply agreement. Cal Comment to Com C §10516. Even though the finance lessee must keep the goods after acceptance of them, the lessee still has a right of action against the seller (supplier) of the goods for their nonconformity to the supply agreement. Cal Comment to Com C §10516.

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§19.37 9. Risk of Loss

Generally, unless the parties agree otherwise, the risk of loss of the goods remains with the lessor. Com C §10219(a). See §19.44. However, under a finance lease, risk of loss passes to the lessee. Com C §10219(a).

PRACTICE TIP: When the agreement is silent on this issue, the Commercial Code provides rules for determining the time at which risk of loss passes in a personal property lease. Com C §10219(b). See §19.44. On risk of loss under the Commercial Code, see generally §§16.40-16.50. Nevertheless, it is advisable to specify the time at which the parties intend to have risk of loss pass to the lessee.

When goods under a finance lease fail to conform to the lease agreement to such an extent that the lessee has a right of rejection, risk of loss will remain with the supplier until the nonconformity is cured or the lessee accepts the goods. Com C §10220(a)(1).

If there is a total loss of the goods before the risk of loss passes to the lessee, the lease agreement is voided. If the loss is only partial or the goods have deteriorated to such an extent that they no longer conform to the lease agreement, a finance lessee must either reject them for the nonconformity or accept them and pay the full amount required under the lease agreement irrespective of the loss. Com C §10221.

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C. Consumer Leases

§19.38 1. Definition

A "consumer lease" is one in which the lessor is regularly engaged in the business of selling or leasing the goods, the lessee is an "individual," and the lessee is acquiring the goods for a personal, family, or household purpose. Com C §10103(a)(5). This definition is consistent with the Song-Beverly Consumer Warranty Act. See CC §1791(a), (g).

A significant number of California and federal statutes may be relevant to a consumer leasing transaction, depending on the status of the parties or the type of goods involved in the transaction. These include:

- The Consumer Leasing Act (15 USC §§1667-1667f) and its implementing regulation, Regulation M (12 CFR pt 213);
- The Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312);
- The Vehicle Leasing Act (CC §§2985.7-2992);
- The Song-Beverly Consumer Warranty Act (CC §§1790-1795.8);
- The Consumers Legal Remedies Act (CC §§1750-1784), including CC §1770(a)(19) (which makes the inclusion of an unconscionable provision in a lease an unfair method of competition and a deceptive act or practice);
- The Consumer Contract Awareness Act (CC §§1799.200-1799.206);
- The Rosenthal Fair Debt Collections Practices Act (CC §§1788-1788.32);
- The Home Solicitation Contract Law (CC §§1689.5-1689.11);
- The Unruh Act governing retail installment sales (CC §§1801-1812.20), which applies to leasing transactions that do not create "true leases";
- CC §§1925-1936, which include special protections for consumers renting a passenger vehicle; and
- CC §§1955-1959, which deal with the hiring of personal property.

For discussion of California law relating to consumer financing, including leasing, see Secured Transactions in California Commercial Law Practice, chap 7 (2d ed Cal CEB 2001).

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Source: Business Law/California UCC Sales and Leases/19 Leasing of Goods/§19.39 2. Protections Given to Consumer Lessees

§19.39 2. Protections Given to Consumer Lessees

Although Division 10 leaves most consumer protection aspects of leasing to other law, it does contain certain provisions that are intended to benefit consumers. If a lease qualifies as a consumer lease, the lessee has the following principal protections:

- **Restricted use of liquidated damages clauses.** The Commercial Code endorses liquidated damages clauses in consumer leases but makes them subject to compliance with CC §1671. Com C §10504(a). See Official Comment to UCC §2A-504. Consequently, for a liquidated damages clause to be upheld in a consumer lease, it must be "impracticable or extremely difficult" to calculate the amount of actual damages that would result from breach of the lease agreement. See CC §1671(d). In addition, the amount of liquidated damages reflected in the lease contract must have been arrived at as the result of a reasonable endeavor to estimate a "fair average compensation" for any loss that may be sustained. *Hitz v First Interstate Bank* (1995) 38 CA4th 274, 288, 44 CR2d 890.
- **No exclusion of consequential damages for personal injury.** In a lease of consumer goods, any limitation, alteration, or exclusion of consequential damages for injury to the person is prima facie unconscionable. Com C §10503(c). In *Westlye v Look Sports, Inc.* (1993) 17 CA4th 1715, 22 CR2d 781, the court of appeal, in reviewing a transaction that predated Division 10, rejected the argument that the Division 2 counterpart to Com C §10503 (*i.e.,* Com C §2719) should be applied to the rental of ski equipment. Thus, Com C §10503(c) may represent a protection in consumer leases that was not available under the law before the adoption of Division 10. The court of appeal considered the validity of a broad disclaimer of liability in the context of a consumer lease that predated Division 10. In *Westlye,* a rental agreement covering snow skiing equipment contained a broad disclaimer of any liability of the lessor as well as an express assumption of risk by the lessee, but did not contain an express disclaimer of strict liability. The court concluded that such a disclaimer was void as against public policy. 17 CA4th at 1743. The court also found the express assumption of risk by the lessee ineffective to shield the lessor from strict liability in tort for injuries caused by a defective product. 17 CA4th at 1747. Although the case involved a consumer lease, the court's reasoning would not necessarily limit its application to the consumer context. For a discussion of the doctrine of strict liability to lessors generally, see §19.93.
- **Limit on amount lessor can retain on lessee's default.** When the lessor has withheld or stopped delivery due to the lessee's default or insolvency (see generally §19.100), the Code gives the consumer lessee greater protection on the amount of rentals that the lessor can retain. Outside the consumer lease context, a lessor in such circumstances could retain up to 20 percent of the present value of total rent payable by the lessee for the balance of the lease term. With a consumer lease, that amount would be limited to $500. Com C §10504(c)(2).
- **Lessee not required to give notice of default.** A consumer lessee avoids some of the significant burdens and presumptions that otherwise accompany the acceptance of goods under a lease. For instance, unless a lessee notifies the lessor and supplier (if any) within a reasonable period after the lessee discovers or should have discovered a default, the lessee ordinarily is barred from pursuing any remedy against the party who should have been notified. Com C §10516(c)(1). This rule does not apply to a consumer lessee. Com C §10516(f). Similarly, the burden of establishing a default after acceptance is typically on the lessee, but a consumer lessee does not have this burden. Com C §10516(c)(3), (f).
- **Different rules regarding lessee's right to repudiate lease.** An anticipatory breach or repudiation of a lease by a lessee will generally excuse the lessor from further performance. The lessor is permitted to treat the lessee as being in breach, even after the lessor has notified the lessee that the lessor would await the lessee's performance and urged the lessee to retract the repudiation. Com C §10402(a). A consumer lessor is not granted this right explicitly; instead, the Code refers the parties to other laws for the effect of a repudiation of a consumer lease. Com C §10402(b). Under general principles of contract law, a consumer lessee may be entitled to defend against the lessor's alleged anticipatory breach by arguing that the lessor, through some conduct, has become estopped from enforcing the lessor's remedies and that the lessor must first allow the consumer lessee

a reasonable period of time to perform or retract the lessee's repudiation. Alternatively, the lessee may argue that the lease has become, in essence, a unilateral contract that cannot be breached other than by the lessee's actual default in rendering performance when performance is due. See *Diamond v University of S. Cal*. (1970) 11 CA3d 49, 53, 89 CR 302.

- **Statute of limitations period cannot be shortened.** Although the Code establishes a general statute of limitations period of four years following accrual of the cause of action, the parties are permitted to shorten the period to one year. In a consumer lease, the option to shorten the statute of limitations is not available. Com C §10506(a).
- **Greater warranty protection.** A consumer lessee apparently has the benefit of certain warranties arising under the Civil Code that, before the adoption of Division 10, applied to all leases. Civil Code §1955 obligates a lessor, unless otherwise agreed, to secure the lessee's quiet enjoyment against all lawful claimants, put the property into a condition fit for the purpose for which it was leased, and repair any deterioration of the property that either was not caused through the lessee's fault or resulted naturally from using the property.
- In addition, a consumer lessee is entitled under the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) to the same warranty protections and rights against the manufacturer as a purchaser would have had. CC §1795.4(b). If the goods are leased from the inventory of the lessor, the lessee has the same warranty rights as a purchaser would have had against the lessor. CC §1795.4(c). See §3.4. The Commercial Code clearly makes these obligations applicable to consumer leases by providing that, in the event of a conflict between Division 10 and the Civil Code provisions specified in Com C §10104(a)(3) in the context of a consumer lease, the provisions of the Civil Code will prevail. Com C §10104(b).
- **Restrictions on choice of law and choice of forum.** The Commercial Code limits abusive choice-of-law or choice-of-forum provisions in consumer leases. See Com C §10106. That section invalidates those clauses unless (a) the law chosen is that of the state in which the consumer's residence is located or where the goods will be kept, or (b) the forum chosen is one that would otherwise have jurisdiction over the lessee. See Official Comment to UCC §2A-106. See §§19.23-19.27 for further discussion.
- **Provisions prohibiting assignment.** In a consumer lease, any prohibition on assignment must be specific and conspicuous. Com C §10303(g).

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§19.40 3. Consumer Finance Leases

Because Division 10 does not preclude a consumer lease from also qualifying as a finance lease, certain provisions of Division 10 address the resulting hybrid category of leases that are both consumer leases and finance leases. For example, the provisions of Com C §10407 that make the lessee's obligations under a lease agreement irrevocable and independent on acceptance of goods (see §19.34) do not apply to a finance lease that is also a consumer lease. Com C §10516(b), (f). In contrast, a finance lessee that ordinarily does not receive the protection of the warranties of merchantability, fitness, or freedom from infringement (Com C §§10211(b), 10212-10213) obtains no additional benefit by virtue of also being a consumer lessee.

The provisions of the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) that relate to leases recognize the circumstance in which the lessor acquires goods from a manufacturer or supplier and then leases them to the lessee. In those situations, the benefit of the warranties required of the manufacturer or the seller is passed directly to the lessee. CC §1795.4(d). Each of the other protections discussed in §19.39 with respect to consumer leases applies equally to a consumer lease that is also a finance lease.

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D. Installment Leases

§19.41 1. Definition

A third category of leases under Division 10 is the "installment lease contract." An installment lease contract is one in which the goods are delivered in lots, even though the lease may state that each delivery forms a separate lease. Com C §10103(a)(9). This is one of the few instances in which the parties cannot by agreement alter the rules that Division 10 prescribes; characterizing separate deliveries as separate leases will not prevent the arrangement from being treated as an installment lease. As with the treatment given to installment sales under Division 2, the approach is to view each installment in the context of a single unified agreement. See Com C §2612.

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§19.42 2. Breach

When a lessor's action or failure to act regarding a particular delivery represents a breach of the installment lease agreement, the question arises as to whether the lessee's rights are linked to that particular delivery alone or relate instead to the lease agreement as a whole. If the value of the whole lease agreement is substantially impaired, the lessor is considered to be in default under the lease agreement as a whole and the lessee is entitled to exercise all remedies available under Division 10 or the lease. See Com C §§10508(a), 10510(b).

If the lessor's action or inaction does not meet the "substantial impairment" test, the lessee must accept the nonconforming delivery, provided that the lessor (or the supplier) gives an adequate assurance that the nonconformity will be cured. Com C §10510(a).

This rule does not preclude a lessee from obtaining a recovery for a particular breach; it simply limits the circumstances in which a breach of a particular installment can be treated as a breach of the entire lease agreement.

For a finance lease, when the lessor has few obligations to evaluate for breach and the manufacturer (rather than the lessor) is responsible for defects, the greatest significance of this rule may arise in the bankruptcy context. Characterization of a transaction as creating an installment lease may require a lessee either to assume or reject all of the installments, rather than selecting only the most favorable ones. See §19.129.

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§19.43 3. Master Lease

A "master lease" is a common form of lease that may be treated as creating an "installment lease" for purposes of Division 10. In such a lease, the parties set out in a master lease form all the terms of the lease agreement (other than the description of the property, rental amount, and term) and then enter into lease schedules to provide the omitted terms with respect to each item (or lot) of property. The master lease form provides a convenient format for leasing property that will be delivered at different times and subject to different pricing or other economic terms but will still be within the general terms provided under the master lease.

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VI. RISK OF LOSS; INSURANCE

§19.44 A. Rules for Determining Risk of Loss

Except for finance leases (see §19.37), the Commercial Code allocates the risk of loss of the goods to the lessor. See Com C §10219(a). The parties are free, however, to allocate the risk of loss differently, and lease agreements almost always provide that the lessee assumes the risk of loss.

If the lease agreement puts the risk of loss on the lessee but does not specify when the risk of loss will pass, the following rules apply:

- When the lease contract requires or authorizes the goods to be shipped by carrier and does not require delivery at a particular destination, the risk of loss passes to the lessee when the goods are delivered to the carrier. Com C §10219(b)(1)(A).
- When the lease contract requires or authorizes the goods to be shipped by carrier and delivered at a particular destination, and the goods are tendered there while in the carrier's possession, the risk of loss passes to the lessee when the tender of the goods enables the lessee to take delivery. Com C §10219(b)(1)(B).
- When the goods are held by a bailee to be delivered without being moved, the risk of loss passes to the lessee on acknowledgment by the bailee of the lessee's right to possession of the goods. Com C §10219(b)(2).
- In any situation not covered above, when the lessor is a merchant (or, for finance leases, when the supplier is a merchant), the risk of loss passes to the lessee on the lessee's receipt of the goods. Otherwise, the risk passes to the lessee on tender of delivery. Com C §10219(b)(3).
- When the goods are nonconforming:
- If a tender or delivery of goods establishes a right of rejection by failing to conform to the lease contract, the risk of loss remains with the lessor (or, for finance leases, the supplier) until cure or acceptance (Com C §10220(a)(1)); and
- If the lessee rightfully revokes acceptance, he or she may treat the risk of loss as having remained with the lessor from the beginning to the extent of any deficiency in the lessee's insurance coverage (Com C §10220(a)(2)).

If the goods are conforming and already identified to the lease contract and the lessee repudiates the contract or is otherwise in default, the lessor (or, for finance leases, the supplier) may treat the risk of loss as resting on the lessee for a commercially reasonable length of time, to the extent of any deficiency in the lessor's insurance coverage. This is true regardless of whether the risk of loss is to pass to the lessee. Com C §10220(b).

If the goods suffer a casualty before delivery or before the risk of loss passes to the lessee (without the fault of the lessor, lessee, or supplier):

- When the loss is total, the lease contract is avoided (Com C §10221(1));
- When the loss is partial or the goods have so deteriorated as to no longer conform to the lease contract, the lessee may demand inspection and either treat the contract as avoided or (except for finance leases) accept the goods with due allowance from the rent payable for the balance of the lease term for the deterioration or the deficiency in quantity but without further right against the lessor (Com C §10221(2)).

Division 10 does not state when the risk of loss passes back to the lessor, which must occur when the lessee returns the goods at the end of the lease term. A not uncommon lease provision requires the lessee, on expiration of the lease term, to ship the goods to a place designated by the lessor, which may be a subsequent lessee's business site. This scenario may require a court to decide when the risk passes back to the lessor or the subsequent lessee.

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§19.45 B. Insurable Interest in Goods

A lessee obtains an insurable interest when existing goods are identified to the lease contract, even though the goods identified are nonconforming and the lessee has an option to reject them. Com C §10218(a).

If the lessee has an insurable interest only by reason of the lessor's identification of the goods, the lessor, until default or insolvency or notification to the lessee that identification is final, may substitute other goods for those identified. Com C §10218(b).

Notwithstanding a lessee's insurable interest, the lessor retains an insurable interest until an option to buy has been exercised by the lessee and risk of loss has passed to the lessee. Com C §10218(c).

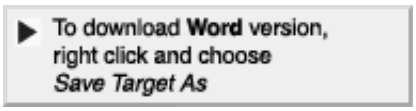
None of the above rules impairs any insurable interest recognized under any other statute or rule of law. Com C §10218(d).

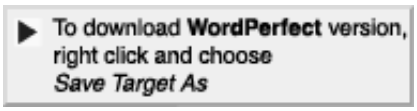
The parties' agreement may determine who has an obligation to obtain and pay for insurance covering the goods and who will be the beneficiary of any insurance proceeds. Com C §10218(e). See form 19.46-1.

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Source: Business Law/California UCC Sales and Leases/19 Leasing of Goods/§19.46 C. Form: Insurance Covenant

§19.46 C. Form: Insurance Covenant





19.46-1 Insurance covenant

INSURANCE OBLIGATION

Lessee will at all times during the lease term, at Lessee's own expense, carry and maintain or cause to be carried and maintained:

(1) All-risks property insurance for the Property equal to the casualty value of the Property; and

(2) Public liability insurance for third party bodily injury, death, and personal and property damage, including contractual liability,

[*Option 1: Coverage consistent with industry practice*]

in amounts, against risks, and with insurance companies that are consistent with prudent industry practice,

[*Option 2: Coverage specified*]

in amounts no less than _ _[*dollar amount*]**_ _, against the following risks, _ _**[*specify*]**_ _, and with the following insurance companies, _ _**[*specify*]**_ _,**

[*Option 3: Coverage determined by lessee*]

in amounts, against risks, and with insurance companies customarily chosen by Lessee for insurance protection for equipment owned or leased by Lessee similar in nature to the Property,

[*Continue*]

with deductibles or self-insurance _ _[*for the first _ _*[*dollar amount*]*_ _ (per occurrence) against property or public liability risks/in amounts and against risks that are reasonably satisfactory to Lessor and Lessee*]**_ _.**

PROCEEDS

If no event of default has occurred and is continuing, the proceeds of any insurance for damage to the Property not constituting a casualty event will be used for the repair of that damage to the extent required to maintain the property in accordance with the requirements of this lease, if Lessee has not already paid the cost of the repair.

If Lessee has already paid the cost of repair and no event of default has occurred and is continuing, the insurance proceeds will be paid over to or retained by Lessee as a reimbursement for payment for the repair, including any balance remaining after restoring the Property to the condition required under this Lease.

Insurance proceeds in excess of _ _[*dollar amount*]**_ _ (or any insurance proceeds if an event of default of which Lessee has been given notice has occurred and is continuing), however, will be remitted by the insurer directly to an escrow account, to be established by Lessee and Lessor under an escrow agreement that Lessee and Lessor agree to enter into with an escrow agent mutually acceptable to both parties. The escrow agreement will provide that the escrow agent will deposit the insurance proceeds in the escrow account, invest the proceeds in permitted investments, and pay the proceeds to Lessee (together with all accrued earnings as long as no default has occurred) when the repair of the property is carried out, reasonable proof of the repair is submitted to Lessor, and Lessor notifies the escrow agent of the repair.**

SEPARATE INSURANCE

Lessor or any other person may, at that party's own expense, provide insurance for the Property or its operation, unless that insurance would conflict with or otherwise limit any insurance maintained by Lessee. Any insurance maintained by Lessor or any other person, however, must provide that the insurer will have no rights of subrogation against Lessee with respect to claims under the policy.

INSURANCE CERTIFICATE

Lessee will cause all policies of insurance procured and maintained under this insurance covenant (and, with respect to paragraphs (3) and (5)-(7) below, to the extent commercially available in the marketplace without regard to Lessee's creditworthiness) to do the following:

(1) Name Lessor as an additional insured.

(2) Be payable to the parties as their interests may appear.

(3) Waive (a) any right of subrogation of the insurer to any right against Lessor or any other person insured under the policy and (b) any right of the insurer to any setoff or counterclaim or any other deduction, whether by attachment or otherwise, regarding any liability of Lessor or Lessee.

(4) Provide that (a) there is no recourse against any additional insured for the payment of premiums, commissions, direct calls, assessments, or advances; (b) if any premium or premium installment is not paid when due or if the insurance is canceled, terminated, or materially changed for any reason, the insurers will promptly notify Lessor and Lessee; and (c) any cancellation, termination, or change will not be effective for any party until 30 days after that party receives such notice.

(5) Provide primary coverage up to and including the stated policy limits without right of contribution from any insurance effected by any party.

(6) Include a cross-liability endorsement providing that inasmuch as the policies are written to cover more than one insured, all terms and conditions, insuring agreement, and endorsements, with the exception of limits of liability, will operate in the same manner as if there were a separate policy covering each insured.

(7) Insure Lessor regardless of any breach or violation of any warranty, declaration, or condition contained in those policies by Lessee or any other person (other than Lessor).

Lessee will promptly deliver to Lessor a copy of each notice received by Lessee with respect to insurance provided under this covenant. On the closing date and annually thereafter, Lessee will furnish to Lessor a certificate signed by a firm of independent insurance brokers containing details about the insurance maintained by Lessee under this covenant, specifying the particular policies, and stating that the insurance complies with this covenant.

Comment: In almost every instance, the lease will allocate the risk of loss to the lessee and require the lessee to provide insurance covering loss, damage, destruction, or theft of the leased property and liability to others resulting from operation of the property. Often the parties will agree on a "stipulated loss value" for the property, which may be set in an amount to compensate the lessor for the loss of not only the replacement value of the property but also the profit (including tax benefits) that would have been derived from the lease agreement had the property not suffered a loss.

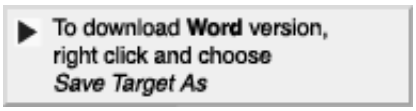
Generally, the insurance policy should name the lessor (and, when appropriate, any assignee of the lessor) as an additional insured (giving the lessor a direct right of coverage). If the lessor seeks protection against the risk that the lessee may fail to properly apply the insurance proceeds toward repairing the leased property, or fail to pay amounts owed to the lessor under the lease for a total loss of the leased property, the lessor should also be named as loss payee. The insurance policy may also include a "breach of warranty" endorsement, protecting the lessor's right to coverage even though the lessee invalidates the coverage by breaching a warranty the lessee has made to the insurer as a condition of coverage. The policy may also include a "waiver of subrogation" endorsement, protecting the lessor against a claim made against the lessor by the insurer on the theory that the lessor has become subrogated to the rights of the lessee. The lessee ordinarily should be required to provide evidence of the insurance coverage obtained by presenting a certificate signed on the insurer's behalf.

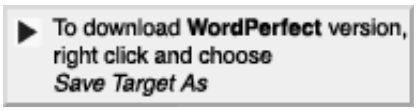
It is prudent to specify the credit quality of the insurer (*e.g.,* "The insurer must have a Best's rating of at least B+").

It is also prudent to require an endorsement from the insurance company that it will provide prior notice to the lessor of any cancellation or modification of insurance coverage.

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§19.47 D. Form: Risk of Loss Covenant





19.47-1 Risk of loss covenant

Lessee will bear the entire risk of destruction, loss, theft, requisition of title, or use, confiscation, taking, or damage (collectively, casualty loss) of the Property from any cause during the period commencing when the Property is placed in transit to Lessee and ending when the Property is returned to Lessor or its designee following termination of this Lease. If during that period the Property suffers any casualty loss, Lessee will notify Lessor in writing within five days following the casualty loss. On demand by Lessor, Lessee will:

(1) If the damage constituting the casualty loss is repairable, repair the Property to the condition in which the Property is required to be maintained under this Lease;

(2) If the damaged Property is not repairable, replace the Property at Lessee's sole expense with like property approved by Lessor and take all actions and make all payments that may be required to vest in Lessor title to the replacement property, free and clear of all liens, encumbrances, or security interests; or

(3) Pay to Lessor the casualty value (as defined below) and all other amounts then due under this lease.

"Casualty value" will mean, at any time, the sum of:

(a) The discounted value, at that time, of the aggregate unpaid monthly rent payments to be paid through the then-remaining term of this lease, discounting that amount at an annual discount rate of _ _[*number*]_ _ percent; and

(b) Lessor's reasonable estimate, at that time, of the fair market value of the Property at the end of the term of this lease, discounted at an annual discount rate of _ _[*number*]_ _ percent.

Comment: Risk of loss rules are discussed in §19.44.

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VII. DUTY TO MAINTAIN LEASED PROPERTY

§19.48 A. Duty to Maintain

Division 10 does not address maintenance and care of the leased goods, perhaps because the vast bulk of Division 10 is derived directly from Division 2 on sales, in which maintenance responsibility is not an issue.

Provisions governing the obligations of a lessor and lessee with respect to maintenance of the leased goods are found elsewhere in California law. Generally, the lessee has very limited duties. In particular, the lessee must:

- Use ordinary care to preserve the safety and condition of the goods (CC §1928);
- Repair all deteriorations or damage to the goods caused by the lack of ordinary care (CC §1929);
- Bear all the reasonably foreseeable expenses attendant to the lessee's use of the goods (CC §1956); and
- Return the goods to the lessor at the agreed location or, absent agreement, to the place at which the goods were located at the time the lease was entered into (CC §1958).

The lessor has the duty to repair all deteriorations of the goods that were not caused by the lessee or that do not result naturally from use of the goods. CC §1955. In addition, the lessor is responsible for any unforeseeable expenses associated with use of the goods. CC §1956.

In most commercial contexts, the foregoing statutory allocations of responsibility for maintenance and care of the goods are modified by the parties' agreement. See form 19.49-1.

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§19.49 B. Form: Maintenance Covenant

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19.49-1 Maintenance covenant

Lessee will:

(1) Furnish all labor and parts required for maintaining, repairing, and replacing component parts of the Property to keep it in good operating condition and appearance;

(2) Use, operate, maintain, and store the Property in a careful and proper manner;

(3) Protect the Property from deterioration;

(4) Comply with the manufacturer's operating procedures and warranty restrictions and all laws, ordinances, and regulations applicable to the Property or its use;

(5) Put the Property only to the use contemplated by the manufacturer; and

(6) Maintain accurate and complete records of all repairs and maintenance of the Property and allow Lessor to inspect those records at any time.

Lessee will not make any alterations, additions, or improvements to the Property without Lessor's prior written consent. All repairs, replacement parts, additions, alterations, and improvements made to the Property by Lessee will be considered to be Lessor's property and subject to the terms of this Lease.

Comment: Lessors generally want the equipment to be maintained in such a condition that, on its return by the lessee, it can be sold or released immediately. Many lessors require the lessee to enter into a maintenance contract with an entity approved by the equipment's manufacturer.

The lessee may want to add a paragraph at the end of this clause stating that alterations or improvements to the property that do not impair its value and are readily removable either will remain the lessee's property, or if such alterations and improvements become lessor's property during the lease term, will be removable by the lessee at the termination of the lease, and title will re-vest in the lessee on such removal. For a discussion of accessions, see §19.91.

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VIII. ACCEPTANCE AND REJECTION

§19.50 A. Acceptance of Goods by Lessee

After a lessee has had a reasonable opportunity to inspect the goods, the lessee is considered to have accepted them if (Com C §10515(a)):

- The lessee signifies that the goods conform to the lease;
- The lessee acts as if the goods conform to the lease; or
- The lessee fails to take the action required under Com C §10509(b) to effectively reject the goods (see §§19.53, 19.58).

DRAFTING CONSIDERATIONS: To eliminate any doubt that an acceptance has occurred, the lease agreement should describe an acceptance procedure, including a period for inspection that is acknowledged by the parties to be reasonable. It is also advisable to use an acceptance certificate, to be executed by the lessee, to signify unequivocally the lessee's acceptance of the goods. See form 19.51-1.

Establishing what constitutes acceptance is critical because goods that have been accepted cannot be "rejected" on the basis of the liberal "perfect tender" rule (see Com C §10509(a)). Com C §10516(b). Acceptance, however, does not preclude a "revocation" of acceptance under the more restrictive requirements of Com C §10517, discussed in §19.52.

Although acceptance does not impair any other remedy provided by the Commercial Code or the lease agreement for nonconformity (Com C §10516(b)), certain other consequences follow. Within a reasonable period after the default is or should have been discovered by the lessee, the lessee is obliged to notify the lessor or be barred from any remedy. Com C §10516(c)(1). In addition, after acceptance the burden is on the lessee to prove that the default has occurred. Com C §10516(c)(3). Finally, if the lease contains a "hell or high water" clause making the rent payment obligations of the lessee independent and separate from the obligations of the lessor (see §§19.34-19.35), the lessee may be obligated to pay rent with respect to nonconforming goods that have been accepted but would not be bound by the clause if the goods had not been accepted. Because the "hell or high water" clause takes effect only after acceptance has occurred, a lessor who seeks to bind a lessee to the clause should rely only on an acceptance certificate that is signed on or after the delivery date and provide the lessee with a reasonable opportunity to inspect the leased goods. See *Colonial Pac. Leasing Corp. v F.W.C.F.R. Corp.* (Utah Ct App 1999) 977 P2d 541.

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Source: Business Law/California UCC Sales and Leases/19 Leasing of Goods/§19.51 B. Form: Acceptance Covenant and Certificate

§19.51 B. Form: Acceptance Covenant and Certificate

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19.51-1 Acceptance covenant and certificate

ACCEPTANCE COVENANT

The Property to be leased will be delivered to Lessee "AS IS," "WHERE IS," AND SUBJECT TO EVERY DISCLAIMER OF WARRANTY AND REPRESENTATION SET FORTH IN PARAGRAPH _ _[*number*]**_ _. Lessee will make an inspection of the Property and, on tender of delivery in the condition required by the _ _**[*e.g., Property Purchase Agreement*]**_ _, Lessee will accept the Property and indicate and confirm Lessee's acceptance of the Property by delivery to Lessor of a Certificate of Acceptance in the form set forth in Exhibit _ _**[*number*]**_ _.**

Lessee agrees to complete inspection within _ _[*specify time*]**_ _ of Lessee's receipt of a notice from Lessor that the Property is available for inspection. Lessee acknowledges that this time period is sufficient for Lessee to determine whether the Property is in the condition required by the _ _**[*e.g., Property Purchase Agreement*]**_ _. If Lessee determines that the Property is not in the proper condition, within _ _**[*specify time*]**_ _ following the completion of Lessee's inspection, Lessee will provide a written notice to Lessor specifying each item of nonconformity. Lessor will have _ _**[*specify time*]**_ _ within which to cure any nonconformity and, if Lessor fails to do so, Lessee may reject the Property.**

CERTIFICATE OF ACCEPTANCE

The undersigned, Lessee, under the Lease Agreement between Lessee and Lessor dated _ _[*date*]**_ _, represents, warrants, and agrees that:**

(1) Lessee has made a thorough and complete inspection of the Property in accordance with paragraph _ _[*number*]**_ _ of the Lease.**

(2) The Property satisfies the conditions set forth in the Lease, conforms to its requirements, and conforms to Lessee's requirements.

(3) Lessee accepts the Property for all purposes under the Lease.

(4) Lessor has made no affirmation of fact or promise, has given no description, and has otherwise given no assurances on which Lessee has relied, that would create an express or implied warranty regarding the Property and its conformity to such affirmation, promise, description, or assurances.

(5) Lessee acknowledges that Lessor is relying on this certificate to pay the supplier for the Property.

[*Add if a finance lease*]

(6) Lessee selected the Property and negotiated the terms (including the warranty terms) of the _ _[*e.g., Property Purchase Agreement*]**_ _ between the manufacturer and Lessor. Lessor furnished a copy of the _ _**[*e.g., Property Purchase Agreement*]**_ _ to Lessee before Lessee executed the Lease. Lessee reviewed and was fully familiar with the _ _**[*e.g., Property Purchase Agreement*]**_ _ before entering into the Lease.**

Date: _ _ _ _ _ _ _ _[*Typed name of lessee*]_ _
By: __[*Signature of officer*]__
Title: _ _ _ _ _ _ _

Comment: See discussion of acceptance in §19.50. Paragraph (6) applies to a transaction that constitutes a finance lease. See Com C §10103(a)(7), discussed in §19.30.

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§19.52 C. Revocation of Acceptance

Except in the case of finance leases (see §19.36), after a lessee has accepted goods, knowing that they did not conform to the lease agreement, the lessee may revoke the acceptance only under the following conditions (Com C §§10516(b), 10517(a)):

- The acceptance must have been based on a reasonable assumption that the lessor would cure the nonconformity;
- The lessor must fail to effect a cure; and
- The nonconformity must substantially impair the value of the goods to the lessee.

When goods have been accepted *without* knowledge of a nonconformity, the standards for revocation are relaxed only somewhat. The nonconformity still must substantially impair the value of the goods to the lessee, and, in addition, the acceptance must have been induced either by some assurance of the lessor or, except in the case of finance leases (see §19.36), by the difficulty of discovering the nonconformity before the acceptance occurred. Com C §10517(a)(2).

If the goods conform to the lease but the lessor otherwise defaults in such a way that the value of the goods to the lessee is substantially impaired, the lessee may revoke acceptance. Com C §10517(b). The parties may agree that *any* default by the lessor gives the lessee the right to revoke acceptance, whether or not that default substantially impairs the value of the goods. Com C §10517(c).

The right of revocation will be considered to have been waived unless the lessee acts within a reasonable time after the lessee discovers or should have discovered the grounds for revocation and, in any event, before there has been any substantial change in the condition of the goods. Com C §10517(d). A revocation becomes effective on notice to the lessor. Com C §10517(d).

Once a lessee has effectively revoked acceptance, the lessee has the same rights and duties regarding the goods as in the case of rejection of the goods. See §§19.53-19.58.

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D. Rejection of Goods by Lessee

§19.53 1. Perfect Tender Rule

Division 10 establishes a "perfect tender" rule for lease agreements, much like the rule for sales of goods. See Com C §§2601-2602, 10509. See also §§9.51, 17.54. If the leased goods, or the manner in which they are tendered or delivered, fail in "any respect" to conform to the terms of the lease agreement, the lessee has the option to accept or reject the goods as a whole or to accept some portion of the goods and reject the balance. Com C §10509(a).

The rejection must be made within a reasonable period after the tender or delivery, and the lessee must seasonably notify the lessor of the rejection. Com C §10509(b). See Com C §1205(b) ("seasonably").

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§19.54 2. Lessee's Security Interest in Rejected Goods

When a lessee rightfully rejects or revokes acceptance of goods, the lessee has a security interest in the goods in the lessee's possession or control to the extent of any deposits or security the lessee has provided under the lease agreement and any expenses reasonably incurred in dealing with the goods. Com C §10508(e).

In disposing of the goods, the lessee is obligated to act in good faith and in a commercially reasonable manner. Com C §10508(e). In addition, the lessee is required to account to the lessor for any proceeds in excess of the amount of the lessee's security interest. Com C §10527(e).

A good faith purchaser of the rejected goods from a lessee takes title to the goods free of any rights of the lessor or the supplier, even if the lessee has failed to comply with the requirements of Division 10 in making the disposition. Com C §10511(d).

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3. Lessee's Duties as to Rightfully Rejected Goods

§19.55 a. Duties in General

After a lessee notifies a lessor of a rejection of goods in the lessee's possession, the lessee is obliged to hold the goods with reasonable care at the lessor's or the supplier's disposition for a reasonable period. Com C §10512(a)(1). If the lessor or supplier fails to give instructions, the lessee may (Com C §10512(a)(2)):

- Store the goods for the account of the lessor or the supplier;
- Ship the goods back to the lessor or the supplier; or
- Dispose of the goods for the account of the lessor or the supplier.

The lessee has no further obligation with regard to goods rightfully rejected. Com C §10512(a)(3). The lessee's exercise of the foregoing rights will neither be considered an acceptance of the goods nor a conversion. Com C §10512(b).

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§19.56 b. Additional Duties of Merchant Lessee

A "merchant" lessee (Com C §10103(a)(20)) who rejects goods in the lessee's possession or control has additional obligations to those of other lessees as described in §19.55. A merchant lessee must follow any reasonable instructions received from a lessor or supplier with respect to the goods after the lessee has given notification of rejection (*e.g.,* to ship the goods to a third party). Com C §10511(a). Before following those instructions, however, the lessee has the right to demand indemnity for expenses and need not act if indemnity is refused. Com C §10511(a).

In addition to expenses, a merchant lessee disposing of rejected goods is entitled to receive a commission in a customary amount and, if no particular amount is customary, in a reasonable amount not exceeding 10 percent of the proceeds from the sale. Com C §10511(b).

If the lessor fails to provide instructions and the goods threaten to decline in value quickly, a merchant lessee may not simply hold them but must make a reasonable effort to sell, lease, or otherwise dispose of them for the lessor's account. Com C §10511(a). The merchant lessee is held only to acting in good faith, and such good faith conduct will not be considered to be acceptance or conversion of the goods nor the basis of an action for damages. Com C §10511(c).

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§19.57 4. Lessor's Right to Cure

Just as Division 10 follows the rule of Division 2 in requiring a "perfect tender" (see §19.53), it also adopts for the benefit of the lessor the cure rights granted to a seller under Division 2. See Com C §§2508, 10513. See also §§9.62-9.67.

Thus, if the time for performance under the lease agreement has not yet expired, the lessor or supplier has the right to notify the lessee of that party's intention to cure the nonconforming delivery and then to make a conforming delivery within the time provided in the lease agreement. Com C §10513(a). If the lessor or supplier had a reasonable basis for expecting the lessee to accept a nonconforming tender, the lessor or supplier has an additional reasonable period to substitute a conforming tender as long as seasonable notice is given to the lessee. Com C §10513(b).

DRAFTING CONSIDERATIONS: The perfect tender rule and the lessor's right to cure a nonconforming delivery make it important for a lessor to include a provision in the lease agreement that establishes the time frame within which the lessor's performance is expected to occur and notice parameters for rejection by the lessee.

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§19.58 E. Lessee's Waiver of Objections to Nonconforming Delivery

If a lessee rejects goods, but fails to identify a defect that a reasonable inspection would have revealed and that the lessor or supplier could have cured if informed of the defect, the lessee is precluded from relying on that defect to justify the lessee's rejection or to establish that the lessor is in default. Com C §10514(a)(1).

If both the lessor and lessee are merchants, the lessor or supplier has the right to demand that the lessee provide a full written statement setting out each of the defects on which the lessee claims to rely in rejecting the goods. If a purported defect is omitted from the statement, the lessee is precluded from relying on it. Com C §10514(a)(2).

Similarly, if a lessee pays rent or some other consideration against documents in which a defect is apparent, the lessee waives the right to reject the goods on the basis of the defect unless payment is made with a reservation of rights. Com C §10514(b).

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IX. WARRANTY PROVISIONS

§19.59 A. Background

Before Division 10 was adopted, a significant amount of litigation centered around whether Division 2 warranty provisions were directly applicable to leasing transactions, applicable by analogy, or completely inapplicable. See Anno, *Application of Warranty Provisions of Uniform Commercial Code to Bailments*, 48 ALR3d 668. Division 10 settles this dispute by providing lessees with essentially the same warranty rights that Division 2 grants to buyers.

The specific warranty rights of a finance lessee or consumer lessee are discussed in §§19.32-19.33 and 19.39, respectively.

See chap 3 for further discussion of warranties in the context of sales transactions.

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§19.60 B. Express Warranties

The lessor and lessee are free to agree to whatever express warranties they consider to be appropriate in the transaction. Division 10 parallels Com C §2313 in Division 2 in this respect. Express warranties by the lessor are created as follows (Com C §10210(a)):

- An affirmation of fact or a promise by the lessor to the lessee that relates to the goods and becomes part of the basis of the bargain creates an express warranty that the goods will conform to that affirmation or promise;
- A description of the goods that is made part of the basis of the bargain creates an express warranty that the goods will conform to the description; and
- A sample or model that is made part of the basis of the bargain creates an express warranty that all the goods will conform to the sample or model.

Express warranties can be created without using the words "warrant" or "guarantee" and without the lessor's specifically intending to create a warranty. Com C §10210(b). Every lease agreement is likely to contain an express warranty by description simply because it is inevitably necessary to identify the goods being leased.

DRAFTING CONSIDERATIONS: If the lessor does not want aspects of the description to become part of a warranty, counsel for the lessor should carefully set forth the description in the lease agreement. For example, it may be appropriate to identify certain equipment by model and serial number without specifying its performance characteristics.

Because express warranties, by definition, are part of the basis of the bargain, it is difficult to disclaim them. Three techniques can be used to attempt to limit express warranties:

(1) It may be effective to include a merger clause in the lease agreement, stating that the agreement is the full and final expression of the parties' agreement. See §7.54 for an example of such a clause.

(2) It may be helpful to have the lessee represent and warrant to the lessor that the lessee has not relied on any affirmation, description, or sample from any agent of the lessor as part of the basis of the bargain. See §3.126 for an example of such a clause.

(3) Because technical specifications displace any inconsistent sample or model or general language, in some leases it may be possible to include specifications and thereby exclude certain other express warranties.

A simple affirmation of value or a statement that is identified merely as the lessor's opinion does not create an express warranty. Com C §10210(b).

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C. Implied Warranties

§19.61 1. Overview

Division 10 makes implied warranties of "quiet possession," "freedom from infringement," "merchantability," and "fitness for a particular purpose" potentially applicable to a leasing transaction. If the parties do not intend for the lessor to have responsibility for these types of warranties, the lease agreement should include appropriate disclaimers. See form 19.67-1.

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§19.62 2. Quiet Enjoyment

Every lease agreement, including a finance lease, includes an implied warranty that no person has a claim or interest in the goods arising through the lessor that will interfere with the lessee's ability to enjoy its leasehold interest. Com C §10211(a).

Although the warranty of quiet possession was abolished for the law of sales, the Commercial Code drafters reinstated the warranty for leases because a lessee that receives a mere right of possession and use of goods needs greater protection than a buyer. Cal Comment to Com C §10211. The warranty nevertheless is limited to claims resulting from the actions of the lessor.

In *Bancorp Group, Inc. v Michigan Conference of Teamsters Welfare Fund* (Mich Ct App 1998) 585 NW2d 777, a lessee who was already in arrears in its lease payments refused to make further payments once it discovered that the leased equipment could be seized in order to satisfy a judgment against the lessor for failure to pay the lessor's personal property taxes. The lessor sued for breach of the lease agreement based on the lessee's arrearages before the lessor discovered the city's claim against it for taxes. The court held as a matter of law that the lessor breached its implied warranty of quiet possession when the city acquired a claim or interest in the leased property due to the lessor's failure to pay its personal property taxes, which occurred before the execution of the lease agreement. The court upheld an award requiring that the lessee pay a rental value at the fair market price, rather than at the contract rate, for the time that it used the equipment.

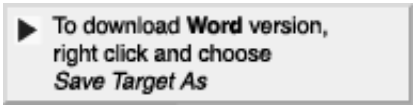
A similar, but somewhat broader, obligation arises under the Civil Code, which requires that, except as otherwise agreed in a lease agreement for a term longer than 20 days, a lessor must secure the lessee's quiet enjoyment of leasehold property against all lawful claimants. CC §1955. Thus, under this provision the lessor has an affirmative obligation to defend the lessee.

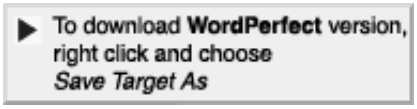
Outside the consumer lease context (see §19.39), it is unclear whether the broader quiet enjoyment covenant of CC §1955 is preempted by Com C §10211(a), because Com C §10104 does not state which law will govern in any context other than a consumer lease. Arguably, only the lessee in a consumer lease transaction has the benefit of the broader warranty contained in CC §1955, which does not have the action-of-the-lessor requirement.

The parties are permitted to disclaim the warranty against interference or infringement, but the disclaimer must be specific, in writing, and conspicuous. Com C §10214(d).

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§19.63 3. Form: Quiet Enjoyment Covenant





19.63-1 Quiet enjoyment covenant

Lessor covenants that as long as an event of default has not occurred, Lessee will quietly enjoy the Property and all rents, revenues, profits, and income from it, without interference by Lessor or any person lawfully claiming by or through Lessor.

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§19.64 4. Against Infringement

Except in a finance lease, if the lessor is a merchant who regularly deals in goods of the kind being leased, the Commercial Code creates an implied warranty in favor of the lessee that the goods are free of a rightful claim of infringement or the like. Com C §10211(b).

If the lessee provides the lessor or supplier with specifications for the goods, the lessor or supplier has an implied right of indemnity against the lessee for any claims of infringement or the like that arise out of compliance with the lessee's specifications. Com C §10211(c).

To exclude or modify a warranty against infringement, the language must be specific, in writing, and conspicuous, unless the circumstances, including course of performance, course of dealing, or usage of trade, give the lessee reason to know that the goods are being leased subject to the claim or interest of any third person. Com C §10214(d).

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§19.65 5. Merchantability

Division 10 creates an implied warranty of merchantability, parallel to that in Division 2, when the lessor, other than in a finance lease (see §19.32), is a merchant who regularly deals in goods of the kind being leased. See Com C §§10212(a), 2314(1). On Division 2 warranties generally, see chap 3. The warranty of merchantability under Division 10 includes the same elements that are found in the warranty of merchantability under Division 2. See Com C §§10212(b), 2314(2). A warranty of merchantability may be disclaimed, but the disclaimer must mention "merchantability," be in writing, and be conspicuous. Com C §10214(b). The warranty may also be excluded by conspicuous written statements like "as is," "with all faults," or other expressions that call the lessee's attention to the fact that there are no implied warranties. Com C §10214(c)(1).

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§19.66 6. Fitness for Lessee's Particular Purposes

Division 10 adopts the same standard for finding an implied warranty of fitness for a particular purpose that is found in Division 2. See Com C §§10213, 2315. Thus, if the lessor has reason to know of the lessee's purpose for leasing the goods and that the lessee is relying on the lessor to provide goods suitable for that purpose, the lessor is held to have made a warranty that the goods are in fact suitable for that purpose.

The Civil Code contains a somewhat broader warranty of fitness. Civil Code §1955 provides that, except as otherwise agreed in a lease agreement for a term longer than 20 days, the lessor is responsible for putting the property into a condition fit for the purpose for which it has been leased, thus creating an affirmative obligation to make the goods conform to the lessee's use. As discussed in §19.62 with regard to the warranty of quiet enjoyment, outside the consumer lease context it is unclear whether Division 10 displaces CC §1955.

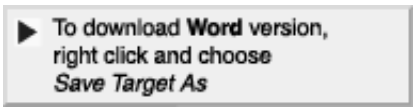
The parties are permitted to disclaim a warranty of fitness. To do so, however, the disclaimer must be in writing and conspicuous. Com C §10214(b). Although it is not necessary to mention the phrase "fitness for a particular purpose" in the disclaimer, the Commercial Code expressly recognizes the sufficiency of a disclaimer that states that "there is no warranty that the goods will be fit for a particular purpose." Com C §10214(b). As with the warranty of merchantability (see §19.65), the warranty of fitness may also be disclaimed by conspicuous written statements like "as is," "with all faults," or other expressions that call the lessee's attention to the fact that there are no implied warranties. Com C §10214(c).

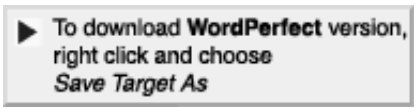
DRAFTING CONSIDERATIONS: The attorney should consider whether the lease agreement should disclaim any warranty that the equipment is in compliance with any applicable government requirements or regulations. The agreement may also disclaim any warranty by the lessor regarding the characterization of the lease for tax, accounting, or other purposes.

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Source: Business Law/California UCC Sales and Leases/19 Leasing of Goods/§19.67 7. Form: Disclaimer of Implied Warranties

§19.67 7. Form: Disclaimer of Implied Warranties





19.67-1 Disclaimer of implied warranties

THE PROPERTY WILL BE LEASED "AS IS" AND "WHERE IS." LESSOR HAS NOT MADE, MAY NOT BE CONSIDERED TO HAVE MADE, AND SPECIFICALLY DISCLAIMS:

(1) ANY EXPRESS OR IMPLIED REPRESENTATION OR WARRANTY WITH RESPECT TO THE PROPERTY, REGARDING TITLE, CONDITION, DESIGN, OPERATION, MERCHANTABILITY, FREEDOM FROM CLAIMS OF INFRINGEMENT OR THE LIKE, FITNESS FOR USE FOR A PARTICULAR PURPOSE, QUALITY OF MATERIALS OR WORKMANSHIP, OR ABSENCE OF DISCOVERABLE OR NONDISCOVERABLE DEFECTS; AND

(2) ANY OTHER EXPRESS OR IMPLIED REPRESENTATION OR WARRANTY WITH RESPECT TO THE PROPERTY (INCLUDING ANY IMPLIED WARRANTY ARISING FROM A COURSE OF PERFORMANCE, COURSE OF DEALING, OR USAGE OF TRADE).

LESSEE WAIVES, RELEASES, RENOUNCES, AND DISCLAIMS EXPECTATION OF OR RELIANCE ON ANY SUCH WARRANTY OR WARRANTIES.

LESSOR WILL NOT HAVE ANY RESPONSIBILITY OR LIABILITY TO LESSEE OR ANY OTHER PERSON, WHETHER ARISING IN CONTRACT OR TORT, OUT OF ANY NEGLIGENCE OR STRICT LIABILITY OF LESSOR OR OTHERWISE, FOR:

(1) ANY LIABILITY, LOSS, OR DAMAGE CAUSED OR ALLEGED TO BE CAUSED DIRECTLY OR INDIRECTLY BY THE PROPERTY; BY ANY INADEQUACY, DEFICIENCY, OR DEFECT OF THE PROPERTY; OR BY ANY OTHER CIRCUMSTANCES IN CONNECTION WITH THIS LEASE;

(2) THE USE, OPERATION, OR PERFORMANCE OF THE PROPERTY OR ANY RISKS RELATING TO IT;

(3) ANY CONSEQUENTIAL DAMAGES, INCLUDING THOSE FOR INTERRUPTION OF SERVICE, LOSS OF BUSINESS, OR ANTICIPATED PROFITS; OR

(4) THE DELIVERY, OPERATION, MAINTENANCE, REPAIR, IMPROVEMENT, OR REPLACEMENT OF THE PROPERTY.

Comment: To be effective, warranty disclaimers must appear clear and conspicuous (*e.g.,* capitalized or in boldface type) and should follow the disclaimer rules for sales transactions. *Bailey v Tucker Equip. Sales, Inc.* (Ga Ct App 1999) 510 SE2d 904. See the discussion of warranty disclaimers in chap 3. The test of "conspicuousness" is "whether attention can reasonably be expected to be called to [the term]." Official Comment 10 to UCC §1-201. See also *Dorman v International Harvester Co*. (1975) 46 CA3d 11, 18, 120 CR 516 (court in sales transaction determined disclaimer to be inconspicuous because, among other things, attempted disclaimer lacked heading, such as "DISCLAIMER OF WARRANTIES").

The parties may also include a disclaimer of the warranty of quiet enjoyment so as to limit the obligations of the lessor to the express covenant of quiet enjoyment set out in the lease agreement. See §§19.61-19.62. Such a disclaimer may be expressed as "freedom from interference."

Note that the court in *Westlye v Look Sports, Inc.* (1993) 17 CA4th 1715, 22 CR2d 781, upheld a disclaimer of implied warranties in a snow ski rental agreement, but found that the lessor may still be liable under the doctrine of strict liability, because a disclaimer of strict liability is void as against public policy. It is unclear whether this case is limited to consumer leases.

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X. ALIENATION, DELEGATION, ASSIGNMENT, AND SUBLEASE

§19.68 A. Restrictions on Alienation as Disfavored

The rules that govern a party's right to transfer a leasehold interest reflect the Commercial Code policy favoring free alienability. The policy in turn reflects the commercial reality that the financing of leases is an important economic activity; to restrict it would hamper economic growth.

Division 10 generally gives effect to a transfer notwithstanding its prohibition by the lease agreement. Although this principle is simple enough, the rules can be somewhat complex and may vary depending on whether the transfer in question is (1) a sublease by the lessee, (2) an assignment of rights and delegation of duties, (3) the grant of a security interest, (4) the foreclosure of a security interest, or (5) the transfer of a right to receive payments or damages. To create an enforceable restriction on transfer, the parties must draft their lease provision with the Code's standards in mind. See form 19.71-1.

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§19.69 B. Subleases

If a lease agreement prohibits the lessee from entering into a sublease, and the lessee subleases the goods in violation of the agreement, the sublease is generally considered to be effective, but the lessee-sublessor is in breach of the lease agreement and subject to the remedies set forth in the agreement and to certain Division 10 remedies, including damages and cancellation of the lease contract or an injunction against the transfer. Com C §10303(b), (d)(1).

If the lease agreement does not contain an express prohibition on subleasing, a lessee is permitted to sublease the goods unless the sublease will materially impair the lessor's prospect of obtaining return performance or materially change the lessor's duties, burdens, or risks. Com C §10303(d)(2).

For details about actions and remedies related to unlawful motor vehicle subleasing, see CC §3343.5.

DRAFTING CONSIDERATIONS: Subleasing issues are common in transactions involving many types of equipment. The scope of authority granted, and the nature of the restrictions, tends to vary from one industry to the next. The attorney should be careful to understand the relevant considerations for the specific type of equipment being leased and make sure that the lease agreement clearly spells out any desired restrictions.

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§19.70 C. Assignment and Delegation

If the lease agreement prohibits assignment or makes it an event of default, an assignment generally will still be effective, but the nonassigning party will have whatever remedies the lease agreement provides for its breach. This rule applies both to an assignment by the lessor or lessee of their interest in the lease and to an assignment by the lessor of its residual interest in the leased goods. Com C §10303(b).

One instance in which a prohibition will be enforced, however, is when the transfer involves the actual delegation of a material performance of either party. Com C §9407(b)(2), (c). See §19.74.

In the context of a typical "net" lease, in which the lessee undertakes responsibility for virtually all matters relating to the goods and the lessor's remaining performance relates primarily to honoring the covenant of quiet enjoyment, no material performance remains for the lessor. Consequently, a prohibition on assignment by the lessor in a net lease most likely will not be enforceable.

In certain types of operating leases, in which the lessor agrees to undertake responsibilities such as performing repairs or providing some related service, the lessor's remaining performance may be considered material and the restriction on assignment is likely to be effective.

Suppose a lessor with an express right of disapproval disapproves a proposed assignment by a lessee, but the circumstances make disapproval arguably unreasonable. At least one court, applying California law, has held that such a lessor may be held liable to the lessee for any damages resulting from the refusal to permit the assignment. *E.D.S. Corp. v W.A. Foote Mem. Hosp., Inc*. (6th Cir 1994) 25 F3d 406.

If the lease does not prohibit assignment or make it an event of default, the nonassigning party may still have a claim for relief if the assignment materially impairs the prospect of obtaining return performance, materially changes the nonassigning party's duties, or increases the burdens or risks imposed on it. Com C §10303(d)(2). The assignor in that situation could be liable for damages caused by the assignment (to the extent they could not reasonably be prevented by the nonassigning party). Other appropriate relief might be the cancellation of the lease contract or an injunction against the assignment. Com C §10303(d)(2)(C)-(D).

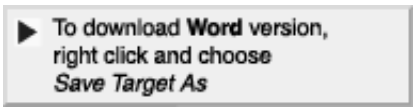
An assignment of "the lease" or of "all my rights under the lease" is both a transfer of rights and a delegation of duties, unless the language of the assignment or the circumstances indicate otherwise. For example, in an assignment for security only, the secured party is given rights under the lease as security for the assignor's performance of an obligation but has no duties to perform. In all other instances, the assignee's acceptance constitutes a promise to perform the assignor's duties under the lease. This promise is enforceable both by the assignor and the other party to the lease contract. Com C §10303(e).

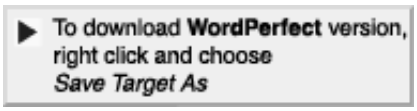
Unless otherwise agreed, however, a delegation of performance does not relieve the transferor of any duty to perform or of any liability for default. Com C §10303(f).

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Source: Business Law/California UCC Sales and Leases/19 Leasing of Goods/§19.71 D. Form: Restrictions on Transfer

§19.71 D. Form: Restrictions on Transfer





19.71-1 Restrictions on transfer

LESSEE MAY NOT SUBLET OR TRANSFER POSSESSION OF THE PROPERTY WITHOUT THE PRIOR WRITTEN CONSENT OF LESSOR, WHICH _ _[*MAY NOT BE UNREASONABLY WITHHELD OR DELAYED/MAY BE WITHHELD IN THE SOLE AND ABSOLUTE DISCRETION OF LESSOR*]_ _. LESSEE MAY NOT ASSIGN, PLEDGE, OR OTHERWISE ENCUMBER THIS LEASE.

With respect to any sublease or transfer of possession of the Property, the rights of the sublessee or transferee will be subject and subordinate to all the terms of this Lease, including Lessor's right of repossession on the occurrence of an event of default. Lessee will remain primarily liable for the performance of all the terms of this Lease to the same extent as if the sublease or transfer of possession had not occurred.

Lessor will have the right, at Lessor's sole expense, to assign, sell, or encumber any part of Lessor's interest in the Property or in this Lease and any proceeds of the disposition of that interest, subject to Lessee's rights under this Lease. To effect or facilitate such assignment, sale, or encumbrance, Lessee agrees to provide, at Lessor's sole expense, all agreements, consents, conveyances, or documents that may be reasonably requested by Lessor, including an unrestricted release of Lessor from Lessor's obligations under this Lease. That release will not release Lessor from any liability that arose before the assignment or sale.

Any person who succeeds to the rights and interests of Lessor under this clause will agree to be bound by the terms of this Lease without alteration.

Lessee acknowledges that an assignment, sale, or encumbrance of Lessor's interest would not materially change Lessee's duties under the Lease or materially increase Lessee's burdens or risks. Even if such a transfer could be deemed to have that effect, Lessee agrees that the assignment, sale, or encumbrance will nevertheless be permitted.

Without prejudice to any rights that Lessee may have against Lessor, Lessee agrees that Lessee will not assert against an assignee any claim or defense that Lessee may have against Lessor.

The agreements, covenants, obligations, and liabilities contained in this clause, including, but not limited to, all obligations to pay rent and to indemnify each indemnitee, are made for the benefit of the indemnitees and their respective successors and assignees.

Comment: In a consumer lease, language prohibiting the transfer of an interest or making a transfer an event of default must be specific, in writing, and conspicuous. Com C §10303(g). Consequently, the first paragraph of this clause is in capital letters.

The assignment provision in an equipment lease often proves to be controversial. Lessees seldom need assignment rights, with the possible exception of the right to assign the lease to an affiliate or in connection with a business acquisition transaction, and lessors are hesitant to grant them. The lessor usually regards the identity of the lessee as integral to the pricing of the lease, and does not want to lose control over who is the lessee after the lease terms are agreed on. When flexibility is required with respect to the period of time the lessee is committed to keep and use the equipment, the flexibility can usually be accomplished through an option to terminate the lease early or to sublease the equipment. An early termination provision usually involves a payment to the lessor that will allow the lessor to achieve the expected return for the transaction. Depending on the type of equipment and the particular industry's practice, subleasing rights for a lessee may be covered as simply as reflected in the preceding form, or may involve complex and detailed criteria. In either case, a sublease allows the lessee to pass the right to use the equipment (which may be in excess of the lessee's needs at the time) to another party (in exchange for rent payments), while leaving the lessee

as the party primarily responsible to the lessor for performing the terms of the lease. In other words, the lessee is expected to perform the lease obligations whether or not the sublessee performs. In comparison, the lessor almost always seeks the maximum amount of assignment flexibility possible. This flexibility helps ensure that the lessor retains the ability to liquidate the investment in the equipment at any time and pledge the lease and equipment to secure the lessor's financing.

Most lessees are not eager to allow the lessor such flexibility, preferring to preserve the relationship with the lessor involved only for administrative purposes such as billing, dealing with the lessee's concerns, assisting in renegotiating lease terms, and so forth. Furthermore, even if the lessor's role in the transaction is quite passive, the lessee nevertheless has a significant interest in the lessor's creditworthiness and ability to perform the covenant of quiet enjoyment. If the lease contains a purchase option, particularly one at a bargained-for fixed price, the lessee may have an even stronger interest in holding the originally-contracting lessor liable under the lease contract for any nonperformance by an assignee. Lessees must bear in mind that a lessor who files a petition under the Bankruptcy Code has the right to reject the lease, leaving the lessee with an unsecured claim for damages in the bankruptcy proceeding. See §§19.125-19.130. In balancing the interests of the lessor and the lessee, it is important to distinguish between an outright assignment of the lessor's interest in the lease and an assignment made for security. Although the lessee may have a number of legitimate concerns with respect to the former type of assignment and may successfully require that an outright assignee meet certain criteria (such as creditworthiness and industry experience), the lessee is generally protected in full with respect to a security assignment by requiring the security assignee to acknowledge that the lessee is entitled to quietly enjoy the leased property as long as no default under the lease has occurred.

Leases often contain provisions whereby the lessee waives, or agrees not to assert against an assignee, any defenses and claims it may have against the lessor. Under Com C §9403(b), such provisions are enforceable by the assignee who pays value, in good faith, and without notice of any claim or defense.

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§19.72 E. Grant of Security Interest

Commercial Code policy strongly disfavors any restriction on a party's freedom to pledge its interest in the lease as a security interest. Thus, even if the lease agreement expressly prohibits such an encumbrance, the restriction is not only ineffective as to the rights of a third party to whom the security interest has been granted but also ineffective between the lessor and lessee. Com C §10303(c). This provision is consistent with the commercial reality that lessors commonly finance their acquisition of goods by pledging their interest in the lease agreement and in the leased goods as collateral to a lender. It is customary for the lessee to receive a "quiet enjoyment letter" from the lender to the lessor. See form 19.73-1. Such a letter sets forth the lender's promise to the lessee that the lessee will be entitled to quietly enjoy use of the equipment unless the lessee defaults in performing its obligations under the lease.

For these purposes, the lease constitutes "chattel paper" as defined in Com C §9102(11). To protect its security interest in the lease against potential claims by other creditors, the secured party should comply with the perfection requirements of Division 9 for chattel paper. A security interest in chattel paper may be perfected by either filing or possession. See Com C §§9312(a), 9313(a); Secured Transactions in California Commercial Law Practice §§3.41, 3.60-3.62 (2d ed Cal CEB 2001). Under Com C §9330, however, a purchaser of chattel paper meeting certain requirements has priority over a holder of a security interest in the chattel paper that is perfected by filing only. Thus, lease financiers strongly prefer clearly designating the counterpart of the lease agreement that constitutes the "chattel paper original" and taking possession of that counterpart to avoid the risk of conflict with a subsequent purchaser.

PRACTICE TIP: If the security includes the lessor's residual interest in the leased goods in addition to the right to receive rental payments, the secured party should file a financing statement to perfect its interest. A lessor's assignee should also file a financing statement against the lessor's inventory because any equipment returned to, or repossessed by, the lessor probably would be considered inventory (Com C §9102(48)) and therefore subject to blanket liens.

Although not required to do so, a lessor may file a precautionary financing statement for leased equipment. Such a filing will not be considered evidence that the lease was intended as security, but if the lease is later determined to have been a security transaction, the lessor's interest in the equipment will have been perfected by the filing. Com C §9505. As a practical matter, in many instances such a filing will prevent the "lease or security interest" issue from being raised. See §19.4.

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§19.73 F. Form: Quiet Enjoyment Letter

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19.73-1 Quiet enjoyment letter

_ _[*Letterhead of mortgagee*]_ _

LETTER OF QUIET ENJOYMENT

_ _[*Date*]_ _
_ _[*Name of lessee*]_ _
_ _[*Address*]_ _

Ladies and Gentlemen:

Reference is made to (1) the _ _[*e.g., Aircraft Lease Agreement*]_ _ (the Lease), dated as of _ _[*date*]_ _, between _ _[*name of lessor*]_ _ (Lessor) and _ _[*name of lessee*]_ _ (Lessee); (2) the Mortgage, dated as of _ _[*date*]_ _, between Lessor and _ _[*e.g., name of bank, as Administrative Agent*]_ _ (Mortgagee); (3) the Assignment of Lease, dated as of _ _[*date*]_ _, between Lessor and _ _[*e.g., name of bank, as Administrative Agent*]_ _ (Assignee); and (4) the Acknowledgment of Lessee (the Lessee Consent), dated as of _ _[*date*]_ _. Capitalized terms used in this letter and not otherwise defined herein shall have the meanings assigned to them in the Lease.

In consideration of Lessee's agreements set forth in paragraph _ _[*reference to "assignment" clause*]_ _ of the Lease and in the Lessee Consent, the undersigned, as Mortgagee and as Assignee

[*If appropriate, add*]

for itself and for the other Lenders,

[*Continue*]

hereby covenants that:

(a) As long as no Event of Default shall have occurred and be continuing under the Lease, and then only in accordance with the provisions of the Lease, neither Assignee nor any person acting through Assignee will take or cause to be taken any action inconsistent with Lessee's quiet enjoyment of, or otherwise in any way interfere with or interrupt the continuing use, operation, and possession of the Equipment provided for in the Lease;

(b) Until such time as Lessee has received a notice (a Lessor Rights Notice) from Assignee stating that Assignee has succeeded to the rights of Lessor under the Lease to exercise and receive any of the claims, rights, powers, privileges, remedies, and other benefits of Lessor as "Lessor" under the Lease (collectively, "Lessor's Rights and Powers"), Lessee shall be entitled to acknowledge and rely on the exercise by Lessor of all of Lessor's Rights and Powers, and any consent, notice, approval, amendment, waiver, or release or other exercise of Lessor's Rights and Powers by Lessor shall be binding on Lessor and Assignee for all purposes;

(c) Assignee's exercise at any time of Lessor's Rights and Powers shall be subject to all of the terms and conditions of the Lease, to the same extent as if exercised by Lessor; and

(d) Any Security Deposit or Letter of Credit or insurance payments under any policy maintained by Lessee pursuant to paragraph _ _[*reference to "security" clause*]_ _ of the Lease received or held by Assignee from time to time shall be held subject to the terms of the Lease and shall be applied only in the manner permitted under the terms of the Lease.

This letter has been delivered in the State of _ _[*specify jurisdiction whose law governs*]_ _ and shall be governed by and construed in accordance with the laws of the State of _ _[*specify*]_ _.

_ _[*Name of bank*]_ _,
as Administrative Agent, Mortgagee, and Assignee
By: __[*Signature*]__
Title: _ _ _ _ _ _

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§19.74 G. Foreclosure of Security Interest

If a lessor grants a security interest in its leasehold interest that is subsequently foreclosed on, the transfer effected by the foreclosure is essentially an assignment and delegation by the lessor. A restriction on transfer by foreclosure is enforceable against the lessor only to the extent that the lessor had a material remaining performance. Com C §9407(b)(2), (c).

The rules regarding foreclosure of a security interest granted by the lessee are somewhat different. A lease provision making foreclosure an event of default by the lessee would be given effect. Com C §9407. The lessor then would have the right to exercise its remedies under the lease and under Division 10. Com C §10303(d)(1). See §§19.106-19.112 for discussion of Division 10 remedies.

If the lease has no provision concerning foreclosure of a security interest granted by the lessee, it is still possible that the foreclosure would entitle the lessor to a claim for relief. If the foreclosure would materially impair the lessor's prospect of obtaining performance, materially change its duty, or increase its burden or risk, the lessor would be entitled to the remedies provided in Com C §10303(d)(2). These remedies include damages, cancellation of the lease agreement, and injunctive or other appropriate relief. Com C §10303(d)(2)(C)-(D).

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Source: Business Law/California UCC Sales and Leases/19 Leasing of Goods/§19.75 H. Transfer of Rights to Payments or Damages

§19.75 H. Transfer of Rights to Payments or Damages

Division 10 broadly protects the alienation of a right to receive payments under a lease or the right to receive damages from the other party's default. A provision in the lease agreement that attempts to prohibit such a transfer by either the lessor or lessee is simply not enforceable. Com C §10303(c).

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I. Priorities Among Conflicting Claimants

§19.76 1. Overview

Because Division 10 gives effect to some transfers (see §19.68) that are made in violation of a lease agreement (even though one party may have a right to receive damages or exercise remedies against the other party), conflicting claims to the goods may arise between the transferee and the nondefaulting lessor or lessee. Conflicting claims may arise in other contexts as well, which are discussed in §§19.77-19.81.

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§19.77 2. When Lessor Sells Goods

The sale of leased goods is quite common either close to the inception of a lease or during the middle of its term. As a practical matter, the constraints on any sale are among the negotiated points in a lease. The sale is governed by Division 2 (Com C §2403).

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§19.78 3. When Lessor Subsequently Leases Goods

As a general rule, a subsequent lease of the same goods by a lessor will not disturb the original lessee's right to possession and use. The subsequent lessee's interest remains subject to the terms of the existing lease. Instead, the effect of the subsequent lease is to convey the lessor's remaining rights, such as the right to receive rentals from the original lessee. Com C §10304(a).

The only circumstances in which a subsequent lessee will take free of the existing lease contract are (a) when the original lessee "entrusted" the leased goods to the lessor (Com C §10304(b); see §19.80) or (b) when the lessor is disposing of the goods following a default by the original lessee (Com C §10527(d)).

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§19.79 4. When Lessee Subleases Goods

A sublessee's interest is subject to the terms of the existing lease and, therefore, the sublessee obtains only the interest that the lessee had or had the power to transfer. Com C §10305(a). Accordingly, the lessor retains the right to take possession of the goods at the end of the term of the original lease, or to repossess or otherwise enforce the terms of the original lease, without regard to the terms of the sublease.

There are two circumstances, however, in which a sublessee's interest may be greater than the original lessor's interest:

- If the original lessor "entrusted" the goods to the lessee, and the lessee is a merchant, a sublessee in the ordinary course of business obtains all the original lessor's and lessee's rights to the goods. Com C §10305(b). See §19.81.
- If the sublessee is disposing of rejected goods for the lessor's account, a good faith purchaser of the goods takes them free of the lessor's interest, even if the sublessee failed to comply with Division 10 requirements in making the disposition. Com C §10511(d).

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§19.80 5. When Lessee Sells Goods

A purchaser from a lessee is treated in essentially the same manner as a sublessee; the purchaser takes only the interest in the goods that the lessee possessed. Com C §10305(a). A purchaser from a lessee can, however, obtain rights that are superior to those of the original owner-lessor in two circumstances:

- If the original lessor "entrusted" the goods to the lessee, and the lessee is a merchant, a purchaser from the lessee in the ordinary course of business obtains all the original lessor's and lessee's rights to the goods. Com C §10305(b). See §19.81.
- If the lessee is disposing of rejected goods for the lessor's account, a good faith purchaser of the goods takes them free of the lessor's interest, even if the lessee failed to comply with Division 10 requirements in making the disposition. Com C §10511(d).

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§19.81 6. When Goods Are Entrusted

The concept of "entrusting" also arises, and the term is defined, in Com C §2403 under Division 2. For discussion, see §§12.11-12.14. If a party entrusts goods to a merchant, and the merchant leases, subleases, or sells the goods to a third party in the ordinary course of business (Com C §10103(a)(1), (15)), the lessee, sublessee, or buyer obtains all the lessor's and merchant's rights to the goods and takes free of the existing lease agreement. Com C §§10304(b), 10305(b). This reflects the Commercial Code policy favoring a good faith transferee in the ordinary course of business over the party who made the mistake of entrusting the goods, even though that party's interest was first in time. See *Mercedes-Benz Credit Corp. v Johnson* (2003) 110 CA4th 53, 1 CR3d 396 (delivery of leased goods to lessee dealer is not entrustment of goods that would enable dealer to transfer good title to third party purchaser).

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§19.82 J. Rights of Possessory Lienholder

If someone in the ordinary course of his or her business furnishes services or materials with respect to leased goods, a lien on those goods in the possession of that person takes priority over any interest of the lessor or lessee under the lease contract or under Division 10, unless statute or rule of law creating the lien provides otherwise. Com C §10306. This is similar to the treatment given possessory lienholders under Division 9. See Com C §9333.

DRAFTING CONSIDERATIONS: To protect the lessor against the competing claims of a possessory or other lienholder, it is advisable to include a provision in the lease agreement that obligates the lessee to keep the goods free of liens. See form 19.83-1.

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Source: Business Law/California UCC Sales and Leases/19 Leasing of Goods/§19.83 K. Form: Covenant to Keep Free of Liens

§19.83 K. Form: Covenant to Keep Free of Liens

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19.83-1 Covenant to keep free of liens

Lessee will not directly or indirectly create, incur, assume, or suffer to exist any lien on the Property, Lessee's title, or any interest in the lien, except for:

(1) The respective rights of Lessor and Lessee under this Lease;

(2) Liens granted by Lessor with respect to the Property;

(3) Liens for taxes either not yet due or being contested in good faith by Lessee as long as adequate reserves are maintained with respect to those liens and the Property is not, in Lessor's reasonable opinion, in danger of being sold, confiscated, forfeited, or seized as a result of the liens; and

(4) Inchoate material persons', mechanics', workers', repair persons', employees', or other like liens arising in the ordinary course of business, which either are not delinquent or are being contested in good faith by Lessee, as long as the Property is not, in Lessor's reasonable opinion, in danger of being sold, confiscated, forfeited, or seized as a result of the liens.

Lessee will promptly, at Lessee's sole expense, take any action that may be necessary to discharge any lien (except for the liens referred to in paragraphs (1) and (2)) arising at any time with respect to the Property.

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§19.84 L. Rights of Lessee's Creditors

As a general rule, the rights of a creditor of the lessee are subject to the lease agreement. Com C §10307(a). In other words, a lessee's creditor has rights vis-à-vis the lessor that are no greater than the rights of the lessee. The one exception to this rule is the possessory lienholder, discussed in §19.82.

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M. Rights of Lessor's Creditors

§19.85 1. As Subject to Lease; Exceptions

As a general rule, the rights of a creditor of the lessor are subject to the lease agreement. Com C §10307(b). However, there are several exceptions to this rule in addition to the exception for a possessory lienholder (see Com C §10306, discussed in §19.82). In the following instances, the lessor's creditor is granted priority over the lessee:

- When the creditor has a lien (see Com C §10103(a)(18)) that attached to the goods before the lease agreement became enforceable (Com C §10307(b));
- When the creditor has a security interest that the lessee knew of before the lessee gave value under the lease agreement and took possession of the goods (Com C §9317(c));
- When the creditor has a security interest that was perfected before the lease agreement became enforceable (Com C §9317(c)); and
- When the lease constitutes a fraudulent conveyance (Com C §10308).

Despite this general rule, a lessee in the ordinary course of business (see Com C §10103(a)(15)) is permitted to take the leasehold interest free of a preexisting security interest even if the security interest is perfected and the lessee knows of its existence. Com C §9321(c).

Generally, a lessee of goods, other than a lessee in the ordinary course of business, takes the leasehold interest free of a security interest to the extent that it secures advances made after the earlier of either of the following (Com C §9323(f)):

- The time the secured party acquires knowledge of the lease.
- Forty-five days after the lease contract becomes enforceable.

However, the rule stated in Com C §9323(f) does not apply if the advance is made pursuant to a commitment entered into without knowledge of the lease and before the expiration of the 45-day period. Com C §9323(g).

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§19.86 2. Pledge of Lease as Collateral

Frequently in leasing transactions, the lessor will finance its operations by pledging its leases as collateral to secure a loan from a financier. In order to assure the financier that the leases have value as collateral, the leases are usually structured to include a "hell or high water" clause (see §19.35), making the lessee's obligation to pay rent independent of the lessor's performance. In addition, the lease usually includes a waiver by the lessee of the right to assert against the financier/assignee any of the defenses to payment that the lessee may have against the lessor. (See §19.71 and Com C §9403(b).) Courts have generally found such arrangements effective to require the lessee to continue to perform its obligations under the lease, even when the lessor has breached a material covenant (*e.g.,* quiet enjoyment). *Benedictine College, Inc. v Century Office Prods., Inc.* (D Kan 1994) 853 F Supp 1315, 1324; *Citicorp of N. Am. v Lifestyle Communications Corp.* (SD Iowa 1993) 836 F Supp 644, 655; *Colorado Interstate Corp. v CIT Group/Equip. Fin., Inc.* (10th Cir 1993) 993 F2d 743.

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XI. Fixtures and Accessions

A. Conflicting Interests in Fixtures

§19.87 1. Overview; Definitions

Division 10 establishes detailed rules for determining the priority of conflicting interests in leased fixtures (see §19.88).

It is extremely important for the lessor of goods that may become fixtures to take the steps necessary to protect its interests. Failure to do so can result in the lessor's losing all rights in the property (CC §1013) or being liable to the owner of the real property to which the fixtures are attached for damages resulting from the attachment or removal of the fixtures. CC §1013.5.

The following definitions are pertinent:

- Goods are "fixtures" when they become so related to particular real property that an interest in them arises under real property law. Com C §10309(a)(1). Ordinary building materials incorporated into an improvement do not qualify. Com C §10309(b).
- A "fixture filing" is the filing, in the office where a record of the mortgage on the real property would be recorded, of a financing statement covering goods that are or are to become fixtures and conforming to the requirements of Com C §9502(a)-(b). Com C §10309(a)(2).
- A lease is a "purchase money lease" unless the lessee has possession and use of the goods, or a right of possession and use, before the lease contract becomes enforceable. Com C §10309(a)(3).
- A mortgage is a "construction mortgage" to the extent it secures an obligation incurred for the construction of an improvement on land including the acquisition cost of the land, if the recorded writing so indicates. Com C §10309(a)(4).
- "Encumbrance" includes real property mortgages and other liens on real property and all other rights in real property that are not ownership interests. Com C §10309(a)(5).

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§19.88 2. Priority Rules

A lessor of fixtures has priority over a conflicting interest of an encumbrancer or owner of the real property if:

- The lease is a purchase money lease, the conflicting interest arises before the goods become fixtures, a fixture filing is filed before the goods become fixtures or within 20 days afterwards, and the lessee has an interest of record in the real property or is in possession of it. Com C §10309(d)(1). However, the lessor's interest will be subordinate to the interest of a construction mortgagee whose encumbrance was recorded before the goods became fixtures if the goods became fixtures before the construction was complete. Com C §10309(e). For definitions, see §19.87.
- A fixture filing is made before the interest of the encumbrancer or owner is of record (this also gives the lessor priority over a predecessor in title of the encumbrancer or owner). Com C §10309(d)(2).
- The fixtures are readily removable factory or office machines, readily removable equipment that is not primarily used in the operation of the real property (*e.g.,* heating or air-conditioning equipment), or readily removable replacements of domestic appliances that are goods subject to a consumer lease. Com C §10309(d)(3).
- The conflicting interest is a lien on the real property obtained after the lease contract became enforceable. Com C §10309(d)(4).
- The encumbrancer or owner has consented in writing to the lease or has disclaimed an interest in the goods as fixtures. Com C §10309(d)(5). See form 19.90-1.
- The lessee has a right to remove the goods as against the encumbrancer or owner. If the lessee's right to remove terminates, the priority of the lessor's interest continues for a reasonable time. Com C §10309(d)(6).

If none of the above rules applies to the situation, priority is determined by the priority rules governing conflicting interests in real property. Com C §10309(f).

When the lessor's interest has priority over all others, the lessor may remove the goods free and clear when the lease terminates or in enforcement of its rights. If removal causes damage to the real property, however, encumbrancers (excluding the lessee) must be reimbursed for the cost of repairing the damage. There is no right of reimbursement for any diminution in the value of the real property caused by the absence of the fixtures or by the necessity of replacing them. In addition, if the encumbrancer has otherwise agreed to be responsible for costs related to the removal of fixtures (*e.g.,* in the consent to the lease), the encumbrancer does not have a right of reimbursement. Any party having a right of reimbursement can refuse to allow the removal of the goods until the removing party provides adequate security for performance. Com C §10309(g).

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Source: Business Law/California UCC Sales and Leases/19 Leasing of Goods/§19.89 3. Requirements for Fixture Filings

§19.89 3. Requirements for Fixture Filings

Fixture filings (for definition, see §19.87) are made in the county office where a mortgage on the real property would be recorded. Com C §10309(a)(2). The filing must:

- Cover the goods that are or are to become fixtures;
- State that it is to be filed in the real property records;
- Contain a description of the real property; and
- Show the name of a record owner of the real property if the debtor does not have an interest of record.

See Com C §§9334(c), 9501(a)(1)(B), 9502(b); Secured Transactions in California Commercial Law Practice §§3.96-3.98 (2d ed Cal CEB 2001).

PRACTICE TIP: A prudent lessor will continue to make a "fixture filing" in the real property records if the leased equipment is (or might become) a fixture. Lessors may also wish to obtain landlord and mortgagee waivers to assure themselves of the priority afforded by Com C §10309(d)(5) and avoid any argument as to facts required for such priority under Com C §10309(d)(1)-(4) and (6).

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§19.90 B. Form: Landlord's Waiver

To download **Word** version, right click and choose *Save Target As*

To download **WordPerfect** version, right click and choose *Save Target As*

19.90-1 Landlord's waiver

WAIVER AND AGREEMENT

This Waiver and Agreement is made by and between _ _[*name of owner, landlord, or mortgagee*]_ _ **(Undersigned) and** _ _[*name of lessor*]_ _ **(Lessor) as of** _ _[*date*]_ _**.**

Undersigned is the _ _[*owner/landlord/mortgagee*]_ _ **of the premises located at** _ _[*address*]_ _ **(Premises) and** _ _[*e.g., has leased all or part of, or holds a mortgage on,*]_ _ **the Premises leased to** _ _[*name of lessee*]_ _ **(Lessee).**

Under a lease agreement between Lessor and Lessee dated _ _[*date*]_ _ **(Lease), and incorporated by reference, Lessee has leased or will lease from Lessor the following property (Property):** _ _[*Describe leased property*]_ _**.**

To induce Lessor to enter into the Lease and for other valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Undersigned agrees as follows:

(1) The Property will remain personal property regardless of the manner or mode of its attachment to the premises and will not become fixtures.

(2) Any claim that Lessor or Lessor's assignees may have with respect to the Property is superior to any lien, right, or claim of any nature that Undersigned may have with respect to the Property by law, agreement, or other cause.

(3) Undersigned expressly waives every right that _ _[he*/she/it*]_ _ **may have under law, or by virtue of any agreement, now in effect or hereafter executed, to levy on or distrain the property for rent (in arrears, in advance, or both) or to claim or assert title to the property.**

(4) This Waiver and Agreement will also apply to any of the above-described Property that is already on the Premises or may hereafter be delivered or installed or become subject to the Lease.

(5) Undersigned agrees that Lessor or Lessor's assignee or agents may enter on the Premises and remove all or part of the Property from the Premises in accordance with the terms and conditions of the Lease. Undersigned will allow Lessor to exercise this right of entry at any reasonable time.

(6) This agreement will inure to and be binding on the heirs, personal representatives, successors, and assigns of Undersigned and Lessor.

Date: _ _ _ _ _ _ __[*Signature of lessor*]__
_ _[*Typed name*]_ _
__[*Signature of owner, landlord, or mortgagee*]__
_ _[*Typed name*]_ _

ACKNOWLEDGMENT

STATE OF CALIFORNIA)
COUNTY OF _ _ _ _ _ _ **) S.S.**
_____)

On _ _[*date*]_ _**, before me,** _ _[*insert name and title of officer*]_ _**, a notary public for the State of California,**

personally appeared _ _[*name(s)*]_ _, personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) _ _[*is/are*]_ _ subscribed to the within instrument and acknowledged to me that _ _[*he/she/they*]_ _ executed the same in _ _[*his/her/their*]_ _ authorized capacity(ies), and that by _ _[*his/her/their*]_ _ signature(s) on the instrument the person(s), or the entity on behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

_ _[*Seal*]_ _ __[*Signature of notary*]__
_ _[*Typed name*]_ _

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§19.91 C. Conflicting Interests in Accessions

Both Division 10 and the Civil Code contain provisions that address the treatment of conflicting ownership claims when goods having separate owners are attached to one another. See Com C §10310; CC §§1025-1033. Goods are "accessions" for purposes of Division 10 when they are installed in or affixed to other goods. Com C §10310(a). Civil Code §1025 defines accessions in a more limited fashion to include only those items of personal property that have been united in such a manner that their separation cannot be accomplished without causing damage. Although these definitions have a broad overlap, Division 10 does not clearly indicate when its rules will prevail over those established under the Civil Code. In general, the Civil Code provisions treat the owner of the goods forming the principal part of the joined product as the owner of the whole and give the owner of the lesser component goods a right to reimbursement. CC §1025.

Commercial Code §10310 treats the lessor's rights in accessions in a manner almost identical in substance to a secured party's rights under Com C §9335. If the leased goods become accessions after the lease begins, the lessor's interest is superior to all others' except the following (Com C §10310(d)(1)-(2)):

- The interest of a buyer (or lessee) in the ordinary course of business, buying (or leasing) any interest in the goods to which the accessions have become attached; or
- The interest of a creditor with a prior perfected security interest in the goods to which the accessions have become attached, who makes future advances without knowledge of the lease contract.

If a lease contract is entered into at the time the goods became accessions or afterwards, the lessor's interest is superior to all subsequent interests, but subordinate to those interests already in existence, unless the holders of those interests consent in writing to the lease or disclaim their interests in the goods. Com C §10310(c).

When the lessor's interest has priority over all others, the lessor may remove the accessions from the whole free and clear of other interests when the lease terminates or in enforcement of the lessor's rights. Any holder of an interest in the whole, however, has the same rights of reimbursement as those described in §19.85, and the same limitations apply. Com C §10310(e).

NOTE: Accessions are a critical issue in computer leasing and a subject of serious negotiation because there may be significant costs of removal at the end of the lease term (*e.g.,* as in equipment upgrades that change internal parts and may themselves be worth more than the host machine). As discussed in the comment to §19.49, when the property being leased is of a type that may be improved by an additional device or part, the parties should include terms in the lease agreement that address questions such as the right or obligation to remove the addition at the end of the lease term and whether title to the addition passes to the lessor on installation or is retained by the lessee.

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§19.92 D. Filing Financing Statement

The lessor is not required to file a financing statement or take any other action to protect its interest in the goods against challenge by a lessee or a creditor of a lessee. Cal Comment to Com C §10301.

Thus, a secured creditor must investigate the nature of the debtor's interest in property to determine whether the debtor holds an ownership rather than a leasehold interest. If the debtor's interest in the goods arises in a transaction that constitutes a "lease," the creditor will only obtain a security interest in the debtor's interest as lessee under the lease agreement.

PRACTICE TIP: Lessors can avoid giving a lessee's creditors an incentive to challenge a leasing transaction as a disguised security interest by making a precautionary filing of a financing statement under Com C §9505. Although the definition of "security interest" in Com C §1201(b)(35) and the clarification in Com C §1203 lessen the chance that a lease will be unexpectedly characterized as a security interest for purposes of the Commercial Code, filing a financing statement is a simple step and a good practice. The only circumstance in which a filing is *required* under Division 10 is when a lessor wants to protect its interest in fixtures against the claims of the owner of the underlying real property or against a third party holding a security interest in the underlying real property. Com C §10309. For further discussion, see §§19.5-19.18.

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XII. LIABILITY TO THIRD PARTIES AND INDEMNIFICATION

§19.93 A. Indemnification

Division 10 does not contain any provisions that allocate between the lessor and lessee the risk of liability to third parties for property damage or personal injury resulting from the possession or use of the leased goods. In most leasing transactions outside the consumer context, the lessee assumes those risks, as part of the risk of conducting business, by agreeing to indemnify the lessor for third party claims.

A lessor may be held strictly liable in tort to the same extent as a similarly situated seller of the same type of property. *Price v Shell Oil Co.* (1970) 2 C3d 245, 85 CR 178; *Westlye v Look Sports, Inc.* (1993) 17 CA4th 1715, 22 CR2d 781. Whether a lessor is held strictly liable appears to depend on whether the lessor can be characterized as a "merchant" who places the goods in the stream of commerce, or instead merely acts as a "financier" or the provider of a service to which the provision of the goods is incidental. *San Diego Hosp. Ass'n v Superior Court* (1994) 30 CA4th 8, 35 CR2d 489.

Because a lessor may be held strictly liable in tort to the same extent as a similarly situated seller of the same type of property, great care must be taken in drafting an indemnification provision to avoid an unintended allocation of the risk of third party liability. The court in *Price v Shell Oil Co.* (1970) 2 C3d 245, 85 CR 178, reviewed a provision by which the lessee agreed to indemnify the lessor for "any and all claims and liability" that were "caused by or happening in connection with the equipment or the condition, maintenance, possession, operation or use thereof." 2 C3d at 256. The court concluded that the provision did not cover any liability based on either the negligence or strict liability of the lessor, because these bases of liability were not "expressly and unequivocally" addressed. 2 C3d at 257. Thus, when the parties intend for the lessee to assume all risks associated with the leased property, the indemnity provision should specifically refer to the negligent acts of the lessor and should also include language mentioning strict liability in tort. See *Dart Transp. Serv. v Mack Trucks, Inc.* (1970) 9 CA3d 837, 88 CR 670, and *Hernandez v Badger Constr. Equip. Co.* (1994) 28 CA4th 1791, 34 CR2d 732 (finding that lessor's active negligence, which contributed to loss, did not bar recovery from lessee of portion of loss attributable to lessee's negligence). See form 19.94-1.

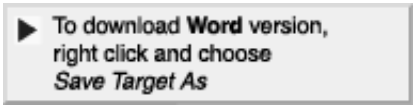
Can a lessor who is otherwise strictly liable in tort avoid liability by having the lessee sign a waiver? In *Westlye v Look Sports, Inc.* (1993) 17 CA4th 1715, 22 CR2d 781, the court of appeal held that neither a broad disclaimer of liability nor an express assumption of risk by the lessee in the rental agreement shielded a lessor of ski equipment from liability arising under the doctrine of strict liability in tort. The transaction before the court was clearly a consumer lease, but the court did not explicitly limit its holding to consumer leases and its reasoning could be applied more broadly.

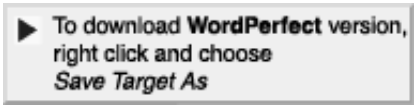
If the lessee might use the leased property in any fashion that may result in the release of potentially toxic substances into the environment, special additional indemnities in favor of the lessor should be considered. Under federal law, current and past owners of property may be held liable for environmental damage attributable to their property. See 42 USC §§6901-6992k, 9601-9675. Although further examination of this area of the law is beyond the scope of this chapter, additional information may be found in Zimmer & Carow, *Environmental Liability Risks of Equipment Lessors*, 11 J Equipment Lease Financing 3 (Spring 1993), and Wong & Goldin, *Equipment Financing and CERCLA: Where Have You Gone, Lender Liability Rule*, 13 J Equipment Lease Financing 13 (Spring 1995).

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Source: Business Law/California UCC Sales and Leases/19 Leasing of Goods/§19.94 B. Form: Indemnification Covenant

§19.94 B. Form: Indemnification Covenant





19.94-1 Indemnification covenant

Lessee agrees to indemnify, reimburse, and hold harmless each indemnitee from and against all claims, damages, losses, liabilities, demands, suits, judgments, causes of action, civil and criminal legal proceedings, penalties, fines, and other sanctions, and any attorney fees and other reasonable costs and expenses, arising or imposed with or without Lessor's fault or negligence (whether active or passive) or under the doctrine of strict liability (collectively, "claims"), relating to or arising in any manner out of:

(1) This Lease or the breach of any representation, warranty, or covenant made by Lessee under this Lease;

(2) Manufacture, purchase, lease, delivery, nondelivery, acceptance, rejection, ownership, possession, use, operation, return, or disposition of the property;

(3) The property's condition or any discoverable or nondiscoverable defect in it arising from its design, testing, or construction; any article used in the property; or any maintenance, service, or repair, whether or not the Property is in Lessee's possession and regardless of where the Property is located; or

(4) Any transaction, approval, or document contemplated by this lease.

Lessee waives and releases each indemnitee from any existing or future claims in any way connected with injury to or death of Lessee's personnel, loss or damage of Lessee's property, or loss of use of any property that may:

(a) Result from or arise in any manner out of the ownership, leasing, condition, use, or operation of the Property; or

(b) Be caused by any defect in the Property; its design, testing, or construction; any article used in the Property; or any maintenance, service, or repair, whether or not the Property is in the lessee's possession and regardless of where the Property is located.

The indemnities described in this clause will continue in full force and effect notwithstanding the expiration or other termination of this lease and are expressly made for the benefit of and will be enforceable by each indemnitee.

Comment: The term "indemnitee" is often used to broaden coverage of the covenant beyond the lessor to other persons, such as the lessor's parent company or other affiliates who might be charged with liability in relation to the property. The lessor and lessee may negotiate a number of exclusions to the indemnification clause. Typical points of negotiation include exclusions for the gross negligence or willful misconduct of the lessor, losses attributable to acts or events that occur before the commencement of the lease or following termination of the lease, losses attributable to the lessor's own breach of a representation or covenant, and losses that are expressly covered by a separate agreement between the parties (*e.g.,* a tax indemnity agreement).

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XIII. PERFORMANCE AND REPUDIATION

§19.95 A. Adequate Assurances of Performance

If a party to a lease agreement has reasonable grounds for being insecure about the other party's performance, the insecure party has the same type of right found in Division 2 to demand (in writing) an adequate assurance of the other party's performance. See Com C §§2609, 10401. To the extent that the insecure party has not already been paid for its performance, the insecure party has the right to suspend performance if this is a commercially reasonable course of action. Com C §10401(b).

The other party has a reasonable period (not to exceed 30 days) after receipt of a demand for assurances of due performance to respond to that demand. Failure to provide adequate assurances when a demand has been made is treated as a repudiation of the lease agreement. Com C §10401(c). The Commercial Code does not establish a standard for what constitutes an adequate assurance but instead leaves that to be decided by the circumstances of each case. Between merchants, the issues of whether a party has reasonable grounds for insecurity and whether the assurance provided is adequate must be judged on the basis of commercial standards. Com C §10401(d).

For discussion of this right in the context of a sales transaction, see §§16.2-16.18.

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§19.96 B. Repudiation

Division 10 adopts the concept of "repudiation" found in Division 2. See Com C §§2610, 10402. Assume that the time for a party's performance of the lease has not yet arrived, but either party to a lease, other than a consumer lease, states that it does not intend to perform. If the loss of the repudiating party's performance will substantially impair the value of the lease contract, the aggrieved party is given the right to:

- Wait for a retraction of the repudiation for a commercially reasonable time (Com C §10402(a)(1));
- Make a demand for adequate assurances of future performance (Com C §10402(a)(2)); or
- Treat the lease agreement as being in default and exercise its rights and remedies under the lease agreement or under Division 10 (Com C §10402(a)(3)).

In addition, the aggrieved party is permitted to suspend its own performance of the lease agreement. Com C §10401(b).

A repudiating party has the right to retract the repudiation before performance is due as long as the aggrieved party has not canceled the lease agreement, materially changed its position as a result of the repudiation, or otherwise indicated that the repudiation is considered to be final. Com C §10403(a). To retract a repudiation, the repudiating party must take some action that demonstrates an intention to perform. Com C §10403(b). If a repudiation is effectively retracted, the repudiating party's rights under the lease agreement are reinstated. Com C §10403(c).

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§19.97 C. Substituted Performance

Under certain circumstances, a party may substitute a different form of delivery or payment for that called for by the lease agreement. Com C §10404. See also Com C §2614.

If the agreed means of delivery becomes unavailable or commercially impracticable without the fault of any of the parties, and a commercially reasonable substitute means of delivery is available, the substituted means must be tendered and accepted. Com C §10404(a).

Similarly, if a manner of payment fails as a result of government regulation after a delivery under a lease agreement has been made, whatever payment is permitted by the regulation is good to discharge the lessee's obligations unless the regulation is discriminatory, oppressive, or predatory. Com C §10404(b)(2).

PRACTICE TIP: For example, in a cross-border transaction, if payment in a substituted currency would upset the parties' expectations by shifting a currency risk from the party who agreed to assume it to the other party, it is important to include in the lease agreement an express recognition that payment in the specified currency is of the essence.

If the payment mechanism fails because of a government regulation before delivery of the goods under the lease agreement, the lessor has the right to withhold or stop delivery unless the lessee offers a payment means that is a commercially substantial equivalent. Com C §10404(b)(1).

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§19.98 D. Excused Performance

Delay or failure to deliver goods by a lessor or supplier may be excused due to commercial impracticability arising out of an unanticipated contingency or compliance with a government regulation or order. Com C §10405(1). The lessor is required to seasonably notify the lessee (or, in the case of a finance lease, the supplier must notify the lessor and lessee, if known) that there will be a delay or a nondelivery. If the precipitating cause affects only part of the lessor's capacity to perform, the lessor is required to allocate deliveries in a fair and reasonable manner. Com C §10405(2)-(3). After receiving such a notification, a lessee, except in a finance lease, has the right to terminate the lease agreement or to accept the available quota with due allowance from the rent for the deficiency. Com C §10406(a).

Division 10 does not contain any provisions that excuse a lessee from performance, even though the same types of events that prevent a lessor from delivering goods at the inception of a lease might also prevent a lessee from returning goods or otherwise complying with some lease provision during the lease term. However, other provisions of California law make the defenses of impracticability and frustration of purpose available to the lessee. See, *e.g., Federal Leasing Consultants, Inc. v Mitchell Lipsett Co.* (1978) 85 CA3d Supp 44, 150 CR 82 (lessee of electronic burglar alarm system forced to discontinue its use because it interfered with secret government radio frequencies; court held that this unforeseeable supervening event frustrated purpose of lease and excused further performance). See also CC §1511.

If a law makes the continued use of goods under a lease agreement illegal, the lease contract will be rendered void and the lessee will be excused from performance. See CC §1667.

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XIV. DEFAULT AND REMEDIES

A. Default by Lessor; Lessee's Remedies

§19.99 1. Overview

Because lease agreements generally do not detail the events and circumstances that would constitute a default by the lessor, or remedies available to the lessee when the lessor defaults, Commercial Code provisions addressing these matters have particular importance. The parties to a leasing transaction would be well advised to consider those provisions and to agree on any appropriate waivers or modifications to the extent that they do not reflect the parties' expectations.

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§19.100 2. General Provisions

The Commercial Code identifies the following events as defaults by the lessor (Com C §10508(a)):

- The lessor's failure to deliver the goods in conformity with the lease agreement;
- The lessor's repudiation of the lease agreement;
- The rightful rejection of the goods by the lessee; and
- The rightful revocation of acceptance of the goods by the lessee.

Following the occurrence of one of the above events, the lessee may (Com C §10508(a)(1)-(4)):

- Cancel the lease agreement;
- Recover rent and security previously paid;
- Effect cover and recover damages; or
- Exercise the remedies set forth in the lease agreement.

If the lessor's default is not one of those listed above, the lessee is entitled to any remedies that are available under the lease agreement and to recover its foreseeable losses. Com C §§10508(c), 10519(c). See *E.D.S. Corp. v W.A. Foote Mem. Hosp., Inc.* (6th Cir 1994) 25 F3d 406 (lessor breached covenant of good faith and fair dealing by failing to consent to lessee's assignment of lease; lessor liable for lessee's losses occasioned by refusal to grant such consent); §§19.101-19.103.

When a lessee has possession or control of goods following a rightful rejection or justifiable revocation of acceptance, the lessee has a security interest in the goods to the extent it has a right to recover rent and any security deposit it has given the lessor, plus the expenses the lessee reasonably incurs in dealing with the goods. Com C §10508(e).

In addition, after notice to the lessor, the lessee can offset against any rent it owes all or part of the damages it has the right to recover as a result of the lessor's default. Com C §10508(f). An exception to this right applies to the finance lease, which gives the lessor statutory "hell or high water" protection. See Com C §§10407, 10508(f). See also §19.34.

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§19.101 3. Measure of Damages Following Cover

A lessee has a "cover" remedy similar to that given to the buyer in Division 2. See Com C §§2712, 10518. See also §§17.67-17.69. Following the lessor's "default" (see Com C §10508), the lessee has the right to cover by either purchasing or leasing substitute goods (Com C §10518(a)). Although the lessee is not *required* to cover, failure to do so may bar the lessee's recovery of consequential damages. Com C §10520(b)(1).

Division 10 provides a special measure of damages when the lessee covers by leasing substitute goods. To qualify for this measure of damages, the cover lease must be substantially similar to the original lease and must be entered into in good faith and in a commercially reasonable manner. Com C §10518(b). Under Com C §10518(b), the damages recoverable with a qualifying cover lease equal:

- The present value of rental payments payable for the portion of the cover lease term that is comparable to the remaining term of the original lease, minus
- The present value of the rent payable for the remaining term of the original lease.

As a result, a lessee that improves its position under a cover lease could not recover damages by this measure. On recovery of incidental and consequential damages, see §19.103.

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§19.102 4. Measure of Damages Without Cover or Nonqualifying Cover

If a lessee covers by purchasing goods or obtains a covering lease that for any reason is not considered to be comparable to the original lease, it is as if the lessee had elected not to cover at all. In such an instance, the measure of damages is (Com C §10519(a)):

- The present value of a market rate of rent for a period equaling the remaining balance of the original lease term, minus
- The present value of the actual rent payable under the original lease agreement for the balance of the term.

Thus, if the market rate is less than the rate of rent under the original lease agreement, the lessee has suffered no damages. Market rent is determined as of the place for tender or, in instances of rejection after arrival or revocation of acceptance, as of the place of arrival. Com C §10519(b). On recovery of incidental and consequential damages, see §19.103.

If the lessee accepts nonconforming goods but notifies the lessor of the nonconformity within a reasonable period after acceptance (see Com C §10516(c)(1)), the lessee preserves the right to recover damages. The measure of those damages is the loss resulting in the ordinary course of events from the lessor's default, determined in any manner that is reasonable.

If the lessee's loss results from the lessor's breach of warranty, the measure of damages is the difference between the present value of the goods at the time of acceptance if they had been as warranted for the lease term and the actual value of the goods as accepted, unless special circumstances show proximate damages of a different amount. Com C §10519(d).

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§19.103 5. Incidental and Consequential Damages

In addition to the damages measures described in §§19.101-19.102, a lessee is entitled to receive incidental and consequential damages. See Com C §§10518(b), 10519.

"Incidental damages" resulting from a lessor's default include the expenses incurred by the lessee in the inspection, transportation, receipt, care, and custody of goods that have been rightfully rejected or with respect to which acceptance has been rightfully revoked, plus the charges, expenses, or commissions incurred by the lessee in effecting cover, and any other reasonable expense incident to the default. Com C §10520(a).

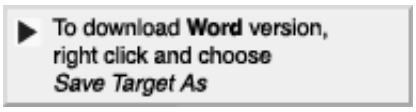
"Consequential damages" resulting from a lessor's default include losses stemming from any general or particular requirements of the lessee about which the lessor had reason to know and which could not reasonably be prevented by cover or other means. Com C §10520(b)(1). See *Bescos v Bank of America* (2003) 105 CA4th 378, 129 CR2d 423 (bank that financed leases entered into between dealer lessor and lessees did not have liability as "lessor" under either California Vehicle Leasing Act or California Consumers Legal Remedies Act for misrepresentations made by actual lessor, because bank did not know of alleged misrepresentations and they were not apparent on face of lease; dealer did not become agent of bank simply by using lease form provided by bank).

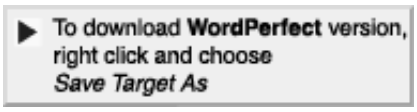
Consequential damages also include any loss resulting from injury to person or property that was proximately caused by the lessor's breach of warranty. Com C §10520(b)(2).

PRACTICE TIP: In many instances, the lessor will find it advantageous to limit the risk of liability for consequential damages by including in the lease agreement a waiver by the lessee of the right to recover those damages. See form 19.104-1. A limitation, alteration, or exclusion of consequential damages for injury is prima facie unconscionable in the case of consumer goods, but not when the loss is commercial. Com C §10503(c).

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§19.104 6. Form: Waiver of Consequential Damages





19.104-1 Waiver of consequential damages

Lessee will not be entitled to recover, and hereby disclaims and waives any right that Lessee may otherwise have to recover, consequential damages as a result of any breach or alleged breach by Lessor of any of the agreements, representations, or warranties of Lessor contained in this Lease.

Comment: Further discussion of consequential damages and provisions excluding their recovery in sales transactions can be found in §§18.36-18.41.

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§19.105 7. Specific Performance and Other Remedies

The remedy of specific performance is available to the lessee if the leased goods are unique or other circumstances are present that provide the basis for a decree of specific performance. Com C §10521(a). A decree of specific performance may include any terms and conditions regarding payment of rent, damages, or other relief that the court considers just. Com C §10521(b). On specific performance in sales transactions, see §18.47.

A lessee also has the right to such remedies as replevin, detinue, sequestration, and claim and delivery, if the lessee makes a reasonable attempt to effect cover and is unable to obtain substitute goods (or if it is clear from the circumstances that such an effort would be unsuccessful). Com C §10521(c).

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B. Default by Lessee; Lessor's Remedies

§19.106 1. General Provisions

The Commercial Code identifies the following events as defaults by the lessee (Com C §10523(a)):

- Wrongful rejection of the goods;
- Wrongful revocation of the lessee's acceptance of the goods;
- Failure to make a payment due under the lease agreement;
- Repudiation of the lease agreement; and
- Commission of some other default that substantially impairs the value of the lease agreement to the lessor.

Following the occurrence of one of the above events, the lessor may do the following (Com C §10523(a)):

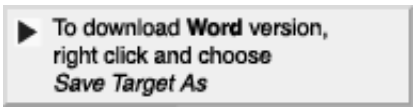
- Cancel the lease agreement;
- Dispose of the goods (or salvage or complete uncompleted goods);
- Withhold delivery of the goods or retake possession of goods previously delivered;
- Stop delivery of the goods;
- Dispose of the goods and recover damages;
- Retain the goods and recover damages; and
- Recover rent.

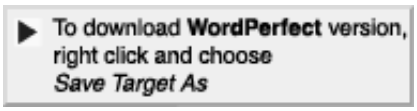
In addition, the parties are free to augment by agreement the remedies available by statute. Com C §10523(a)(6). See form 19.107-1.

In *CIT Group/Equip. Fin., Inc. v Super DVD, Inc.* (2004) 115 CA4th 537, 8 CR3d 927, the lessees defaulted under a master lease agreement. The lessor sold the equipment, which left a balance due and owing. Lessor sought a writ of attachment (*i.e.,* a right to attach order, or RTO) to recover the deficiency, which the trial court granted. On appeal, the lessees argued that damages under the contract were uncertain because at the time of formation it was impossible to know how many payments would be made. The court noted that, following this logic, a debt owing under a lease would never be subject to attachment. Clearly, under CCP §483.010(a), which authorizes attachments, leases of real or personal property are meant to be included. In this case, there was no profit or other calculation to be made to ascertain the monthly rent due. Each of the lease schedules set forth the rental period and the monthly rent due for each machine. The contract provided a clear and definite formula for the computation of damages, and thus the order of attachment was proper.

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§19.107 2. Form: Remedies Clause





19.107-1 Remedies clause

A. *Remedies.* On the occurrence of any event of default and at any time afterwards as long as it continues, Lessor may, at its option and without notice to Lessee, declare this Lease to be in default and exercise one or more of the following remedies, to the extent available, permitted by, and subject to any mandatory requirements of applicable law:

(1) Demand that Lessee immediately return the Property to Lessor in the manner specified by written notice, which will be effective on delivery;

(2) Enter on the premises where all or part of the Property is located and, without incurring liability, take immediate possession of the Property and remove it;

(3) With or without notice, declare immediately due and payable all rent and other charges for the unexpired portion of the term of this Lease, discounted to present value in the manner specified in paragraph C;

(4) Sell the Property at private or public sale or hold, use, operate, or lease the Property to others, free and clear of any rights of Lessee;

(5) Proceed by appropriate court action or actions, either at law or in equity, to enforce performance by Lessee of the applicable covenants of this Lease and to obtain relief that the court considers appropriate for the breach;

(6) Proceed by appropriate court action or actions to recover damages for breach of this Lease;

(7) Cancel all of Lessee's rights to possess and use the Property under this lease by written notice, which will be effective on delivery; and

(8) Exercise all rights available to Lessor under the California Commercial Code.

In effecting any repossession, Lessor and its representatives and agents, to the extent permitted by law, will:

(a) Have the right to enter on any premises where Lessor reasonably believes the Property is located;

(b) Not be liable, in conversion or otherwise, for the taking of any personal property of Lessee that is in or attached to the repossessed Property as long as Lessor promptly returns that property to the lessee;

(c) Not be liable in any manner for any damage to any of the lessee's property in repossessing and holding the Property, except for damage caused by Lessor's gross negligence or willful misconduct; and

(d) Have the right to maintain possession of and dispose of the Property on any premises owned by Lessee or under Lessee's control.

If reasonably required by Lessor, Lessee, at Lessee's sole expense, will assemble and make the property available at a place designated by Lessor. If the Property is returned to or repossessed by Lessor, any rights in any express or implied warranty previously assigned to Lessee or otherwise held by Lessee will without further act, notice, or writing be assigned or reassigned to Lessor, if assignable. Lessee will be liable to Lessor for all reasonable expenses, costs, and fees incurred in (1) repossessing, storing, preserving, shipping, maintaining, repairing, and refurbishing the Property to the condition required by this Lease; and (2) preparing the property for sale or lease, advertising the sale or lease, and selling or reletting the Property.

At any public sale of the Property under this clause, Lessor may bid for and purchase the Property. Lessee agrees that the amounts paid will be used in the computations contemplated in this clause.

No remedy referred to in this clause is intended to be exclusive, but, to the extent permissible under applicable law, each will be cumulative and operate in addition to any other remedy referred to above or otherwise available to Lessor at law or in equity. The exercise or beginning of exercise by Lessor of any one or more of Lessor's remedies will not preclude the simultaneous or later exercise by Lessor of any other remedies.

No express or implied waiver by Lessor of any default or event of default will be construed as a waiver of any future or subsequent default or event of default.

B. *Measure of Damages.* Lessor and Lessee agree that the measure of damages may be extremely difficult to determine in the absence of prior agreement. Therefore, the parties agree that, as damages for loss of a bargain and not as a penalty, the lessor shall be entitled to receive all rent and other amounts that are or become due and payable under this Lease to and including the date of payment (in the case of rent, prorated on a daily basis) plus one of the following amounts, as applicable, and as selected by Lessor in Lessor's sole discretion:

(1) The amount by which the aggregate rent for the remainder of the Lease term discounted to present value in the manner specified in paragraph C exceeds the fair market rental value of the Property for the remainder of the Lease term less _ _[*insert number*]_ _ months (representing the reasonably anticipated period that the Property will remain off lease) discounted to present value in the manner specified in paragraph C; or

(2) If Lessor, under paragraph A(4) above, relets the Property under a lease that extends at least to the date on which the Lease term for the Property hereunder would have expired but for Lessee's default, the amount by which the aggregate rent for the remainder of the Lease term, discounted to present value in the manner specified in paragraph C, exceeds the aggregate rental payments to become due under the reletting from the date of reletting to the date on which the lease term for the Property would have expired but for Lessee's default, discounted to present value in the manner specified in paragraph C; or

(3) _ _[*If the lessor has not repossessed the goods, is unable to dispose of the goods, or reasonably determines that an attempt to dispose of the goods will be unavailing,*]**_ _ the aggregate amount of rent for the remainder of the lease term discounted to present value in the manner specified in paragraph C; _ _**[*or*]**_ _**

[*If appropriate, add*]

(4) If the lessor sells the property under paragraph A(4) above, the amount by which the _ _[*scheduled early termination value; insert reference*]**_ _ of the Property computed as of the date of sale exceeds the net cash proceeds of the sale.**

[*Continue*]

In each case, Lessor shall also be entitled to receive the amount, if any, as reasonably calculated by Lessor, required for Lessor to receive the same after-tax economic return from this Lease that Lessor would have received if Lessee had performed all of Lessee's obligations under this Lease through the end of the Lease term.

In addition to the foregoing, Lessee will be liable for interest on unpaid amounts at an annual interest rate of _ _[*number*]**_ _ percent from the date the same became due until payment in full, and for all reasonable legal fees and other reasonable costs and expenses incurred by Lessor in connection with the occurrence of any event of default or the exercise of Lessor's remedies.**

C. *Present Value Calculation*. Each reduction to present value under this Lease shall be as of the date of sale, re-lease, or payment of damages, whichever is applicable, and at a rate of interest equal to the prime rate quoted from time to time by _ _[*insert name of bank*]**_ _ at the date of payment and at a frequency equal to the frequency of rental payments under this Lease.**

Comment: In many transactions, paragraph B(4) would not be an appropriate measure of the lessor's damages. The provision has the effect of making a lessee who commits a default responsible not only for the lessor's loss of rental

income, but also for the goods having depreciated at a rate that differs from the rate specified on the casualty value schedule. In cases in which the lessor is a merchant lessor and the goods have a long life relative to the rental term, the parties most likely anticipate the lessor reletting the property to another lessee at the conclusion of the lease term and assuming the risks and benefits attendant to the property appreciating or depreciating in value during the lease in an unexpected fashion. In that case, the remedy set forth in paragraph B(4) would inappropriately shift the risks and benefits of an unanticipated change in the value of the property from the lessor to the lessee in addition to compensating the lessor for the loss of expected rents. In a finance lease transaction, particularly if the lease term and expected life of the property are not substantially different, paragraph B(4) is much more reflective of the damages that may be suffered by a lessor when the lessee fails to perform its obligations through the end of the lease term.

The measure of damages specified in paragraph B(3) would be appropriate for a "lost volume" lessor, as discussed in §19.110, or for a lessor who cannot be reasonably expected to dispose of the property in order to mitigate damages.

Each of the measure of damages calculations with respect to future rentals uses a present value calculation. Under California law before adoption of Division 10, parties were clearly required to use a present value calculation with respect to future rents in a damages clause. See CC §3308 (which by its terms does not apply to leases subject to Division 10); *Newco Leasing, Inc. v Hull* (1985) 167 CA3d Supp 1, 213 CR 202. Division 10 of the Commercial Code expressly recognizes the use of present value calculations in calculating damages owed with respect to future rents, but it is not entirely clear that such a calculation is necessary. Compare Official Comment (u) to UCC §2A-103 (Official Comment (aa) to UCC §2A-103 (2003)) (present value) with Official Comment to UCC §2A-101 (damages). Nevertheless, in light of prior California law and cases in other jurisdictions, it seems doubtful that a court would uphold an acceleration of rents that neglected to reduce the future rentals to present value. *Frontier Leasing Corp. v. Griffin Petroleum Inc.* (SD Iowa 2001) 172 F Supp 2d 1172; *Kedziora v Citicorp Nat'l Servs., Inc.* (ND Ill 1991) 780 F Supp 516. Present value is commonly calculated in one of two ways: (1) the actuarial method (as shown in the form); and (2) the "rule of 78's" (the name being derived from the sum of the first 12 integers, which would be the denominator in a one-year lease calling for monthly installment payments). The rule of 78's results in a greater portion of the finance charge being allocated in the early part of the period. As a result, in the instance of a longer term stream of payments, the actuarial method results in a smaller amount being paid. If the parties do not select a method for discounting rental payments to present value, a court will likely do so rather than striking the acceleration-of-rents remedy altogether. A lessor is well advised to specify a discount rate in the lease. When left to select a discount rate on its own, at least one court selected the interest rate applicable to late payments, typically much higher than a discount rate that would have been agreed to between a lessor and a lessee. *In re Dailey* (Bankr DC Mont 1994) 167 BR 932.

Each of the damage measures outlined in paragraph B would be characterized as liquidated damages formulas. Civil Code §1671 establishes the standard for enforceability of a liquidated damage clause in any contract, and is discussed in §19.113.

Civil Code §1717 states that, in an action on a contract, where the contract specifically provides that attorney fees incurred to enforce the contract will be awarded to one of the parties, the party who is determined to be the prevailing party, whether or not so specified in the contract, will be entitled to reasonable attorney fees. Parties to a lease transaction thus must select between (1) permitting neither party to recover attorney fees for enforcement of the lease, or (2) permitting whichever party prevails to recover attorney fees. At least one court has held that language similar to that found in the foregoing form provision, to the effect that the lessor may recover attorney fees in connection with exercising remedies following a lessee's default, creates a mutual right of the prevailing party in any such action to recover attorney fees. *E.D.S. Corp. v W.A. Foote Mem. Hosp., Inc.* (6th Cir 1994) 25 F3d 406.

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§19.108 3. Retention or Repossession of Goods

The lessor has the right to either retain or retake possession of leased goods under the circumstances specified in the lease and in the following situations (Com C §10525(a)-(b)):

- When the lessor discovers before delivery of the goods that the lessee has become insolvent; and
- When the lessee commits one of the defaults identified in §19.106.

A lease agreement may require the lessee to assemble goods at the lessor's direction and make them available for the lessor's repossession. In addition, the lessor may render goods unusable without repossession and dispose of them on the lessee's premises. Com C §10525(b). A lessor is permitted to exercise the right of repossession through self-help if the lessor can do so without risking a breach of the peace. Otherwise, the lessor must proceed by court action. Com C §10525(c). As a practical matter, unless a lessee agrees to relinquish possession to the lessor, the lessor will be required to forgo the self-help remedy and proceed in court. For further discussion of a secured party's right of repossession, see Secured Transactions in California Commercial Law Practice §§5.19-5.24 (2d ed Cal CEB 2001).

A lessor is not required to dispose of repossessed goods. However, if the lessor chooses to dispose of repossessed goods, by sale or otherwise, no notice to the lessee is necessary and the lessor is not accountable to the lessee for any profit from the disposition. See Com C §10527.

PRACTICE TIP: Nevertheless, the lessor should give notice of a post-default sale (see Com C §§9611-9613) to the lessee and any guarantor to avoid litigation over whether the lease was a true lease or a security arrangement. See §§19.5-19.18.

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Source: Business Law/California UCC Sales and Leases/19 Leasing of Goods/§19.109 4. Disposition of Goods Under Substantially Similar Lease

§19.109 4. Disposition of Goods Under Substantially Similar Lease

Under certain circumstances, the lessor has the right to dispose of leased goods and recover damages. The right of disposition is triggered by any event that gives the lessor the right to retain possession of the goods or retake possession under Com C §10525. Com C §10527(a). Those events include the lessee's insolvency and any default listed in §19.106.

If the lessor disposes of the goods by a new lease agreement that is substantially similar to the original lease agreement, and acts in good faith and in a commercially reasonable manner in doing so, the lessor is entitled to recover the damages specified in Com C §10527(b). Otherwise, the measure of damages is specified by Com C §10528. Com C §10527(c). See §19.110.

Under Com C §10527(b), the lessor can receive the accrued and unpaid rent under the original lease plus the difference between the present value of total rent for the remaining term of the original lease as of the date of recovery and the present value of rent under the new lease for the comparable period, plus incidental damages and less any expenses saved as a result of the lessee's default. See Com C §10103(a)(21) on calculating present value.

If the lessor's position improves under the new lease, the foregoing formula will not result in any damages for future rentals being owed to the lessor. However, the lessor is not accountable to the lessee for any profit made by the reletting. Com C §10527(e). In contrast, a lessee must account for any excess over the amount of the lessee's security interest under Com C §10508 on disposition of goods following a rightful rejection or justifiable revocation of acceptance. Com C §10527(e). See §19.54.

Whether the new lease agreement is substantially similar to the original is determined on a case-by-case basis, and factors to be considered include (Cal Comment to Com C §10527):

- The term of the lease;
- Options to purchase or re-lease;
- The lessor's representations, warranties, and covenants to the lessee and those made by the lessee to the lessor; and
- The services, if any, to be provided by the lessor or lessee.

The Commercial Code does not draw a bright-line test; all factors must be taken as a whole, and the court's determination should be pervaded by "a sense of commercial judgment." Cal Comment to Com C §10527.

DRAFTING CONSIDERATIONS: If the lessor's bargain is based in part on factors that are not readily apparent, the lease agreement should identify those factors so that a re-lease that does not include them will not be considered "substantially similar" to the original lease contract.

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§19.110 5. Measure of Damages in Absence of Qualifying Disposition

Unless the lease agreement has a liquidated damages clause or specifies some other remedy, the amount of damages recoverable by a lessor who does not dispose of retained or repossessed goods is governed by Com C §10528(a).

The same Commercial Code provision applies when the retained or repossessed goods are sold by the lessor or the goods are relet under a new lease agreement that is not substantially similar to the original lease, entered into in good faith and in a commercially reasonable manner. Com C §10528(a).

In either situation, the lessor is entitled to receive the accrued and unpaid rent as of the following dates (Com C §10528(a)):

- The date of the default, if the lessee never took possession of the goods; or
- The date of repossession or tender of the goods back to the lessor, if the lessee took possession and the goods have been returned to the lessor.

In addition, the lessor is entitled to receive, as of the same date (whichever applies), the present value of the rent for the remaining term of the original lease minus the present value of market rent for the goods for the same period. Com C §10528(a). See Com C §10103(a)(21) on calculating present value.

In some circumstances, recovery of the foregoing damages may be inadequate to put a lessor in as good a position as performance would have. In those circumstances, the lessor is entitled to receive (a) the present value of the profit, including reasonable overhead, that the lessor would have made if the lessee had completely performed the lease agreement; (b) any incidental damages; and (c) allowance for reasonably incurred costs and credit for payments or proceeds of disposition. Com C §10528(b).

For example, California courts have recognized the concept of a lost volume lessor with a business that is understood to be "expandable" to meet the market. See *Seaboard Music Co. v Germano* (1972) 24 CA3d 618, 101 CR 255 (lessor was in business of leasing coin-operated equipment and had warehouse full of equipment similar to that leased). Such a lessor is in a position to meet any demand for additional leasing business through available inventory. Thus, crediting the lessee with a mitigation factor equaling the fair market rental value of the equipment in these circumstances would fail to compensate the lessor for the reduction in the volume of its business occasioned by the lessee's default.

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§19.111 6. Recovery of Rent for Balance of Lease Term

Under certain conditions, the lessor has the right to recover rent for the balance of the lease term. For this remedy to apply, the lessee must have committed one of the defaults listed in §19.106 or some other default for which recovery of rent is the remedy agreed on by the parties. The remedy is available following such a default when the circumstances make it impractical for the lessor to sell or relet the property. This may arise in the following situations:

- When the lessee has retained possession of the goods after acceptance and has not tendered them back to the lessor, and the lessor has not repossessed them (Com C §10529(a)(1));
- When the goods were damaged or lost after the risk of loss (see Com C §10219) passed to the lessee (Com C §10529(a)(1)); or
- When the goods were identified to the lease agreement but were not delivered, or were delivered but repossessed or tendered back by the lessee, and the lessor is unable to dispose of them after making a reasonable effort (or encounters circumstances that would make an attempt to sell or relet futile) (Com C §10529(a)(2)).

In the foregoing situations, the lessor is entitled to receive any accrued and unpaid rent under the lease agreement plus an amount equal to the present value of rent for the remaining term of the lease. Com C §10529(a). See Com C §10103(a)(21) on calculating present value.

If a lessor is entitled to receive rent for the balance of the lease term as damages, the lessee is entitled to the possession and use of the goods for the balance of the term in accordance with the terms of the lease agreement. In such circumstances the lessor is required to hold for the lessee any goods that are identified to the lease contract and that are in the lessor's control. Com C §10529(b)-(d).

If a lessor obtains a judgment against a lessee for unpaid rent, however, the lessor is free to dispose of the goods before collecting that judgment. Com C §10529(c). In that situation, the lessor's recovery against the lessee is governed by either Com C §10527 or Com C §10528, depending on the nature of the disposition. The lessee is entitled to receive a credit against the judgment to the extent that the rental damages recovered under Com C §10529 exceed the amount of disposition damages that would have been available under §10527 or §10528.

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§19.112 7. Incidental Damages

Whenever the lessor is entitled to recover damages for the lessee's default, those damages include incidental damages. "Incidental damages" are defined to include any commercially reasonable charges, expenses, or commissions incurred in stopping delivery, transporting, or providing for the care and custody of goods after the lessee's default in connection with return or disposition of the goods or otherwise resulting from the lessee's default. Com C §10530. Thus, the incidental damages to which a lessor is entitled are substantially the same as those to which a seller is entitled under Division 2. See Com C §2710. See also §§18.8-18.9.

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§19.112A 8. Consequential Damages

The Commercial Code does not create the right to recover, or directly prohibit the recovery of, consequential damages by a lessor. While Division 10 expressly addresses the issue of consequential damages with respect to a claim for damages by a lessee, there is no corresponding provision that addresses the rights of a lessor. Com C §1305(a) states that consequential damages are not recoverable unless specifically allowed by a provision of the Commercial Code "or by other rule of law." In considering whether a lessor is entitled to recover consequential damages, one court concluded that the absence of a provision in the Commercial Code only meant that such damages were recoverable under a lease to the same extent as in any contract. *Linc Equip. Servs., Inc. v Signal Med. Servs., Inc.* (7th Cir 2003) 319 F3d 288.

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C. Other Remedies

§19.113 1. Liquidated Damages

The parties may by agreement liquidate the damages payable by either party for a default, including consequential damages. Com C §§10503(c), 10504(a). Any liquidated damages provision, however, must comply with CC §1671. Under CC §1671(b), a liquidated damages provision is presumed to be valid unless the party seeking to invalidate it establishes that the provision was not reasonable under the circumstances existing at the time the contract was made.

Courts reviewing liquidated damage clauses under California law have stated that a liquidated damage provision will be considered unreasonable, and therefore unenforceable, if it does not bear a reasonable relationship to the range of actual damages that the parties could have anticipated would flow from a breach. *Harbor Island Holdings, L.L.C. v Kim* (2003) 107 CA4th 790, 132 CR2d 406; *Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 977, 73 CR2d 378; *Atel Fin. Corp. v Quaker Coal Co.* (ND Cal 2001) 132 F Supp 2d 1233. In *Atel,* the court reviewed a liquidated damage provision that would have awarded the lessor of heavy industrial equipment an amount equaling the present value of the rentals for the remainder of the term, plus the present value of the anticipated residual value of the property at the end of the term, less a mitigation credit equaling any rental proceeds received by the lessor from any re-letting of the property during the balance of the lease term. The lessor argued that the legislative history of Com C §10504 indicated the reasonableness in allowing the lessor to receive compensation for the lost value of its equipment, but not for double recovery in terms of lost value plus resale proceeds. The court stated that the problem with the liquidated damages provision in *Atel* was that, according to its literal terms, the anticipated residual value operated without regard to the postdefault status of the equipment and regardless of whether that status (*e.g.,* sale) brought the lessor any compensation. The court noted that even though the lessee would be required to pay the amounts in the liquidated damages provision, the lessor would be entitled to retain title to the leased property at the end of the lease term. The court concluded that the inclusion of the residual value element in this damage formula constituted a penalty because it would almost certainly result in a recovery to the lessor that far exceeded its actual damages. That is, the lessor would recover funds from the lessee equaling the value of the property at the end of the lease and would recover the leased property at the end of the lease as well, which would amount to a double recovery. On appeal, the Ninth Circuit Court of Appeals affirmed the district court and held that the liquidated damage provision was invalid. *Atel Fin. Corp. v Quaker Coal Co.* (9th Cir 2003) 321 F3d 924. However, it did so on different grounds than those relied on by the district court. The court found that the parties continued to perform under the lease after the payment default that triggered the liquidated damage provision and that the late fees paid by the lessee fully compensated the lessor for any damage caused by the payment default. Thus, the court held that the liquidated damage provision was unenforceable because the lessor suffered no uncompensated damage.

Division 10 does not incorporate two other tests that under sales law determine the enforceability of liquidated damages provisions: the difficulty of proving loss and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. Cal Comment to Com C §10504. See §§18.51-18.52.

A liquidated damages formula that is common in leasing practice provides that the lessor's damages include the sum of lease payments past due, accelerated future lease payments (discounted to present value), and the lessor's estimated residual interest (discounted to present value), less the net proceeds of disposition of the leased goods (whether by sale or re-lease). Tax indemnities, costs, interest, and attorney fees are also added to the lessor's damages.

Another common formula provides for a fixed number of periodic payments as a means of liquidating damages. Stipulated loss or stipulated damages schedules are also common.

Whether these formulas are enforceable will be determined in the context of each case by applying the reasonableness test of CC §1671. See Cal Comment to Com C §10504; form 19.107-1.

Other jurisdictions also rely on a reasonableness test in analyzing the enforceability of agreements with liquidation clauses. In *Carter v Tokai Fin. Servs., Inc.* (Ga Ct App 1998) 500 SE2d 638, 641, a Georgia court held that a liquidated

damage clause in a finance lease was not enforceable because it was not a reasonable estimate of probable loss caused by the lessee's default and amounted to a penalty. The lessor in this case brought a claim against the guarantor and sought to recover under the terms of the lease agreement. Under that agreement, the lessor was entitled to receive all future rental payments until the lease expiration date plus the amount of the equipment's fair market value. In addition, the lessor could sell the equipment without "any duty to account for the proceeds of such sale." Similarly, in *Interface Group-Nevada, Inc. v Trans World Airlines, Inc. (In re Trans World Airlines, Inc.)* (3d Cir 1998) 145 F3d 124, 133, in applying New York law, the court found that the liquidated damages clause in an aircraft lease agreement was unenforceable. Under the terms of the lease agreement, the lessee was liable for the difference between a stipulated termination value stated in the agreement and either the fair market rental value or the fair market sale value of the aircraft on the date of default (the lessor had complete discretion to choose which terms to enforce). This provision was found to be unreasonable because the lessee could be bound to pay the fair market sale value of the aircraft (which could exceed the total rental value owed under the lease) even if it defaulted on the lease one month before the termination date. The case is worth noting because many leases provide that the lessor is entitled to a liquidated damage award based on the termination value or casualty value of the leased property. Other courts have invalidated or expressed doubts about the validity of this type of liquidated damage provision. See, *e.g., In re Montgomery Ward Holding Corp.* (3d Cir 2003) 326 F3d 383; *ePlus Group, Inc. v Panoramic Communications LLC* (SD NY 2003) 50 UCC Rep Serv 2d 213.

If the subject of the lease is consumer goods, a liquidated damages provision will be considered to be void unless fixing the actual damages is impracticable or extremely difficult. CC §1671(d); Com C §10504(a).

Division 10 expressly acknowledges the legitimacy of including loss of anticipated tax benefits in a liquidated damages provision. Com C §10504(a).

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§19.114 2. Restitution

If the lessor justifiably withholds or stops delivery of goods because of the lessee's default or insolvency, the lessee is entitled to restitution of a portion of payments already made. If the lessee's payments exceed the liquidated damages to which the lessor is entitled under a valid liquidated damages clause, the lessor must return the difference to the lessee. Com C §10504(c)(1).

If the lease agreement does not contain a valid liquidated damages clause, the amount that the lessor must return is determined by calculating the present value of the rent payable for the balance of the lease term and then subtracting 20 percent of that figure from the amount of lease payments already made. The balance of lease payments must be returned to the lessee. Com C §10504(c)(2). This is essentially a statutory form of liquidated damages that allows the lessor to keep 20 percent of whatever remaining value the lease has. If the lease agreement does not specify an interest rate that can be used for calculating present value, the discount is determined by a commercially reasonable rate that takes into account the facts and circumstances of each case at the time the transaction was entered into. Com C §10103(a)(21). The same approach will be used if the parties have chosen a rate that is "manifestly unreasonable" at the time the transaction was entered into. Com C §10103(a)(21).

The Commercial Code does not specify what date should be used for discounting purposes. The present value of the remaining lease payments will vary depending on whether the discounting is done as of the date of default, as of the date on which the lessor obtains possession of the goods or the lessee tenders the goods back to the lessor, or (if the lessee retains the goods) as of the date of judgment.

In making a payment of restitution, the lessor is entitled to offset its other damages (*i.e.,* those not already included in the liquidated damages remedy) and the amount or value of any benefits that the lessee has received through performance of the lease agreement. Com C §10504(d).

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§19.115 3. Cancellation and Termination

The Commercial Code distinguishes between "cancellation" and "termination" of a lease agreement. Cancellation occurs when either party puts an end to the lease contract for default by the other party. Com C §10103(a)(2). Termination occurs when either party, under a power created by agreement or law, puts an end to the lease contract other than for default. Com C §10103(a)(26).

In either situation, the parties' unperformed obligations are completely discharged. Com C §10505(a)-(b). If the lease was canceled rather than terminated, the canceling party retains any remedy for default of the whole lease contract or any unperformed balance. Com C §10505(a).

DRAFTING CONSIDERATIONS: Notwithstanding the terminology used in the Commercial Code, lease forms typically refer to the lessor's remedy following a breach of the lease by the lessee as a "termination" of the lease. Because a lessor who exercises the lease agreement remedy of "termination" undoubtedly expects to remain in the position of collecting damages for the unperformed balance of the lease term, which Com C §10505(a) states is available in the case of a "cancellation" but Com C §10505(b) does not make available in the case of a "termination," this lease agreement terminology could prove to be a source of confusion in enforcing the lease. It seems clear, however, that whatever language is selected by the parties in the lease agreement, the rights described in Com C §10505(a) as pertaining to a "cancellation" should be available whenever the situation involves a party exercising a remedy that arises on the default of the other party. Nevertheless, confusion could be avoided by using the term "cancellation" in the remedy section of the lease agreement rather than the term "termination."

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Source: Business Law/California UCC Sales and Leases/19 Leasing of Goods/§19.116 D. Standing to Sue Third Parties for Damage to Leased Goods

§19.116 D. Standing to Sue Third Parties for Damage to Leased Goods

Because the lessee under a lease agreement has possession of the goods while the lessor has title, it may be unclear who has standing to sue a third party who damages the goods. The lessor always has standing to do so, and the lessee also has that right if certain conditions are met. Com C §10531(a).

The lessee's right to bring an action depends on whether it has (Com C §10531(a)):

- A security interest in the goods;
- An insurable interest in the goods (see §19.45); or
- Responsibility for the risk of loss of the goods (see §19.44).

Either the lessor or the lessee may bring an action for the benefit of both parties if the other party's consent to the action has been obtained. Com C §10531(c).

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§19.117 E. Statute of Limitations

An action based on a lease agreement default must be commenced within four years after accrual. The parties are free, however, to shorten the period of limitations to one year, and there is no restriction on how long it may be extended. If the lease is a consumer lease, the period of limitations may not be shortened. Com C §10506(a).

A cause of action for default accrues when the aggrieved party discovers (or should have discovered) the act or omission constituting the default or the date of the default, whichever occurs later. Com C §10506(b).

An action for indemnity accrues when the party seeking indemnity actually discovered or should have discovered (whichever occurs later) the underlying act or omission on which the claim is based. Com C §10506(b). Interpreted literally, this provision would allow a party to argue that the actual discovery of the underlying act or omission occurred at a time earlier than the party "should have discovered" the underlying act or omission, and thus that the cause of action should not have started to run until the later time. It is doubtful, however, that such an anomaly was intended. The provision should be read to mean that a cause of action for indemnity accrues on the earlier to occur of the time when the party seeking indemnity should have discovered, or actually did discover, the underlying act or omission. The same is probably true regarding accrual of a cause of action for default.

The Commercial Code leaves intact laws and theories under which the statute of limitations may be tolled for a particular cause of action. Com C §10506(d).

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§19.118 XV. FRAUDULENT CONVEYANCE ISSUES

Because a sale and leaseback transaction involves the transfer of title to goods without the seller-lessee's transferring possession, the transaction may be scrutinized for fraudulent conveyance possibilities. See CC §3440. The sale and leaseback will be valid for these purposes if two tests are met: The buyer must have purchased the goods for value, and it must have purchased the goods in good faith. Com C §10308(c). See also CC §3440.1(k).

As a matter of caution, however, the attorney still may want to comply with the filing and publication requirements of CC §3440.1. Compliance is advisable in transactions in which there is uncertainty over whether the sale and leaseback will be characterized as a lease under Com C §1203(b).

To comply with CC §3440.1, a financing statement signed by the transferor should be filed with the Secretary of State before the date of the transfer. Notice of the intended transfer must be published one time in a newspaper of general circulation in the judicial district in which the property is located, no less than 10 days before the transfer. The notice should contain the names and addresses of the transferor and transferee and a general statement of the character of the property to be transferred. The notice should also indicate the property's location and the date on or after which the transfer will be made. CC §3440.1(h)(1)-(2).

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XVI. BANKRUPTCY ISSUES

§19.119 A. Introduction

In the past several years, there has been an unprecedented increase in bankruptcy filings. The remainder of this chapter deals with issues of particular interest to lessors and financers of goods, including:

- The right of the trustee or debtor-in-possession to assume, reject, or assign an unexpired lease;
- The effect of the automatic stay;
- The use of leased property by the debtor's estate; and
- The lessor's claims against the estate.

Some of the authorities cited for principles of bankruptcy law may not necessarily involve the leasing or financing of personal property. Unless otherwise noted, the term "debtor" refers to the lessee.

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B. Applicability of Bankruptcy Law

§19.120 1. Terminated Versus Unexpired Leases

The debtor's interest in a lease is property of the bankruptcy estate until the lease is terminated. 11 USC §541.

Expiration or termination of the lease before bankruptcy proceedings commence terminates the debtor's right to use the leased property. *In re Scarsdale Tires, Inc*. (Bankr SD NY 1985) 47 BR 478. If the lease expires during the bankruptcy proceedings, the debtor's right to use the leased property also terminates. See, *e.g., Gloria Mfg. Corp. v International Ladies' Garment Workers Union* (4th Cir 1984) 734 F2d 1020.

A lease that has been validly terminated before bankruptcy may not be assumed by the debtor. *Chart House, Inc. v Maxwell (In re Maxwell)* (Bankr ND Ill 1984) 40 BR 231.

Whether a lease has been terminated before the petition has been filed is an issue that should be determined through an adversary proceeding. A lessor is not entitled to a jury trial of this issue. Fed R Bankr P 7001(2); *In re Windmill Farms Mgmt. Co*. (Bankr SD Cal 1990) 116 BR 755.

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§19.121 2. Unenforceability of Bankruptcy Clauses in Leases

Notwithstanding the terms of the lease agreement, the insolvency, financial condition, or commencement of bankruptcy proceedings by a lessee does not terminate the lease or constitute an enforceable breach or event of default. These so-called ipso facto clauses are expressly made unenforceable in bankruptcy by 11 USC §365(e)(1). *Computer Communications, Inc. v Codex Corp. (In re Computer Communications, Inc.)* (9th Cir 1987) 824 F2d 725. The clauses may still be enforceable, however, during the period before the bankruptcy petition is filed and after the bankruptcy case is dismissed.

DRAFTING CONSIDERATIONS: Ipso facto clauses are really a shorthand way of expressing one party's concern for protecting the bargain in the event of the financial deterioration of the other party. The party seeking to include such a clause in a lease agreement should recognize that the real concern is not bankruptcy; it is the possibility of being contractually bound to a financially strapped party. Financial difficulties may impair or destroy the lessee's ability to repair and maintain the property, to pay taxes and insurance premiums, and so forth. The attorney should identify these risks at the drafting stage and address them in the lease agreement through affirmative and negative covenants that, if breached, would provide a warning signal of potential financial problems. See further discussion in Pietzman & Pesterfield, *Drafting Bankruptcy Provisions in Commercial Contracts and Leases*, 2 CEB Cal Bus L Prac 32 (Winter 1987).

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Source: Business Law/California UCC Sales and Leases/19 Leasing of Goods/§19.122 3. Lessors of Aircraft, Vessels, and Rolling Stock

§19.122 3. Lessors of Aircraft, Vessels, and Rolling Stock

The Bankruptcy Code provides special protections to lessors of aircraft and related aircraft equipment and to lessors of vessels and rolling stock. Although a discussion of this specialized area of law is beyond the scope of this book, the following brief synopsis should serve as a useful introduction to this topic. See 11 USC §§1110, 1168.

Section 1110 provides that the automatic stay against actions by creditors of an entity filing a bankruptcy case will terminate after only 60 days for parties within its scope. Parties within the scope of §1110 include holders of security interests (limited to purchase money security interests for property placed in service on or before October 22, 1994) in, or lessors or conditional vendors of, the following:

- Aircraft, engines, and other specified equipment owned by, leased to, or conditionally sold to a debtor that, at the time the transaction is entered into, holds an air carrier operating certificate issued by the Secretary of Transportation under 49 USC §§44701-44729 for aircraft capable of carrying 10 or more individuals or 6000 pounds or more of cargo; and
- Documented vessels (as defined in 46 USC §106) owned by, leased to, or conditionally sold to a water carrier holding a certificate of public convenience and necessity or a permit issued by the Interstate Commerce Commission.

There are two exceptions to the general rule stated above:

- First, the automatic stay will remain in effect and the secured party-lessor-vendor will be unable to repossess its equipment if, within 60 days after the order for relief and subject to court approval, the debtor agrees to perform all its obligations under the relevant lease or contract.
- Second, an exception is made for situations in which there is a cure of any default under the relevant lease or contract. If the default occurred before the date of the order for relief, the debtor must cure it within 60 days after the order for relief. If the default occurred after the date of the order for relief, it must be cured within 30 days after the date of that default or within 60 days after the order for relief, whichever occurs later.

Before its amendment in 1994, and further clarification by amendment in 2000, significant disputes arose under 11 USC §1110 over issues such as:

- Whether sale-leaseback transactions and renewal and extended leases would fall within its ambit;
- Whether a purported lease constituted a true lease (and therefore within the coverage of §1110 as drafted before its amendment) or a security interest (and therefore not within the coverage of §1110 as drafted before its amendment);
- How to apply the "certificated air carrier" requirement imposed by §1110;
- Whether the creditor could immediately obtain possession of the property from the trustee after the 60th day or instead was merely permitted as of that date to commence a repossession action; and
- Whether the debtor, having satisfied its obligation to cure all defaults before the expiration of the 60-day period, could thereafter commit a new default concerning which the creditor's special protections under §1110 would not be applicable.

As currently in force, 11 USC §1110 clearly seems to apply to all leases, whether part of a sale-leaseback transaction or not, and whether renewed or extended. Further, the elimination of the distinction between purchase money security interests and other security interests for equipment placed in service after October 22, 1994, substantially eliminates the incentive under §1110 to debate the appropriate characterization of a lease of such equipment. With respect to equipment placed in service on or before October 22, 1994, when the distinction between purchase money security interests and other security interests continues to exist, §1110 creates a safe harbor that affords the benefits of §1110 to a lessor if the lessor and lessee have set forth in writing that the lease agreement is intended to be treated as a lease for income tax purposes. Accordingly, disputes over lease versus security interest characterization for such older equipment can be avoided as well.

Title 11 USC §1168 provides for substantially the same, but not identical, treatment of railroad rolling stock.

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Source: Business Law/California UCC Sales and Leases/19 Leasing of Goods/§19.123 C. Effect of Automatic Stay

§19.123 C. Effect of Automatic Stay

A voluntary or involuntary filing of a petition under the Bankruptcy Code operates as an automatic stay of, among other things, the following (11 USC §362(a)):

- The commencement or continuation of legal proceedings against the debtor;
- The enforcement, creation, or perfection of liens against the debtor's property;
- Any action to obtain possession of property of the debtor's estate; and
- Any action to collect on any prepetition claim against the debtor.

Consequently, the lessor is stayed from taking any direct action to terminate a lease or to retake possession of the leased property. Even if a lease has been validly terminated under state law before bankruptcy, relief from the automatic stay may still be required for the lessor to regain possession of the leased property. See, *e.g., In re Scarsdale Tires, Inc*. (Bankr SD NY 1985) 47 BR 478. The automatic stay does not preclude the expiration of a lease agreement by its own terms. *Shell Oil Co. v Anne Cara Oil Co.* (*In re Anne Cara Oil Co.)* (Bankr D Mass 1983) 32 BR 643.

PRACTICE TIP: A cautious lessor wishing to avoid the consequences of the automatic stay in an impending bankruptcy case should act promptly to terminate the lease and, if practical, take possession of the property before the lessee files. However, a negotiated settlement with the lessee to obtain possession of the leased goods may be challenged by the trustee as a fraudulent transfer. See 11 USC §548. The fair market value of the lessee's remaining leasehold interest is an asset of the potential bankruptcy estate, and adequate consideration must be given for it. See, *e.g., Fitzgerald v Cheverie (In re Edward Harvey Co.)* (Bankr D Mass 1987) 68 BR 851 (lessor forgave $30,000 in unpaid rent for surrender of lease, which had a present value in excess of $500,000; court held that trustee could avoid transfer).

Although case law is not consistent in this area, the court may prohibit the debtor's use of leased property pending its decision to assume or reject the lease, unless the debtor provides adequate protection of the lessor's interest in the property. See 11 USC §363(e); *In re Grant Broad., Inc*. (Bankr ED Pa 1987) 71 BR 891.

The automatic stay may be lifted for cause, including the lack of adequate protection. 11 USC §362(d)(1). Before amendment of the Bankruptcy Code in 1994, lessors sought adequate protection in the form of regular lease payments, insurance coverage, maintenance of equipment, and periodic cash payments or a lien on other collateral to protect against deterioration in the market value of the leased property. See, *e.g., In re Wheeling Pittsburgh Steel Corp*. (Bankr WD Pa 1985) 54 BR 385; *In re Attorney's Office Mgmt., Inc.* (Bankr CD Cal 1983) 29 BR 96. The amendments to the Bankruptcy Code adopted in 1994 grant a personal property lessor an explicit right to seek adequate protection under 11 USC §363(e), but to the exclusion of any right to seek to have the automatic stay lifted on the basis of a lack of adequate protection. The right to seek relief from stay continues to be relevant to a personal property lessor for a lease that was either terminated before commencement of the bankruptcy case or expired before or during the bankruptcy case.

A request for relief from the stay is made by a motion under Fed R Bankr P 9014. Fed R Bankr P 4001(a)(1). Under 11 USC §362(e), the automatic stay is terminated 30 days after making a motion for relief from it unless the bankruptcy court orders the stay continued pending a final hearing. The bankruptcy court will order the stay continued if there is a "reasonable likelihood" that the debtor will prevail at the conclusion of the final hearing. The bankruptcy court has the option of holding a preliminary hearing or proceeding directly to a final hearing. 11 USC §362(e). If a preliminary hearing is held, then 11 USC §362(e) provides that the final hearing must be concluded within 30 days after conclusion of the preliminary hearing, unless the period is extended "with the consent of the parties" or for some specific time which the court finds is "required by compelling circumstances." Before amendment in 1994, 11 USC §362(e) specified the time frame within which the final hearing must be "commenced," but did not provide a time within which the final hearing had to be concluded. As a result, the procedure for lifting the automatic stay had the potential of extending the stay for an unspecified period of time.

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§19.124 D. Use, Sale, or Lease of Property of Estate

Unless the court orders otherwise, a trustee or debtor may use, sell, or lease property in the ordinary course of its business without the necessity of court approval. Thus, a lessee-debtor may continue to use leased property in the ordinary course of its business, and a lessor-debtor may continue to lease or sell its assets to others in the ordinary course of its business. 11 USC §363(c)(1).

Transactions to use, sell, or lease property of a debtor's estate other than in the ordinary course of business require notice and a hearing. 11 USC §363(b)(1).

NOTE: Any dispute over the validity, priority, and extent of any lien must be adjudicated in an adversary proceeding. *In re Kirkland Knightsbridge, LLC* (Bankr ND Cal Feb. 9, 2007, No. 06-10628) 2007 Bankr Lexis 491.

Section 363(e) gives a lessor the right to seek an order from the bankruptcy court to provide "adequate protection" of the lessor's interest in the leased property. Thus, a lessor may seek an order compelling the lessee to pay certain unpaid amounts under the lease agreement or to perform certain nonmonetary obligations. The right to seek adequate protection under 11 USC §363(e) is exercisable only to the exclusion of seeking an order for relief from the automatic stay under 11 USC §362. In contrast to §362 (see §19.123), §363 does not specify a time period within which such a motion must be heard or decided.

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E. Assumption or Rejection of Lease

§19.125 1. Rule Permitting Assumption or Rejection of Unexpired Term

The Bankruptcy Code permits a trustee as a matter of business judgment to reject an unexpired lease and thereby transform a future obligation of the lessee to make the remaining lease payments into a general unsecured claim of the lessor. See 11 USC §365(a). Although it rarely occurs in practice, a trustee for a lessor filing for bankruptcy also has the right to reject an unexpired lease. *State of W. Va. v Hassett (In re O.P.M. Leasing Servs., Inc.)* (Bankr SD NY 1982) 21 BR 993. The following discussion focuses on the rights of a lessee in bankruptcy because that is the situation typically faced. However, the concepts discussed would apply equally to a situation in which the lessor is the party in bankruptcy.

The debtor is permitted to use leased property pending the lessor's decision to assume or reject the lease. See §§19.126-19.127. The automatic stay prevents the lessor from recovering leased equipment from the bankruptcy estate and payment of prepetition rents from the debtor's estate. See §19.123.

A lease that has been validly terminated before bankruptcy may not be assumed. *In re Escondido W. Travelodge* (Bankr SD Cal 1985) 52 BR 376.

Some courts have stated that the primary concern of the bankrupt estate's trustee in determining whether to accept or reject a lease should be what is in the best interest of the estate. See *In re Knight* (Bankr D Or 1997) 211 BR 747, and the cases cited in that opinion. Generally, the court must determine that the debtor's decision to assume or reject the lease meets the "business judgment" test. The fundamental inquiry is whether the decision is so manifestly unreasonable that it could not be based on sound business judgment, but only on bad faith, whim, or caprice. See *Lubrizol Enters. v Richmond Metal Finishers, Inc*. (4th Cir 1985) 756 F2d 1043, 1047.

As applied to a decision to assume the lease, the business judgment test has been held to mean that the assumption merely benefits the estate. *In re Lionel Corp*. (Bankr SD NY 1983) 29 BR 694. As applied to a decision to reject the lease, the test does not require the debtor to show that the lease is a burden on the estate, but rather that rejection would benefit the general creditors of the estate, as weighed against any disproportionate burden on the lessor. *Robertson v Pierce (In re Chi-Feng Huang)* (BAP 9th Cir 1982) 23 BR 798.

An unexpired lease may not be assumed by the debtor if (1) the lessor does not consent to assumption and applicable nonbankruptcy law excuses it from performance, or (2) the agreement contemplates the making of a loan or an extension of debt financing or financial accommodations to or for the benefit of the debtor. 11 USC §365(c). The purpose of this latter exception is to prevent a trustee or debtor in possession from requiring new advances of money or other property. Stated another way, a lessor is not required to finance a debtor's reorganization involuntarily, based on a contract that was negotiated without knowledge that the debtor would be filing bankruptcy.

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§19.126 2. Time Limits for Assumption or Rejection

In a Chapter 7 bankruptcy case, an unexpired lease is considered to be rejected unless the trustee assumes the lease within 60 days after the order for relief or within additional time fixed by the court for cause. 11 USC §365(d)(1); *Willamette Water Front, Ltd. v Victoria Station, Inc. (In re Victoria Station, Inc.)* (9th Cir 1989) 875 F2d 1380.

A motion to extend the time for assumption or rejection must be filed within the 60-day period, but the court need not act on the motion within that time. *Southwest Aircraft Servs. v City of Long Beach (In re Southwest Aircraft Servs.)* (9th Cir 1987) 831 F2d 848. The statute does not require notice and a hearing for this motion; arguably, it may be done ex parte. See *Chapman Inv. Assoc. v American Healthcare Mgmt., Inc. (In re American Healthcare Mgmt., Inc.)* (5th Cir 1990) 900 F2d 827. The court may grant a string of extensions beyond the 60-day period as long as each extension is granted within the period allowed. *Willamette Water Front, Ltd. v Victoria Station, Inc. (In re Victoria Station, Inc.), supra*. In extending the time, the court might consider such things as whether the lease is one of the debtor's primary assets, how the debtor's business operations would be affected if the lease were considered to be rejected, other matters that the debtor must cope with within the 60-day period, whether the debtor was current in performing its part of the lease, and the harm that the lessor would suffer if the period to assume or reject were extended. See *In re S & M Food Servs*. (Bankr ED Mo 1990) 117 BR 497.

In a Chapter 11 bankruptcy case, the trustee may assume or reject an unexpired lease at any time before confirmation of a plan of reorganization or as part of a plan of reorganization. 11 USC §§365(d)(2), 1123(b)(2).

If a bankruptcy case is converted from Chapter 11 to Chapter 7, a new 60-day time period commences. *In re Joyner* (Bankr MD Ga 1987) 74 BR 618. Any party to the lease, however, may ask the court to order the debtor to decide within a specified time whether it will assume or reject the lease. The debtor must be given a reasonable period to do so. 11 USC §365(d)(2). The motion to assume or reject is most useful to the lessor when the equipment is tied up and the bankruptcy proceedings are not moving forward.

In a Chapter 11 bankruptcy case, the trustee is required to perform all the obligations under the lease that arise during the period beginning on the date 60 days after the bankruptcy case is commenced and ending on the date that the lease is assumed or rejected, unless the bankruptcy court, after holding a hearing, orders otherwise. 11 USC §365(d)(5). Thus, the debtor is not obligated to cure defaults that occurred before the bankruptcy filing or those that occurred during the first 60 days after the filing. In essence, this provision, which was adopted in 1994, gives the debtor a 60-day rent moratorium within which to decide whether to assume or reject a lease. At the expiration of that time, absent a bankruptcy court exception based on the facts of the case, the debtor must pay rent at the contract rate in order to continue to have the right to assume or reject the lease. The United States Bankruptcy Court for the District of Connecticut, however, held that a debtor can further delay the payment obligation of §365(d)(5) until the court has adjudicated the issue of whether or not the lease is a "true" lease or merely a disguised security agreement. *In re Circuit Wise, Inc.* (Bankr D Conn 2002) 277 BR 460.

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§19.127 3. Procedure for Assumption or Rejection

A debtor's assumption or rejection of an unexpired lease must be approved by the bankruptcy court after notice and motion. Fed R Bankr P 6006(a), 9014. Conduct or promises alone will not suffice. *Treat Fitness Center, Inc. v Rainbow Inv. Co. (In re Treat Fitness Center, Inc.)* (BAP 9th Cir 1986) 60 BR 878; *Corporate Prop. Investors v Chandel Enters., Inc. (In re Chandel Enters., Inc.)* (Bankr CD Cal 1986) 64 BR 607. But see *George v City of Morro Bay (In re George)* (9th Cir 1999) 177 F3d 885, 889 (discussing without determining whether waiver or estoppel might be applicable to prevent lease forfeitures under 11 USC §365(d)(4)). Neither will a statement filed with the court, informing it that the debtor is assuming the lease. Notice to the lessor and an opportunity to be heard are required. *Sea Harvest Corp. v Riviera Land Co*. (9th Cir 1989) 868 F2d 1077.

NOTE: A formal motion to assume a lease is not required in Chapter 13 proceedings. See *In re Flugel* (SD Cal 1996) 197 BR 92 (assumption provision in debtors' plan, together with notice of creditors' meeting that included specific notice that debtors intended to assume lease, satisfied bankruptcy rule requirements; court stressed that result might have been different had debtors' intention to assume particular lease not been specifically mentioned in notice of creditors' meeting).

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§19.128 4. Assumption When Defaults Exist

To assume a debtor's lease, the trustee must cure defaults or provide adequate assurance that the trustee will promptly cure defaults. 11 USC §365(b)(1)(A). This will ordinarily require payment of pre- and postpetition rent. Formerly, 11 USC §365(b)(2)(D) provided that there was no requirement of curing a default that related to the satisfaction "of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations." It has been held that the word "penalty" in 11 USC §365(b)(2)(D) modified both "rate" and provision" and that the statute was intended by Congress to address the single issue of the payment of penalties. *Worthington v GMC (In re Claremont Acquisition Corp.)* (9th Cir 1997) 113 F3d 1029 (debtors' failure to operate franchise for seven days was not default of contractual provision relating to satisfaction of penalty rate or payment of penalty, and therefore obligation to cure default was not excused). This interpretation was explicitly confirmed in Congress's adoption of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Pub L 109-8, 119 Stat 100), when the word "penalty" was inserted as a modifier for "provision," so that the statute now reads "any penalty rate or penalty provision."

The trustee must compensate the lessor for actual pecuniary loss resulting from the lessee's/debtor's defaults or provide adequate assurance that the trustee will promptly compensate those losses. 11 USC §365(b)(1)(B). Although there is contrary authority, the majority view appears to be that there is no independent right to attorney fees as part of the lessor's "actual pecuniary loss." *Lacey v Westside Print Works, Inc. (In re Westside Print Works, Inc.)* (9th Cir 1995) 180 BR 557, 563-564 (expressly disagreeing with holding to contrary, in *In re Westworld Community Healthcare, Inc.* (Bankr CD Cal 1989) 95 BR 730, as being against majority view in other circuits). However, the landlord may recover such fees if the lease clearly provides for them. *In re I-Mind Educ. Sys., Inc.* (Bankr ND Cal 2001) 269 BR 47.

The trustee may not require the lessor to provide services or supplies incidental to the lease before assumption of the lease without compensating the lessor for those services or supplies. 11 USC §365(b)(4).

The trustee must provide adequate assurance of future performance under the lease. 11 USC §365(b)(1)(C). Adequate assurances are determined on a case-by-case basis and include such factors as the debtor's ability to generate funds to meet its obligations (taking into account its history of profitability), the economic outlook of the industry, and the presence of a guarantee. *Richmond Leasing Co. v Capital Bank* (5th Cir 1985) 762 F2d 1303.

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§19.129 5. Assumption of Entire Lease

The debtor must assume or reject all provisions of the lease as a whole; it may not keep the beneficial aspects of the contract while rejecting its burdensome aspects. See, *e.g., In re EI Int'l* (Bankr D Idaho 1991) 123 BR 64 (rejection of contract includes liquidated damages provision). An agreement may be considered to be two or more severable agreements, however, thereby allowing the debtor to reject or assume each independently of the others. Whether an agreement will be treated as one contract or several contracts depends on the parties' intent and is a question of state law. *Byrd v Gardinier (In re Gardinier)* (11th Cir 1987) 831 F2d 974 (agreement for purchase and sale of real property was severable from listing agreement creating right to commission). Thus, in the instance of a lease that is characterized as an "installment lease," the debtor would be obligated to assume or reject the lease in its entirety. See §19.41.

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§19.130 6. Rejection as Breach of Lease

Rejection of an unexpired lease constitutes a breach that may give rise to a claim for damages under 11 USC §502(g). 11 USC §365(g)(1). The breach is considered to have occurred immediately before the date of filing. 11 USC §365(g)(1).

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F. Lessor's Claims in Bankruptcy Proceedings

§19.131 1. Prepetition Claims

The lessor may assert a claim against the debtor's estate for unpaid prepetition rent and damages for breach of the lease. See 11 USC §365(g). In Chapter 11 bankruptcy cases, payment of claims of prepetition creditors may be stretched out or discharged by partial payment under the debtor's plan of reorganization.

If the lease is breached after being assumed by the trustee or debtor-in-possession after the bankruptcy proceeding commences, the lessor may be entitled to claim prepetition damages as an administrative expense if the breach benefited the estate. See *In re Norwegian Health Spa, Inc*. (Bankr ND Ga 1987) 79 BR 507.

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§19.132 2. Postpetition Claims

Because rejection of the lease is considered to be a breach as of the date on which the bankruptcy case was filed (11 USC §365(g)(1)), a claim arising from the rejection of the lease must be valued as of the date on which the petition for bankruptcy was filed. See *In re O.P.M. Leasing Servs.* (Bankr SD NY 1987) 79 BR 161.

An administrative claim may be available for the actual and necessary value of the use of the leased property during the period between filing and the assumption or rejection of the lease. See 11 USC §503(b)(1); *In re Daisy/Cadnetix, Inc*. (Bankr ND Cal 1991) 126 BR 87. However, the lessor must demonstrate that the use of the leased property before the rejection benefited the debtor's estate; otherwise, the lessor's claim for damages relating to unpaid rent will be an ordinary unsecured claim. *In re Continental Airlines, Inc.,* (Bankr D Del 1992) 146 BR 520, 526. To show a benefit to the estate, the lessor need demonstrate only that the leased property was "actually used by the debtor post-petition in the ordinary course of debtor's business." 146 BR 527.

Unless evidence is presented that the lease rental amount is unreasonable, the amount of the claim will be determined by the lease terms. See, *e.g., In re Thayn Farms, Inc*. (Bankr D Neb 1988) 117 BR 510. The holding of *Thayn Farms* may have been weakened by the decision in *In re Continental Airlines, Inc.* (Bankr D Del 1992) 146 BR 520, 528, in which the court questioned why, in determining the amount of an administrative claim for postpetition rent, courts should favor the rent specified in the rejected lease over current market rates, "when the rejected lease was typically negotiated many years prior to the pertinent filing date," and ultimately found a lessor to be entitled to rent that was more than thirty percent lower than the rent specified in the lease. But see *Paul Harris Stores, Inc. v Mabel L. Salter Realty Trust (In re Paul Harris Stores, Inc.)* (Bankr SD Ind 1992) 148 BR 307, 313, in which the court concluded that, as a general matter, lessors are entitled to a claim for the amount of rent specified in the relevant lease agreement.

With the amendment of the Bankruptcy Code in 1994 to give the debtor, in effect, a 60-day rent payment moratorium within which to decide whether to assume or reject the lease, the significance of disputes over the amount of an administrative claim for rent under 11 USC §503(b) has been diminished. See §19.126. Because the trustee is required to pay rent at the rate set in the lease agreement after the 60th day following commencement of a bankruptcy case if the trustee wishes to preserve the option to assume or reject a personal property lease, the dispute over the amount of the administrative claim would seem limited to the initial 60-day period. See 11 USC §365(d)(1). If the trustee ultimately assumes the lease, it would seem difficult to argue that any rate other than the rate specified in the lease agreement should be used to measure the amount owed under 11 USC §503(b).

Once a lease is assumed, all future obligations are expenses of administration. *GATX Leasing Corp. v Airlift Int'l (In re Airlift Int'l)* (11th Cir 1985) 761 F2d 1503.

Administrative expense claims generally receive first priority payment from the debtor's estate and must be paid in full at confirmation of any Chapter 11 bankruptcy plan. 11 USC §§507(a)(2), 1129(a)(9)(A). Unsecured prepetition claims are paid only after all administrative expense claims are paid.

If the lease is assumed but later breached, the lessor may also be entitled to an administrative claim for damages if the breach benefited the debtor's estate. 11 USC §503(b)(1); *United Trucking Servs. v Trailer Rental Co. (In re United Trucking Servs.)* (6th Cir 1988) 851 F2d 159. The damages claimable may include pre- as well as postpetition amounts. *In re Norwegian Health Spa, Inc*. (Bankr ND Ga 1987) 79 BR 507.

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§19.133 G. Assignment of Leases After Bankruptcy

A lease provision that prohibits, restricts, or conditions its assignment to another party is unenforceable against a trustee in bankruptcy. 11 USC §365(f)(1). See, *e.g., South Coast Plaza v Standor Jewelers W. (In re Standor Jewelers W.)* (BAP 9th Cir 1991) 129 BR 200 (lease provided that landlord was entitled to 75 percent of appreciation in value of leasehold as precondition to its consenting to assignment; court considered this to be unenforceable restriction); *In re David Orgell, Inc*. (Bankr CD Cal 1990) 117 BR 574 (lease provided for rental increase on assignment; court considered this to be unenforceable restriction).

The trustee, however, must first assume the lease, cure any default, compensate the lessor for losses resulting from any default (or provide adequate assurances that it will cure and compensate), and provide adequate assurance of future performance by the assignee, whether or not there has been a default in the lease. 11 USC §365(b), (f)(2). See *In re Boogaart of Fla., Inc*. (Bankr SD Fla 1981) 17 BR 480 (assignment of real property and equipment leases permitted on showing of assignee's financial strength).

On assignment, the trustee and the debtor's estate are relieved from liability for any breach of the lease occurring after the assignment, leaving the lessor to look solely to the assignee for future payment. 11 USC §365(k). The consideration paid by the assignee becomes property of the estate.

A proceeding to assign a lease is governed by Fed R Bankr P 6006(a). Motion and notice requirements for such a proceeding are set out in Fed R Bankr P 9014.

Contracts with the federal government are nonassignable. 41 USC §15.

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§19.134 H. Preferential Transfer Questions

A "preferential transfer" is defined as the debtor's transfer of an interest in property to a creditor on account of an antecedent debt while the debtor was insolvent, made on or within 90 days before the filing of the debtor's petition for relief in bankruptcy, which results in the creditor's receiving more than the creditor would have if the debtor's assets were liquidated in a Chapter 7 bankruptcy proceeding. 11 USC §547(b).

NOTE: Creditors should be aware of the possibility that they may be classified as insiders for purposes of the preference provisions of the Bankruptcy Code and thereby subjected to the one-year preference period applicable to insiders instead of the 90-day period applicable to noninsiders.

If the creditor is an "insider" as defined in 11 USC §101(31), the 90-day period is extended to one year. 11 USC §547(b)(4)(B). The Bankruptcy Code defines an insider of a debtor corporation to include any officers of the corporation; persons "in control" of the corporation; partnerships in which the corporation is a general partner; general partners of the corporation; and relatives of a general partner, director, officer, or person in control of the corporation. 11 USC §101(31). Affiliates of the debtor and insiders of affiliates also are considered to be insiders. 11 USC §101(31). The term "affiliate" is defined in 11 USC §101(2).

Although most traditional creditors fall outside the definition of "insider," a creditor might be classified as an insider if the creditor could be considered to be in control of the debtor. Before the amendment of the Bankruptcy Code in 1994, the creditor could also be subjected to the extended preference period applicable to insiders if the creditor held a guaranty from an individual or an entity that was itself an insider of the debtor.

Payments made directly to the creditor on an obligation guaranteed by an insider benefit the insider by reducing the insider's obligations under the guaranty. Consequently, before the amendment of the Bankruptcy Code in 1994, several courts held that such payments were subject to the one-year preference period applicable to insiders. See, *e.g. Levit v Ingersoll Rand Fin. Corp. (In re Deprizio Constr. Corp.)* (7th Cir 1989) 874 F2d 1186. Section 550(c) of the Bankruptcy Code, adopted in 1994, supersedes the *Deprizio* doctrine by providing that if a transfer made between 90 days and one year before the filing of the petition was made for the benefit of a creditor that at the time of transfer was an insider, the trustee cannot recover under 11 USC §550(a) from a transferee that was not an insider.

The trustee may avoid and recover any preferential transfer for the debtor's estate. Preferential transfers that are made in the "ordinary course of business" and "according to ordinary business terms," however, are not subject to avoidance. 11 USC §547(c)(2). What is considered to be the ordinary course of business may depend on the parties' history of dealings with each other. See *Newton v Andrews Distrib. Co. (In re White)* (Bankr ED Tenn 1986) 64 BR 843 (to fall within 11 USC §547(c)(2) exception, creditor need show only that timing and manner of payment is consistent with timing and manner of payments in parties' prior course of dealings); *Ewald Bros. v Kraft, Inc. (In re Ewald Bros.)* (Bankr D Minn 1984) 45 BR 52 (payments that were seven to twelve days late were not made "in ordinary course of business," because payments had usually been made one or two days late).

Timely lease payments accepted as payment for the current month's rent are not avoidable as a preference. *Bernstein v RJL Leasing (In re White River Corp.)* (10th Cir 1986) 799 F2d 631. Payments of past-due rent may be subject to attack. See, *e.g., Armstrong v General Growth Dev. Corp. (In re Clothes, Inc.)* (Bankr D ND 1983) 35 BR 489. But see, *In re Garrett Tool & Eng'g* (ED Mich 2002) 273 BR 123 (holding that payment of past-due rents was made in usual course of business and thus exempt from preference rules). The trustee has the burden of proof on the issue of avoidability, and the creditor against whom recovery is sought has the burden of proof with respect to the availability of any preference exception. 11 USC §547(g).

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Appendix A

Sales Agreement Checklist

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PRACTICE TIP: This checklist is provided as an aid for drafting a sales agreement. The attorney is reminded, however, that every transaction is unique, and no provision should be included in a sales agreement without careful consideration of the purpose it serves for the client. Because Division 2 of the Commercial Code governs the sale of goods as diverse as apricots and aircraft, no single checklist or form could ever anticipate the multitude of variables that the commercial attorney will encounter in the drafting process.

The checklist refers to sections in this book where forms may be found or applicable legal principles are discussed.

Parties

- Legal names (and state of incorporation)
- Trade names

Addresses

- Chief executive offices
- Location where notices may be delivered

Goods Sold

- Description
- Quantity
- If quantity consists of buyer's requirements or seller's output for a specified period, minimum or maximum quantity or allowable variations from estimated quantity (see §§4.22-4.47)
- Manufacturing terms:
- Seller's duty to manufacture goods according to specifications
- Delivery of plans or patterns
- Confidentiality, patent rights, trademarks
- Time for identification of goods to the contract (see §§8.28-8.31, 17.32-17.37):
- When seller puts goods in possession of carrier for delivery
- When buyer receives seller's notice that goods are ready for shipment
- When buyer receives goods

Price

- Determination of price:
- Agreed on later by the parties (see §§4.5-4.7)
- Determined by one of the parties (see §§4.13-4.19)
- Determined by reference to competitors, the market, or some other standard (see §§4.8-4.12)
- Determination of price is a condition precedent to the contract's existence (see §4.20)
- Per unit
- Total

- Charges included in price, *e.g.,* packaging, shipping, insurance, taxes
- Price discounts
- Price adjustments for increases in costs of, *e.g.,* materials, transportation
- Price protection

Delivery Terms

- Time for delivery; latest date for delivery (see §§4.62-4.70)
- Tender of payment is a condition for delivery (see §10.53)
- Single delivery or delivery in lots (see §§4.57-4.58, 4.74)
- Size and number of deliveries at seller's option, with all goods to be delivered by given date (see §4.56)
- Delivery of all or part of goods as buyer may demand from time to time within specified period (see §§4.22-4.38)
- Delivery terms: F.O.B., F.A.S., C.I.F., C. & F., Ex ship, C.O.D.; modifications of these terms (see §§8.6-8.12, 9.15-9.40)
- Delivery of goods in possession of third party; whether seller may tender delivery through nonnegotiable document of title or written direction to third party to deliver (see §§4.61, 8.14-8.16, 9.46, 15.20-15.28)
- Purchased goods to be stored by seller (keep in mind seller's creditors) (see §§12.28-12.36)
- Seller's packaging duties
- Carrier to be used (see §§9.5-9.6)
- Other shipping instructions; effect of delay or failure to furnish instructions (see §§4.89-4.93, 9.68)
- Effect of delay in shipment (see §§9.9, 16.2-16.18)
- Specify when title passes: on identification, execution of contract, shipment of goods, delivery at destination, payment, or delivery of document of title (see §§8.2-8.27)
- Specify when buyer acquires a special property in the goods (see §8.31)
- Effect of partial or complete destruction of goods (see §§16.51-16.59, 16.64-16.69):
- Seller is not excused and must tender substitute goods
- Seller is not excused but has additional time to deliver
- Seller is excused unless destruction is due to seller's own negligence
- Force majeure provision
- Time when risk of loss passes; effect of breach on risk of loss (see §§8.26-8.27, 16.40-16.50, 16.53)
- Procurement of insurance; consequences of failure to insure (see §§9.30-9.33)
- "No arrival, no sale" term, if appropriate; duty of seller and risk of loss under such a term (see §§8.13, 9.41-9.43, 16.57)
- Notification of shipment (see §9.8)
- Delivery of documents of title (see §§4.72, 9.7, 9.71-9.77, 15.21-15.28)
- Seller's reservation of security interest when goods shipped on credit (see §§4.73, 4.76, 8.21-8.24, 9.10-9.14, 15.31-15.37)
- Whether substituted methods of delivery will be acceptable
- Sale on approval (see §§10.25-10.27, 10.51):
- Terms concerning goods' acceptance and return
- Agreement regarding risk of loss and passage of title
- Sale or return: terms of goods' return; seller's commitment to repurchase unsold goods (see §§10.28, 10.51, 12.53)

Payment

- Manner of payment (see §§10.54-10.55, 10.59-10.66)
- Payment on tender of goods or documents (see §§9.49, 9.71)
- Whether tender of delivery is a condition for payment (see §9.49)
- Credit terms (see §4.76)
- Interest on overdue payments
- Payment with each installment (see §§10.70-10.71)
- Prohibition of substituted manner of payment, if substitution will not be acceptable (see §10.55)
- Payment by letter of credit (see §10.61, chap 13):
- Irrevocable unless otherwise specified
- Bank specified or approved by seller
- Credit confirmed
- Time by which credit must be established
- Amount that letter of credit must cover
- Seller's reservation of security interest in goods until paid (see §§8.21-8.24)

Warranties

- Express (see §§3.8-3.18):
- Limitations on authority of seller's agents to make warranties (see §§3.8-3.12, 3.15)
- Specifications for goods incorporated (see §§3.17, 3.59)
- Exclusion or modification of express warranties (see §§3.50-3.52)
- Disclaimer or modification of implied warranties of merchantability and fitness for particular purpose (see §§3.53-3.61)
- Disclaimer or modification of implied warranties through course of performance, course of dealing, or usage of trade (see §3.58)
- Sale of goods "as is" and "with all faults" (see §§3.56, 3.63)
- Warranty of title (see §§3.42-3.43)
- Warranty against infringement; right to control infringement litigation (see §§3.44-3.45, 3.77-3.78, 3.86-3.88)
- Exclusion or modification of warranties of title and against infringement (see §§3.65-3.69)
- Full warranty versus limited warranty under Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (see §§3.5-3.7)
- Availability of informal dispute settlement mechanism
- Warranties are cumulative unless parties specify otherwise (see §3.93)

Buyer's Acceptance or Rejection of Goods

- Manner of acceptance (see §§2.24-2.27, 5.7)
- Partial acceptance; minimum amount required to be accepted (see §§10.20, 17.57)
- Inspection by buyer (see §§10.4-10.18):
- Time, place, and manner (whether third party may inspect) (see §§10.5-10.11)
- Whether acceptance of goods or payment is a condition for inspection (see §§10.14, 10.56-10.58)
- Intent of parties regarding exclusiveness of place or manner of inspection (see §10.10)
- Whether contract will be voided if there is a failure of the agreed method of inspection (see §10.10)

- Notice of rejection: time, grounds (see §§8.18-8.19, 10.35-10.43, 17.58-17.59)
- Rejection only if nonconformity substantial, noncurable (see §§17.53-17.56)
- Buyer's responsibilities regarding rejected goods, *e.g.,* resell, reship, notify seller and await instructions (see §§10.44-10.51, 17.60)
- Installment contract or unitary contract (see §§9.53-9.54, 9.73)
- Definition of substantial impairment of installment and whole contract (see §§9.55-9.58)
- Acceptance of past-due installment is not waiver (see §6.18)
- Whether buyer is restricted from revoking acceptance (see §§9.61, 9.74, 10.32-10.34, 17.61-17.66)

Seller's Performance

- Seller's right to cure defects and make adjustments or repairs (see §§9.62-9.67, 9.75)
- Seller's right to make accommodation shipment (see §§2.42-2.50)
- Substituted performance (see §§9.69, 9.77)
- Seller's right to resell goods; notice of sale; manner of resale (see §§17.38-17.46)

Other Terms of Performance

- Grounds for demanding assurances of performance, *e.g.,* delivery is late by more than a specified number of days, buyer is delinquent in payment by more than a specified number of days (see §§16.2-16.18)
- Type of assurance to be furnished when assurance must be given, *e.g.,* posting of performance bond, deposit in escrow (see §16.13)
- Specific events that will excuse performance (see §§16.60-16.63, 16.70)
- Requirement of notice of claimed excused performance (see §§16.72-16.78)
- Exclusive dealing terms (see §§4.48-4.55)
- Definition of "best efforts" in fulfilling exclusive dealing obligations (see §§4.51-4.52)
- Buyer's representation of solvency (see §§17.12-17.13, 17.28)

Remedies

- Notice of breach; time for giving notice, manner of notice, receipt (see §§18.63-18.67)
- Shortened limitations period (see §18.68)
- Remedy limitations (see §§18.51-18.58):
- Repair or replacement (see §§3.94, 17.70)
- Exclusion of incidental or consequential damages (see §§18.8, 18.35-18.41)
- Liquidated damages (see §§18.51-18.52)
- Whether remedies are exclusive or cumulative (see §§17.3, 18.58)
- Attorney fees (see §§18.16, 18.43)
- Choice of law (see §18.55)
- Venue for actions (see §18.56)
- Arbitration of disputes (see §17.2)

General Provisions

- Time-of-the-essence provision
- Limitation on or exclusion of application of course of performance, course of dealing, and usage of trade (see §§1.22, 4.94-4.104, 7.42)
- Waiver of contract terms in writing only (see §§6.12-6.18)
- Modification of contract in writing only (see §§6.2-6.8)

- Assignment of rights and delegation of duties: permitted (with or without consent), restricted, or prohibited (see chap 11)
- Severability of unconscionable or unenforceable provisions (see §§18.69-18.71)
- Duration and renewal of contract (see §§4.79-4.85)
- Grounds for termination of contract; notice required (see §§4.81-4.85)
- Merger or integration clause (see §§7.49)
- Proper authorizations given for execution (see §§7.14-7.15)

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Appendix B

Lease Agreement Checklist

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PRACTICE TIP: This checklist is provided as an aid for drafting a simple agreement for the leasing of equipment or other items of personal property. It can serve only as a starting point for drafting, however, because of the complexity of leasing transactions, variations in the practices of equipment lessors, and special requirements of different types of leases. The client's individual needs, goals, and bargaining strength will dictate what terms ultimately go into the lease agreement.

The attorney should bear in mind the law that applies to the transaction. For example, if the lease is later characterized as a security arrangement (see §§19.5-19.18), Commercial Code Division 9 will apply. The provisions of Division 9 may be in conflict with some of the terms customarily used in a lease, particularly the rights of the parties on termination and default. See §§19.2-19.4, 19.23-19.27 for further discussion of applicable law.
The checklist refers to sections in this book where forms may be found or applicable legal principles are discussed.

Parties

- Legal names (and state of incorporation)
- Trade names

Addresses

- Chief executive offices
- Location where notices may be delivered

Recital of Lease

- Statement that no sale or security interest is intended by the parties (see §§19.5-19.18)
- For finance lease, recitals that (see §19.29-19.30):
- Lessee has received a copy of the contract by which lessor acquired the property (the supply contract);
- Lessee has reviewed and approved the supply contract;
- Before lessee executed this lease, lessor informed lessee in writing of covenants, warranties, disclaimers, and remedy limitations in the supply contract; or
- Before lessee executed this lease, lessor informed lessee in writing that lessee had rights under the supply contract and that lessee should contact supplier for explanation of those rights

Goods Leased

- Description of vehicle (license and vehicle identification number) or property (serial and model number)
- If master lease is used, reference to lease schedule (see §19.43)
- If not presently available, description of leased property may be inserted in agreement or schedule
- For lease of fixtures, description of real property to which leased goods will be affixed and names and addresses of owner and mortgagee (see §19.87-19.92)
- Lessor's interest in leased property:
- Ownership of property remains with lessor; lessee has no right, title, or interest except as set forth in the lease
- Lessor has the right to place notices on the property, identifying it as lessor's

Rent

- Amount and payment date
- Place for delivery of rental payments
- Whether the obligation is unconditional ("hell or high water" covenant; see §19.35)
- Late charge on past-due rent; acceptance of late payment not a waiver of timely payment term
- Escalator provision: notice required for rental increases, frequency of increases, limitation on amount of increase
- Security deposit:
- Lessor's option to use deposit to cure lessee's defaults; lessee's obligation to immediately repay amount of deposit used
- Return deposit to lessee at end of lease after all lessee's obligations are satisfied
- Whether security deposit accrues interest

Term

- Dates of commencement and termination

Delivery and Acceptance

- Method of shipment and delivery of property
- Delivery and installation charges
- Consequences of delay in delivery (see §§19.51, 19.55-19.56)
- Manner of acceptance of leased property; certificate of acceptance (see §§19.48-19.49, 19.55-19.56)
- Lessee's inspection before acceptance (see §19.51)
- Whether risk of loss passes to lessee and, if so, when; effect of breach (see §§19.44-19.47)
- Finance lease: lessor orders equipment from supplier on terms and conditions of purchase order initiated by lessee; lessor pays supplier within specified number of days after lessor's receipt from lessee of acceptance certificate (see §§19.29-19.37)

Use and Maintenance of Leased Property

- Use of property restricted to a particular location; no removal or transfer of possession of property without lessor's written consent
- Lessee will not allow property to be used in a manner that violates any applicable law, rule, or regulation
- Other restrictions on use of property:
- Use limited to lessee's employees and agents only
- Use in compliance with manufacturer's guidelines and warranty requirements
- Use in conformance with applicable insurance policies
- Lessee will keep leased property free of materialmen's, mechanics', tax, and judgment liens and other encumbrances; lessee will not allow any execution, attachment, or other legal process to be levied against the property (see §§19.64, 19.83)
- Who is responsible for fees for licenses, registrations, permits, and other certificates required for lawful operation of the property
- Lessee's maintenance and repair duties (see §§19.48-19.49)
- Service or repair by authorized persons only
- No alterations, additions, or improvements to leased property without lessor's consent; improvements to become part of leased property (see §19.87)
- Alterations, additions, or improvements to leased property allowed; lessee has right to remove them at end of

lease term or, if lessor has right to ownership, lessee will be compensated by rental credit or lessor's payment for incremental increase in value of leased property (see §19.87)

- Lessee must maintain accurate and complete records of maintenance and all repairs made; lessor has right to inspect records and property
- Lessor has right to repair property if lessee does not, and recover costs of repair from lessee
- Lessee bears entire risk of loss, damage, theft, or destruction until leased property is returned (see §§19.44-19.47)
- If leased property is damaged, lessee must:
- Repair and restore property to the condition it was in immediately before the time of damage
- If property is not repairable, replace property with like property approved by lessor, with clear title to lessor; lessee retains insurance proceeds and is entitled to lessor's interest in the damaged property for salvage purposes, in its then condition and location, "as is"
- At lessor's option, pay stipulated loss value
- If leased property is lost, stolen, or totally destroyed, lessee must pay its loss value, according to stipulated loss value schedule, or an amount that includes:
- All rent and other amounts due under the lease at the time of loss or destruction; plus
- The present value of all remaining rent, discounted at a specified discount rate; plus
- Lessor's reversionary interest in the property

Insurance

- Required coverages (see §§19.44-19.47):
- Physical damage (all-risks coverage)
- Public liability
- Coverage amounts that are specified
- Coverage amounts that are acceptable to lessor
- Requirement of insurance certificate showing coverages
- Lessee's right to self-insure
- Lessor or successor or assign is loss payee for all-risks policy and additional insured for liability policy
- Lessor's insurance coverage will not be affected by acts or omissions of lessee
- Lessee will immediately notify lessor of any damage to or loss of leased property or of any personal injury or property damage
- Lessor should receive 30 days' advance notice of threatened cancellation or change in terms
- Lessee will cooperate with lessor and insurers in investigation and defense of all claims or suits
- Application of proceeds
- Stipulated loss value schedule for leased property

Taxes

- Lessee will pay, and will indemnify and hold lessor harmless from, any sales and use taxes, property taxes, and license fees relating to possession and use of the leased property
- Lessee will not pay taxes measured by lessor's net income
- Lessee will file all necessary tax returns and furnish lessor with copies of any notices or inquiries from taxing authorities concerning delinquent taxes, fees, or other assessments
- Lessee will at its own expense contest the validity or amount of any tax; lessee must pay tax first; any refund will accrue to lessee unless lessee is in default under lease

Indemnification; Waiver and Release

- Lessee will indemnify and hold lessor harmless for any, *e.g.,* liability, damages, or expense arising from the condition or use of the leased property or any risk relating to it, including property damage and injury or death of any person (including any claim based on strict or absolute liability in tort) (see §§19.93-19.94)
- Lessee will assert no claim or defense against lessor or lessor's assignee arising from the condition or use of the leased property or risks relating to it; lessee waives any claim for incidental or consequential damages, including those for interruption of service, loss of business, or anticipated profits (see §§19.103-19.104)
- If lease terminates early or transaction is characterized as a sale or security arrangement, lessee will indemnify and hold lessor harmless for any loss of federal or state income tax benefits anticipated by lessor in structuring the transaction, including depreciation, interest deductions, income inclusions, transaction cost amortization, and foreign tax credits
- Lessee's duty of indemnification will continue in effect after termination of lease, regardless of reason for termination

Representations and Warranties

- Lessor:
- Condition of leased property
- Disclaimer of implied warranties of merchantability and fitness for particular purpose; lease of property "as is" (exception for finance leases; see §§19.29-19.37, 19.65-19.67)
- Will not interfere with lessee's quiet enjoyment of leased property (see §§19.62-19.63)
- Use of property does not violate or infringe any patent, trademark, trade name, or other similar right of any person (see §19.64)
- Lessor makes no representation regarding appropriate characterization of transaction or proper treatment by lessee of equipment or rental payments for financial statement, tax, or any other purpose (see §§19.5-19.18)
- Finance lease: lessor did not manufacture, supply, or select the property; selection was based on lessee's own judgment and not on representations of lessor (see §19.32)
- Finance lease: supplier is not an agent of lessor
- Finance lease: lessor assigns to lessee all lessor's warranty and indemnity rights under the supply contract (see §§19.32-19.33)
- Lessee:
- Duly organized, validly existing, and in good standing
- Execution of lease is duly authorized and either does not require any third party approvals or such approvals have been obtained
- Execution of lease will not cause default of any other agreement or obligation binding on lessee or its property
- No actions are pending that could have a materially adverse effect on lessee
- All financial information provided to lessor is true and correct
- Leased property will be used for commercial operations only, not for personal, family, or household purposes

Other Terms of Performance

- If leased property may become a fixture, lessor should require that owner of real property and any party holding a security interest in the real property execute a waiver, acknowledging that leased property will remain lessor's (see §§19.87-19.92)
- Lessee required to furnish financial statements monthly, quarterly, or annually
- Lessee appoints lessor as attorney-in-fact to execute financing statements that in lessor's opinion are necessary to secure lessor's interest in the property

Redelivery of Leased Property

- Location where leased property should be delivered at end of lease term
- Lessee must pay costs of restoring property to the condition it was in when leased, reasonable wear and tear excepted
- Who pays expenses of redelivery of property to lessor or delivery to subsequent lessee, *e.g.,* disassembly, packaging, shipping, insurance
- Lessee's right to abandon leased property if unclaimed by lessor; termination of lessee's responsibility for property

Default and Remedies

- Events of default by lessee (see §§19.106-19.112):
- Failure to pay rent or any other amount due under the lease if nonpayment continues for specified number of days
- Failure to perform or observe any other term, covenant, or condition of the lease, *e.g.,* failure to repair and maintain leased property; failure to maintain insurance as required; failure to comply with financial covenants; failure to provide financial information to lessor in timely manner; failure to keep leased property free of encumbrances, seizure, or forfeiture
- Ipso facto clause, *e.g.,* filing of petition in bankruptcy, assignment for benefit of creditors, appointment of receiver for lessee's assets (see §19.121)
- Bulk transfer by lessee
- Cessation of business by lessee
- Material and adverse change in condition of or prospects of payment and performance by lessee
- If lessor performs any obligation of lessee under the lease, this act will not be a waiver of lessor's right to declare lessee in default (see §19.107)
- Cross-defaults with other leases or agreements between lessor and lessee
- Notice of default
- Lessee's right to cure defaults
- Lessor's remedies (see §§19.106-19.112):
- Lessee must redeliver leased property to designated location at lessee's expense
- Lessor may repossess leased property (see §19.108):
- Lessor has right of entry on lessee's premises for that purpose; no court order or other process of law required for repossession
- Lessee waives any right of action arising out of lessor's entry and repossession
- Repossession is not a termination of the lease
- Lessor may sell leased property at public or private sale; lessor may re-lease or otherwise dispose of the property in any manner lessor chooses
- Lessor may declare all rentals immediately due and payable
- Lessor may terminate the lease
- Lessor may sue to enforce lessee's performance
- Lessor may recover as damages (see §§19.110-19.113):
- All accrued and unpaid rent and other amounts due under the lease through the date lessor recovers possession of the property or, if lessor does not recover possession, through the date lessor declares default; plus
- All remaining rent lessor would have received under the lease through the end of the lease term, discounted to present value at a specified discount rate
- All attorney fees and other expenses incurred by lessor in enforcement of its rights, including costs of repossession, recovery, storage, repair, sale, re-lease, or other disposition of the leased property

- Tax indemnities
- Other incidental and consequential damages
- If lessor re-leases the property, calculate present value of rents to be received under new lease from date of new lease through last day of original lease term; deduct that amount from lessor's "remaining rent" damages
- If lessor sells the property, deduct from lessor's damages the net proceeds received by lessor from the sale or disposition
- If lessor does not obtain possession of the leased property after default, lessor should also be entitled to recover the value of its residual interest in the property
- Events of default by lessor (see §§19.99-19.105):
- Failure to deliver goods in conformity with lease agreement
- Failure to perform or observe any other term, covenant, or condition of the lease (be sure to coordinate with any waiver by lessee)
- Lessee's damages (see §§19.99-19.105):
- Cancel lease agreement
- Recover rent and security deposit previously paid (with reasonable offset for use)
- Effect cover and recover its incidental and consequential damages
- Liquidated damages (see §19.113) (restrictions apply to consumer leases; see §19.26)
- Remedies specified in lease agreement are cumulative of any other remedies available under Division 10 of the Commercial Code or any other applicable law; exercise of a remedy is not an election
- Choice of law (note consumer lease restrictions; see §§19.23-19.27)
- Special limitations provision (one year to commence action after accrual; see §19.117)
- Choice of forum for actions arising out of lease (note consumer lease restrictions; see §19.24)
- Whether disputes may be arbitrated

Assignment and Sublease

- Lessee may not assign its interest or sublease without lessor's written consent (see §§19.68-19.86)
- Lessor may assign or sell interest, grant a security interest in, or otherwise transfer the leased property or lessor's interest in it or rents under the lease without notice
- Lessee acknowledges that any assignment or transfer by lessor:
- Will not materially impair lessee's prospect of obtaining return performance by lessor;
- Will not materially change lessee's duties or obligations under the lease;
- Will not materially increase the burden or risk imposed on lessee; and
- Will be permitted even if it could be deemed to materially affect lessee's interest
- Lessee will not assert any claim, defense, or offset against lessor's successor or assignee that lessee may have against lessor; lessee reserves all rights against lessor in event of assignment
- If lease is assigned by lessor, lessee will pay rent to assignee
- If lease is assigned, assignee will not disturb lessee's possession of leased property on account of any act or default of lessor

Termination and Renewal

- Lessee's right to terminate (see §19.115):
- Total destruction or loss of leased property
- Technological or economic obsolescence of property or imposition of environmental restrictions or other restrictions that make continued use of property uneconomical or illegal
- Other events (if lessee cannot terminate the lease, the lease may be characterized as a security

arrangement; see §§19.11-19.12)

- Lessee's right of renewal; notice to lessor required within specified period before termination of lease
- Consideration for renewal (if consideration is nominal, lease might be treated as sale or security arrangement; see §§19.15-19.17)
- Conditions of renewal, *e.g.,* all amounts due must be paid in full, no defaults may exist
- Estimated fair market value of property at conclusion of lease term (see §§19.12)
- Lessee's right to purchase leased property; notice to lessor required within specified period before termination of lease; purchase price is fair market value of property (see §19.16)

General Provisions

- Master lease: recital that, if any conflict exists between terms of master lease and terms of schedule, schedule prevails with respect to that schedule only
- Finance lease: none of the terms of the purchase contract modify any term of this lease or affect in any way the parties' rights and duties
- If lease is deemed to be a security arrangement instead, the leased property will secure, in addition to the lease indebtedness, indebtedness at any time owed by lessee to lessor
- Binding effect on successors and assigns
- Notices; manner of giving
- Merger or integration clause (see §7.54)
- Modification of lease in writing only (see §19.20)
- Waiver of lease terms in writing only (see §19.20)
- Severability of provisions found to be unconscionable or illegal
- Further assurances: lessee will execute any additional documents reasonably required by lessor to effectuate lease
- If more than one lessee is named, liability of each is joint and several
- Counterparts are sufficient for signatures to be effective

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Appendix C

Summary of Available Options and Remedies

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PRACTICE TIP: The attorney should review any contract pertaining to the transaction to determine whether it has modified or limited the remedies available to either party. If the problem is the loss or destruction of the goods, who bears the loss may be affected by the terms of shipment and whether one of the parties is in breach of the contract (see the risk of loss tables in §§8.26-8.27, 16.43; see generally chaps 8-9).

The attorney should also keep in mind that the client may have waived certain rights in its dealings with the other party. See generally chap 6. On modification and rescission of the sales contract, see chap 6.

The following table is by no means an exhaustive summary of the problems that might arise in a sales transaction or of the options available to the parties when problems do arise. For example, the table does not include the variety of rights given to a buyer under consumer protection statutes. It should serve, however, as a starting point for formulating strategy.

SELLER'S OPTIONS AND REMEDIES

Buyer's Actions	Seller's Options	Com C	Book
Accepts goods or is chargeable for their loss	Recover the contract price	§2709(1)	§§18.17-18.19
Accepts part of a commercial unit	May treat as acceptance of entire unit	§2606(2)	§§10.20, 17.57
Fails to make payment due on or before delivery	Withhold delivery	§2703(a)	§§17.10-17.11
	Stop carload, truckload, planeload, or larger shipment of goods in transit	§§2703(a), 2705	§§17.14-17.22
	Resell the goods and recover damages	§2706	§§17.38-17.47
	Cancel the contract	§2703(f)	§§17.48-17.50
	Sue for breach and recover damages	§§2703(e), 2710	§§18.2-18.16
	As long as commercially reasonable, seller may finish manufacturing goods or stop manufacturing and sell the goods for scrap	§2704(2)	§17.35
Fails to make payment due after	Sue for breach and recover damages	§2709	§§18.2-18.16

delivery			
Pays by a check that is later dishonored	Reclaim the goods	§2503(5)(b)	§17.24-17.31
	Sue for breach and recover damages	§2709	§§18.2-18.16
	Sue buyer on the check if seller has possession of it	§3310(b)(3)	§10.60
Letter of credit is not honored after seller's proper presentment of documents	Sue buyer after giving notice of dishonor	§2325(2)	§10.61, 13.26
	May also sue issuer	§5114	§10.61, 13.26
Fails to pay for an installment shipment	If failure substantially impairs the value of the contract to seller, further performance may be excused	§2612(3)	§10.70
Rejects the goods (seller is uncertain whether rejection is wrongful)	Ask buyer to specify defects so that seller can cure before time for performance expires	§§2508(1), 2602(1), 2605	§§9.63-9.69, 9.75
	If seller had reasonable grounds for believing nonconforming tender would be acceptable to buyer, notify buyer of intention to cure and substitute conforming tender within reasonable time	§2508(2)	§§9.63-9.69, 9.75
Wrongfully rejects the goods	If installment contract, request adequate assurance of future performance	§2609	§§16.2-16.20
	Withhold delivery of remaining goods	§2703(a)	§§17.12-17.13
	Stop delivery of carload, truckload, planeload, or larger shipments of remaining goods in transit	§2705(1)	§§17.14-17.22
	Resell the goods and recover damages	§2706	§§17.38-17.46
	Cancel the contract	§2703(f)	§§17.48-17.50
	Sue for breach and recover damages	§§2703(d)-(e), 2708(1), 2710	§§18.2-18.16
	As long as	§2704(2)	§17.35

	commercially reasonable, seller may finish manufacturing goods or stop manufacturing and sell the goods for scrap		
	With merchant buyer, make written request for statement of all defects on which buyer proposes to rely	§2605(1)	§17.58
Buyer's rejection of the goods is ineffective (*i.e.,* not within a reasonable time; reasonable notice not given)	Seller may consider the goods accepted if buyer has had a reasonable opportunity to inspect them	§2606(1)(b)	§10.23
Merchant buyer who has rejected perishable goods (or goods that will speedily decline in value) fails to make reasonable efforts to sell them for seller's account	Sue for damages	§1305(a)-(b)	§10.47
Wrongfully revokes acceptance of the goods	Withhold delivery of remaining goods in seller's possession	§2703	§§17.10-17.11
	Stop delivery of carload, truckload, planeload, or larger shipments of goods in transit	§2705(1)	§§17.14-17.22
	Cancel the contract	§2703(f)	§§17.48-17.50
	Sue for breach and recover damages	§§2703(d)-(e), 2708(1), 2710	§§18.2-18.16
	As long as commercially reasonable, seller may finish manufacturing goods or stop manufacturing and sell the goods for scrap	§2704(2)	§17.35
Falls behind in payments on its account	Suspend performance if commercially reasonable and demand adequate assurance of buyer's future performance	§2609	§§16.2-16.18
Suddenly expands its use of credit terms	Suspend performance if commercially reasonable and demand adequate	§2609	§§16.2-16.18

	assurance of buyer's future performance		
Stops taking advantage of early payment discounts	Suspend performance if commercially reasonable and demand adequate assurance of buyer's future performance	§2609	§§16.2-16.18
Gives seller other reasonable grounds for insecurity about performance	Suspend performance if commercially reasonable and demand adequate assurance of buyer's future performance	§2609	§§16.2-16.18
Fails to give adequate assurance of its future performance within a reasonable time (not exceeding 30 days)	Treat failure as repudiation of the contract; see below	§2609(4)	§16.17
Makes unjustified demand for adequate assurance of seller's performance	Treat as a repudiation of the contract; see below	§2610(c)	§16.21
Repudiates the contract	If seller has any doubts about whether buyer's refusal to perform is a repudiation, demand adequate assurance of buyer's future performance	§2609	§16.25
	Alternatively, notify buyer that it considers repudiation to be final	§2611	§§16.29, 16.39
	Withhold delivery	§2703(a)	§§17.10-17.11
	Stop delivery of carload, truckload, planeload, or larger shipments of goods in transit	§2705(1)	§§17.14-17.22
	Resell the goods and recover damages	§2703(a)	§§17.38-17.46
	Cancel the contract	§2703(f)	§§17.48-17.50
	Sue for breach and recover damages	§§2703(d)-(e), 2708, 2710	§§18.2-18.19
	As long as commercially reasonable, seller may finish manufacturing goods or stop manufacturing and sell	§2704(2)	§§16.32, 17.35

	the goods for scrap		
Buyer fails to provide details about how seller is to perform	Demand assurance of buyer's performance; while waiting for assurance, suspend its own performance if that is commercially reasonable (*e.g.,* cease production, withhold delivery, or stop delivery of goods in transit)	§2609	§§4.91, 16.16
	Perform in any commercially reasonable manner	§2311(3)	§4.91
	Wait until time has elapsed for a material part of seller's own performance, then treat failure to cooperate as a breach	§2311(3)	§4.91
Becomes insolvent	Refuse further deliveries except for cash	§2702(1)	§§17.12-17.13
	Stop goods in transit	§§2702(1), 2705(1)	§§17.14-17.22
	Demand adequate assurance of buyer's future performance	§2609	§§16.2-16.18
	Reclaim goods already delivered	§2702(2)	§§17.24-17.31
	(note that a seller who chooses this option is precluded from exercising any other remedy against the buyer)		

BUYER'S OPTIONS AND REMEDIES

Seller's Actions	Buyer's Options	Com C	Book
Fails to deliver any goods	Cover and recover damages	§2712	§§17.67-17.69
	Cancel the contract	§2711(1)	§§17.84-17.86
	Sue for breach and recover damages	§§2713(1)(a)-(b), 2715	§§18.20-18.45
	Action for replevin if goods are identified to the contract	§2716(3)	§18.46
	Action for specific performance	§2716(1)	§18.47

	Restitution of payments made	§2711(1)	§18.48
Under a shipment contract, carrier is delayed in delivering goods	If seller made reasonable arrangements for shipment, no recourse against it	§2504	§9.6
	If seller did not make reasonable arrangements for shipment, goods may be rejected only if resulting loss or delay is material	§2504	§§9.6, 9.9
Delivers nonconforming goods or delivers goods in a nonconforming manner (*e.g.,* late delivery or wrong quantity)	Accept the goods in substitution	§2601(b)	§§10.30-10.31
	Reject the goods and notify seller of the rejection	§2601(a)	§§10.35-10.37, 10.44-10.49, 17.51-17.60
	(buyer may have certain duties relating to care of rejected goods)		
	Accept one or more commercial units and reject the rest	§2601(c)	§§10.20, 17.57
	If seller gives no instructions within a reasonable time after notification of rejection, store, reship, or resell the goods and recover expenses	§2604	§§10.44-10.47, 17.60
	Special rules for merchant buyers who reject goods	§2603	§10.47
	Note that documents covering the goods are also subject to the perfect tender rule	§2503(5)	§9.72
	If grounds exist, revoke acceptance of goods received	§2608	§§10.32-10.34, 17.61-17.66
	Cover and recover damages	§2712	§§17.67-17.69
	Cancel the contract	§2711(1)	§§17.84-17.86
	Enforce security interest in goods in its	§§2711(3), 2706	§§10.45, 17.71-17.74

	possession		
	Sue for breach and recover damages if seller did not notify buyer that goods were being shipped for accommodation (see Com C §2206(1)(b); §§2.42-2.50)	§§2711-(1)(a)-(b), 2715	§§18.25-18.45
	Deduct its damages from any part of the price still due; notify seller	§2717	§18.45
	Restitution of payments made	§2711(1)	§18.48
Delivers nonconforming installment of goods	If nonconformity cannot be cured and value of installment is substantially impaired, rejection is allowed; if seller can cure nonconformity, installment must be accepted	§2612(2)	§§9.53-9.58, 16.5
	Demand assurance of future performance; while waiting for assurance, suspend its own performance if that is commercially reasonable	§2609(1)	§§16.2-16.18
	If nonconformity substantially impairs the value of the whole contract, buyer may cancel the contract and is entitled to remedies for breach	§2612(3)	§16.5
Delivers only part of order	Demand assurance of seller's performance; while waiting for assurance, suspend its own performance if that is commercially reasonable	§2609	§§16.2-16.18
	Revoke acceptance of initial delivery	§2608	§§10.32-10.34, 17.61-17.66
Justifiably claims that agreed manner of delivery has become commercially impracticable	Seller can use a commercially reasonable substitute method of delivery	§2614(1)	§9.69
Claims to be excused from further deliveries because of increased	Generally not grounds for excused performance; if seller	§2615	§16.61

costs	fails to perform, buyer has remedies for breach		
Fails to give adequate assurance about its future performance within a reasonable time (not exceeding 30 days)	Treat failure as repudiation of the contract	§2609(4)	§16.17
	While waiting for assurance of performance, suspend its own performance if that is commercially reasonable	§2609(1)	§16.16
Unforeseen event causes delay in delivery or nondelivery	If nonoccurrence of the event was a basic assumption on which contract was made, seller's performance is excused	§2615	§§16.60-16.78
Unforeseen event allows only partial delivery	If nonoccurrence of the event was a basic assumption on which contract was made, seller must allocate deliveries among its buyers	§2615(b)	§16.64
Notifies buyer of indefinite delay in deliveries or a need to allocate deliveries among its buyers	Terminate contract	§2616	§16.72
	Modify contract by agreeing to delayed delivery or to taking available quota in substitution	§2616	§16.72
	Do nothing and contract will lapse within 30 days	§2616	§16.72
Fails to reclaim goods rejected by buyer	Store, reship, or resell the goods and recover expenses	§2604	§§10.44-10.47, 17.60
Becomes insolvent before shipment	Recover the goods if certain requirements are met	§2502	§§17.75-17.79
Repudiates the contract	If buyer has any doubts about whether seller's refusal to perform is a repudiation, demand adequate assurance of seller's future performance	§2609	§16.22

	Alternatively, notify seller that it considers repudiation to be final	§2611	§§16.27-16.29
	Cover and recover damages	§2711	§§17.67-17.69
	Cancel the contract	§2711	§§17.84-17.86
	Sue for breach and recover damages	§§2711, 2715	§§18.20-18.45
	Recover identified goods	§2711	§§17.75-17.79
	Action for replevin if goods are identified to the contract	§§2711, 2716(3)	§18.46
	Action for specific performance	§§2711, 2716(1)	§18.47
Some of the goods suffer casualty, through no fault of either party	If risk of loss has not yet passed to buyer, buyer may void contract, or accept goods with due allowance for deficiency, but has no further right against seller	§2613	§16.51

EVENTS AFFECTING BOTH BUYER AND SELLER

Event	Consequence	Com C	Book
All the goods suffer casualty, through no fault of either party	Contract voided if risk of loss has not yet passed to buyer	§2613	§16.51
A dispute arises about the goods' conformity to the contract	Each party has a right to inspect the goods	§2515	§16.79

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Source: Business Law/California UCC Sales and Leases/Internet Resources for California Businesses

Internet Resources for California Businesses

A. Government Sites—Federal

Americans with Disabilities Act	http://www.usdoj.gov/crt/ada Information and technical assistance on the ADA by the U.S. Department of Justice.
Bureau of Industry and Security (BIS), U.S. Department of Commerce	http://www.bis.doc.gov/about/index.htm Federal agency that administers the U.S. export control and treaty compliance system, including the Export Administration Regulations (EAR).
BusinessLaw.gov	http://www.business.gov/ Home page, operated by the U.S. Small Business Administration, with links to legal and regulatory information, and plain English guides for starting a business, handling finances, managing employees, and other topics.
CIA, The World Factbook	https://www.cia.gov/cia/publications/factbook/index.html U.S. government profiles of countries and territories around the world.
Equal Employment Opportunity Commission (EEOC)	http://www.eeoc.gov/ EEOC site with basic introduction to employers' rights and responsibilities under the federal equal employment opportunity laws.
Federal agencies (through Library of Congress site)	http://www.loc.gov/rr/news/fedgov.html A Library of Congress resource page with links to most federal agencies.
Federal Citizen Information Center (FCIC)	http://www.pueblo.gsa.gov/ Part of the U.S. General Service Administration, the FCIC's Small Business Links offer information for persons planning or owning small businesses, including information on procurement, taxes, woman- and minority-owned businesses, human resources, and financial and legal issues.
Federal Deposit Insurance Corporation (FDIC)	http://www.fdic.gov/ Home page with links to statistical data, pertinent regulations, and FAQs.
Federal Reserve Bank of San Francisco	http://www.frbsf.org/ Home page. The current FRBSF discount rate, used to determine the usury ceiling in California, is posted at http://www.frbsf.org/banking/data/discount/index.html.
Federal Trade Commission	http://www.ftc.gov/ftc/business.shtm Home page for businesses, with links to business publications, advertising guidance, fair packaging and labeling, antitrust law guide, and other topics. Information concerning the Hart-Scott-Rodino pre-merger notification requirements is at http://www.ftc.gov/bc/hsr/introguides/introguides.htm.
FirstGov.gov	http://www.firstgov.gov/Business/Business_Gateway.shtml The official web portal of the U.S. government, with links to information on contracting with the U.S. government, export licenses, business financial assistance, and many other topics.
Internal Revenue Service	http://www.irs.gov/ Home page; access to downloadable IRS forms and publications.
Occupational Safety and Health Administration	http://www.osha.gov/ Home page.

(OSHA)	
Office of Federal Contract Compliance Programs (OFCCP)	http://www.dol.gov/esa/ofccp/index.htm Home page with statutory, regulatory, and compliance information regarding nondiscrimination requirements for federal contractors.
Office of the Comptroller of the Currency (OCC)	http://www.occ.treas.gov/ Home page with links to reports and other resources for banking industry professionals as well as public information about the national banking system.
Office of the U.S. Trade Representative	http://www.ustr.gov/index.html Home page.
Securities and Exchange Commission (SEC)	http://www.sec.gov/ Home page with links to information for small businesses; online access to proposed and final rules, SEC releases, policy statements, and other commission notices and information; searchable database of all electronic company filings since 1994.
SEC Edgar	http://www.sec.gov/edgar.shtml SEC Edgar main page, with access to electronic filings and forms.
Small Business Administration	http://www.sba.gov/ Home page with extensive links to federal and other resources for small businesses.
Social Security Administration	http://www.ssa.gov/ Home page. SSA forms are available online at http://www.ssa.gov/online/forms.html.
THOMAS	http://thomas.loc.gov/home/thomas.html Website of the Library of Congress providing federal legislative information.
U.S. Citizenship and Immigration Services	http://www.uscis.gov/portal/site/uscis Home page with links to immigration laws and forms.
U.S. Copyright Office	http://www.copyright.gov/ Home page with links to copyright registration and other information.
U.S. Department of Commerce	http://www.commerce.gov/ Home page.
U.S. Department of Justice, Antitrust Division	http://www.usdoj.gov/atr/public/guidelines/guidelin.htm Link to Antitrust Division Guidelines and Policy Statements.
U.S. Department of Labor	http://www.dol.gov/ Home page with links to statutory and regulatory information, labor statistics, small business regulatory compliance assistance, and other information.
U.S. Department of Labor, Dictionary of Occupational Titles (DOT)	http://www.oalj.dol.gov/libdot.htm Dictionary of job titles and standardized job descriptions; useful for job placement, occupational research, career guidance, labor-market information, curriculum development, and long-range job planning. Last updated in 1991, the DOT has now been replaced by O*NET Online, http://online.onetcenter.org/.
U.S. Department of State	http://www.state.gov/ Home page with links to international commercial laws and guides.
U.S. Environmental Protection Agency	http://www.epa.gov/ Home page.

U.S. Government Printing Office	http://www.gpo.gov/ Home page with links to products and services, including online searchable copies of the United States Code and the Code of Federal Regulations.
U.S. International Trade Commission	http://www.usitc.gov/ Home page with rules, regulations, reports, and other information, including an extensive list of links to international trade resources.
U.S. Patent and Trademark Office	http://www.uspto.gov/ Home page with downloadable forms and information on patent applications and trademark registrations.

B. International Sites

Private International Law Database: Trade/Business Transactions Law, U.S. Department of State	http://www.state.gov/www/global/legal_affairs/transaction_law.html Access to treaties in force for the United States, other international instruments, and information on current negotiations and projects concerning private international law. Updated through January 1, 2001. For treaty actions since President Bush took office, see http://www.state.gov/s/l/treaty/c3428.htm.
CURIA	http://curia.europa.eu/en/transitpage.htm Home page of the courts of the European Communities, with texts governing procedures and searchable case law.
Electronic Embassy Website	http://www.embassy.org/ Information on all foreign embassies in Washington, D.C.
EUR-Lex	http://eur-lex.europa.eu/en/index.htm Website providing direct free access to European Union law. Among other things, it includes the Official Journal of the European Union, treaties, legislation, case law and legislative proposals.
European Franchise Federation (EFF)	http://www.eff-franchise.com/ Non-profit international organization that promotes the interests and development of franchising in Europe.
Hague Conference on Private International Law (HCCH)	http://hcch.e-vision.nl/index_en.php?act=text.display&tid=1 Home page.
International Trademark Association (INTA)	http://www.inta.org INTA is an international nonprofit membership association dedicated to the support and advancement of trademarks and related intellectual property.
North American Free Trade Agreement (NAFTA) Secretariat	http://www.nafta-sec-alena.org/DefaultSite/index_e.aspx Home page with link to text of NAFTA.
United Nations Commission on International Trade Law (UNCITRAL)	http://www.uncitral.org/ Home page with links to UNICITRAL texts, including conventions, model laws, guides to enactment, legislative guides, legislative recommendations, and model contract rules. In particular, this website includes the text of the United Nations Convention on Contracts for the International Sale of Goods (CISG).
CISG Database at Pace University School of Law, Pace Law Library, Institute of	http://cisgw3.law.pace.edu/ Site dedicated to U.N. Convention on Contracts for the International Sale of Goods (CISG), with annotated text of CISG, CISG in different languages, cases organized by countries, and related CISG material.

International Commercial Law	
International Institute for the Unification of Private Law (UNIDROIT)	http://www.unidroit.org/english/home.htm Home page.
Canadian System for Electronic Document Analysis and Retrieval (SEDAR)	http://www.sedar.com/ Home page of the Canadian equivalent to the SEC's EDGAR. Provides access to corporate filings of Canadian companies with Canada's securities regulatory authorities.
World Intellectual Property Organization (WIPO)	http://www.wipo.int/portal/index.html.en A specialized agency of the United Nations, dedicated to developing a balanced and accessible international intellectual property system.
World Trade Organization (WTO)	http://www.wto.org/ Global international organization dealing with the rules of trade between nations.

C. Government Sites—California

California Department of Corporations, Securities Regulation Division	http://www.corp.ca.gov/SRD/Default.asp Access to forms, departmental publications, Commissioner's releases, opinions and notices, franchising information, and other topics.
California Department of Fair Employment and Housing	http://www.dfeh.ca.gov/ Home page.
California Department of Insurance, Workers' Compensation Information	http://www.dir.ca.gov/workers'_comp.html Access to information on workers' compensation insurance.
California Division of Occupational Safety and Health (DOSH)	http://www.dir.ca.gov/dosh Access to information concerning the Cal-OSHA program.
California Employment Development Department (EDD)	http://www.edd.ca.gov Home page; information concerning job placement and referrals, unemployment insurance, disability insurance, employment and training, labor-market information, payroll taxes, and other topics.
California Franchise Tax Board (FTB)	http://www.ftb.ca.gov/ Home page with links to downloadable state tax forms and publications.
California Law Revision Commission	http://www.clrc.ca.gov/ Home page.
Official California Legislative Information	http://www.leginfo.ca.gov/index.html Full text of bills, resolutions, and constitutional amendments, as well as their status, history, votes, analyses, and veto messages.
California Legislative Resource	http://calbar.ca.gov/state/calbar/calbar_generic.jsp?cid=10137&id=10452 Webpage maintained by the State Bar of California with many helpful links regarding California's legislative process, pending bills, legislative calendar, committees, and other topics.

State Bar of California Bill Tracking Service	http://www.calbar.ca.gov/calbar/legislation/State%20Bar%20Bill%20Tracking-Sections.html Centralized legislative monitoring and tracking service listing bills of potential interest to members of the State Bar's sections and their committees.
California Business Permits and Licensing Information	http://www.calgold.ca.gov/ To locate appropriate permitting information for California businesses, the CalGOLD database provides links and contact information that direct users to agencies that administer and issue business permits, licenses, and registration requirements from all levels of government.
California State Office of Privacy Protection	http://www.privacy.ca.gov/ State agency dedicated to promoting and protecting the privacy rights of consumers.
California state agencies	http://www.ca.gov/state/portal/myca_homepage.jsp State of California site with links to California agencies, departments, and commissions.
California State Association of Counties	http://www.csac.counties.org/ Home page with links to all California counties.
California State Board of Equalization	http://www.boe.ca.gov/ Home page with access to information about sales and use taxes, sellers' permits, forms, and publications.
California Secretary of State: California Business Portal:	http://www.ss.ca.gov/business/business.htm Home page.
Forms:	http://www.ss.ca.gov/business/bpd_forms.htm Directory of forms and samples for different business filings, including UCC forms; some in fill-in format.
Business Filings:	
Corporations	http://www.ss.ca.gov/business/corp/corporate.htm Corporations main page with links to filing tips to meet statutory minimum requirements, name availability, FAQs, and more.
Limited Liability Companies (LLCs)	http://www.ss.ca.gov/business/llc/llc.htm LLC main page with links to forms and fees, name availability, FAQs, and more.
Limited Partnerships	http://www.ss.ca.gov/business/lp/lp.htm Limited partnerships main page with links to forms and fees, name availability, FAQs, and more.
General Partnerships	http://www.ss.ca.gov/business/gp/gp.htm General partnerships main page with links to forms and fees, name availability, FAQs, and more.
Limited Liability Partnerships	http://www.ss.ca.gov/business/llp/llp.htm Limited liability partnership main page with links to forms and fees, name availability, FAQs, and more.
Trademarks and Service Marks	http://www.ss.ca.gov/business/ts/ts.htm Trademarks and service marks main page with links to forms and fees, name availability, FAQs, private service companies, and more.
Miscellaneous Filings	http://www.ss.ca.gov/business/other/bp_other.htm Links to filing requirements for unincorporated common interest development

	associations, unincorporated associations, unincorporated nonprofit associations, foreign lending institutions, and foreign partnerships.
California Business Search	http://kepler.ss.ca.gov/list.html Fill-in boxes to check records online for corporations, limited partnerships, and limited liability companies.
Starting a Business	http://www.ss.ca.gov/business/resources.htm A step-by-step guide for starting a business in California; available in English or Spanish.
e-file Statement of Information	https://businessfilings.ss.ca.gov/ Fill-in boxes to file a Statement of Information for a corporation online.
Notary Public	http://www.ss.ca.gov/business/notary/notary.htm Notary public main page, with links to topics such as obtaining a notary public commission, handbook, authentications, apostille or certification, forms, and fees.
Uniform Commercial Code	http://www.ss.ca.gov/business/ucc/ucc.htm UCC main page with links to financing statement forms, amendment forms, requests for information, revised Article 9 (as of July 1, 2001), and FAQs.
International Business Relations Program	http://www.ss.ca.gov/business/ibrp/ibrp.htm Main page in English or Spanish with international resources and business tips; intended to assist foreign corporations with various filing procedures.
Business Program Division, Legislation	http://www.ss.ca.gov/business/bpd_newleg.htm Summaries and links to new state laws affecting businesses.

D. Private Agency Sites

ABA Section of Business Law	http://www.abanet.org/buslaw/home.html Home page with links to publications and other resources for business lawyers.
Active Capital	http://activecapital.org/ Site dedicated to helping individual accredited investors, SBICs, and institutional venture capitalists find small, growing companies through a secure Internet database, and providing ongoing training and research for entrepreneurs and small investors.
AllBusiness	http://www.allbusiness.com Small business portal, with links to forms, directories, and resources on many topics.
American Arbitration Association	http://www.adr.org/ Home page with links to rules and procedures.
Annual Reports.com	http://www.annualreports.com/ Free service offering links to annual reports of public companies.
BenefitsLink	http://www.benefitslink.com Compliance information and tools for employee benefit plan sponsors, service-providers, and participants.
Better Business Bureau	http://www.bbb.org/ Home page.
The Biz-Tech Network by Brint Institute, LLC	http://www.brint.com/ Portal with a meta-index of business, management, and information technology topics; it also provides search capabilities and full text articles on

	related issues.
Business.com	http://www.business.com/ Business search engine and directory intended to help users find companies, products, services, and other business-related information; some features are fee-based.
Business Law Section of the State Bar of California	http://www.calbar.ca.gov/state/calbar/calbar_sections_generic.jsp?sCategoryPath=/Home/Attorney%20Resources/Sections/Business%20Law Home page with links to standing committees, programs, and publications.
Business Week Online	http://www.businessweek.com/ Articles, links, and opportunity to subscribe to free newsletter.
CNN Money	http://money.cnn.com/ General business news website offered by CNN and Fortune, Money and Business 2.0 magazines.
Corporate Finance Sourcebook	http://www.financesourcebook.com/ Link for ordering popular guidebook published by National Register Publishing. The guidebook features over 1500 top investment sources and 1700 service firms for business entrepreneurs.
Corporate Information	http://www.corporateinformation.com/ Subscription-based website offering research reports on public, private, domestic, and foreign corporations.
The Corporate Library	http://www.thecorporatelibrary.com/ The Corporate Library is an independent research firm providing corporate governance data, analysis, and risk assessment tools.
Creative Commons	http://creativecommons.org A nonprofit organization founded by Prof. Lawrence Lessig of Stanford University that provides special copyright license forms and other free tools to enable authors, scientists, artists, and educators to share intellectual property.
DeVry University Business Administration Portal	http://www.academicinfo.net/busmeta.html Portal with annotated links to a variety of business-related topics.
Dun & Bradstreet	http://www.dnb.com/ Home page of Dun & Bradstreet. Subscribers can request reports and run online queries in proprietary databases.
Edgar Online, Inc.	http://www.edgar-online.com/ Edgar Online, Inc. is a private company, not affiliated with the SEC, specializing in the extraction, packaging, and distribution of public company information contained in SEC filings.
Enterpreneur.com	http://www.entrepreneur.com/mag Free access to Entrepreneur magazine articles back to 1997.
Financial Accounting Standards Board (FASB)	http://www.fasb.org/ Access to FASB Statements of Financial Accounting Standards and other resources.
Findlaw Business Center	http://smallbusiness.findlaw.com/ Portal with links to articles and guides on starting a business, taxes and accounting, small business legal concerns, and more. Part of West Group.
FindNews.org	http://www.findnews.org/business-news/small-business.html

	Online news directory with links to other news-oriented sites and small business portals.
Garage Technology Ventures	http://www.garage.com/ Venture capital fund for emerging technology companies.
GNU	http://www.gnu.org/ Organization promulgating the development and use of free software and the use of open-source software licenses.
Google Small Business Directory	http://directory.google.com/Top/Business/Small_Business/ A directory of small business resources.
Hieros Gamos Small Business Center	http://www.hg.org/sbcenter.html Portal with links to topics such as starting a business, choosing a legal structure, and financing.
Hoover's Online	http://www.hoovers.com/ Subscription-based site with industry snapshots, company profiles, earnings, and other information.
Intellectual Property Section of the State Bar of California	http://www.calbar.ca.gov/state/calbar/calbar_sections_generic.jsp?cid=10707 Home page with links to standing committees, programs, and publications.
International Franchise Association (IFA)	http://www.franchise.org/ Trade association promoting responsible franchise development worldwide.
Internet Corporation for Assigned Names and Numbers (ICANN)	http://www.icann.org/ Private agency responsible for global coordination of the Internet's system of unique identifiers, including domain names (such as .com, .org, and country codes such as .fr), as well as addresses used in a variety of Internet protocols.
IP Mall	http://ipmall.info/ Website sponsored by Franklin Pierce Law Center, with links to intellectual property resources around the world (including patents, copyrights, trademarks, trade secrets, licensing, and technology transfers).
JAMS	http://www.jamsadr.com/index.asp Home page with information about JAMS mediation and arbitration services and a search engine to assist in locating qualified mediators and arbitrators. The website also offers a downloadable guide to dispute resolution clauses in commercial contracts.
Jeffren Publishing Co.	http://www.jefren.com Subscription service offering proxy statement forms and strategies.
MarketResearch.com	http://www.marketresearch.com/ Free database of market research reports representing all market and industry sectors.
MegaLaw.com Small Business Portal	http://www.megalaw.com/top/smbusiness.php Portal with links to federal agencies and other websites related to small businesses.
NASDAQ and American Stock Exchanges (mirrored site)	http://www.nasdaq.com/ *and* http://www.amex.com/ Comprehensive current information on market performance and investments.
National Association of Attorneys General	http://www.naag.org/

	Association of the attorneys general of all 50 states, with contact information and links to enforcement initiatives.
National Association of Secretaries of State, Business Registration and Filing Services	http://www.nass.org Access to most state business and corporations divisions from a single webpage.
National Association of Seed and Venture Funds	http://www.nasvf.org/ Network of private, public, and nonprofit organizations investing and facilitating investment in entrepreneurs.
National Business Association	http://www.nationalbusiness.org/ Nonprofit association's site for the self-employed and small business community.
National Venture Capital Association (NVCA)	http://www.nvca.org/ Home page with links to members and other resources.
New York Stock Exchange	http://www.nyse.com/ Comprehensive, current information on market performance and investments.
News Cuts	http://www.newscuts.com/Small.Business.shtml Free and fee-based small business news service.
Open Directory Project - Small Business	http://www.dmoz.org/Business/Small_Business/ Free site with links to topics such as business plans, finance, home offices, and start-ups; edited by volunteers.
Public Register's Annual Report Service	http://www.annualreportservice.com/ Free access to annual reports of over 2200 companies. Site also has links to the SEC's Edgar database for filings.
Reuters	http://today.reuters.com/news/newsChannel.aspx?type=businessNews Database providing research reports on companies and industries.
Safeselling.org	http://www.safeselling.org/ ABA-sponsored resource for business people launching e-commerce enterprises and for businesses venturing into online sales.
The Small Business Portal	http://www.thesmallbusinessportal.com/ Links to topics such as starting a business, franchise advice, financing, and home-based businesses.
Standard & Poor's	http://www.standardandpoors.com/ Home page with search engine for public company credit ratings and other features.
Tripod by Lycos	http://www.tripod.lycos.com/smallbiz/index.html Portal with tips on starting an online business, yellow pages, and some free and some fee-based services.
U.S. GAAP Website	http://cpaclass.com/gaap/ Comprehensive source of information on generally accepted accounting principles in the U.S.
Wall Street Journal Online Edition	http://online.wsj.com General business and financial news.
Washburn University School of Law Small Business	http://www.washlaw.edu/subject/small.business.html Portal with links to a forms library and business and economic data.

Portal	
Yahoo! Finance	http://biz.yahoo.com/i/ Free company profiles and stock charts for over 9000 public companies.
Yahoo! Small Business	http://smallbusiness.yahoo.com/ Portal with links to topics such as creating a website, promoting a business, and selling online.

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Source: Business Law/California UCC Sales and Leases/Table of Statutes, Regulations, and Rules

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