

UNDERSTANDING SALES AND LEASES OF GOODS



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Chapter 1

The Uniform Commercial Code

§ 1.01 BRIEF HISTORY OF COMMERCIAL LAW PRIOR TO THE UNIFORM COMMERCIAL CODE

The earliest regulation of commerce was provided through custom rather than law.¹ The practices of merchants were the dominant source for the standards governing commercial disputes. The institutions and personnel needed to resolve those disputes also developed through commercial activities rather than governmental action. The Law Merchant evolved as customary law by merchants and for merchants.

When exchanges of products began to develop in medieval Europe, trading custom was localized. With the expansion of trade boundaries to include even exchanges of goods with merchants from Asia and Africa, the Law Merchant developed during the 12th and 13th centuries to reflect a more universal custom of merchants. Trading markets and fairs based on unfettered principles of free trade became established in European locations. These markets were mutually beneficial to all parties: the merchants enjoyed the profits, the local rulers collected taxes, and the community attained increased employment and desired goods from other locations. The universality of the Law Merchant meant that it was based on customs of trading practice that were common to all nationalities.

The Law Merchant was truly merchants' law rather than a regulatory scheme imposed as an exercise of local or regional sovereign authority. Values were determined in accordance with commercial custom as reflected in dynamic trade relationships. Even the methods of resolving disputes reflected practical needs of commerce. Separate tribunals considered commercial disputes. The judges selected were usually merchants who could apply their experience and understanding of mercantile customs. The adjudication of disputes often occurred at the markets or ports themselves, with procedures kept informal to promote prompt decisions.

The emergence of national interests and the expansion of trading areas prevented true universality of the Law Merchant, resulting in its incorporation into national legal systems. On the European continent, the essentials of the Law Merchant were basically codified into commercial codes. The initial influence of the Law Merchant was considerably diminished in England, where it was largely subjugated to the strict proceedings of the common law. Trade custom lost much of its role as a source of commercial law.

¹ For an excellent and much more thorough explanation, see L. Trakman, *The Law Merchant: The Evolution of Commercial Law* (1983).

The continued vitality of the Law Merchant in international trade and England's position as a world trading power meant that the English courts could not ignore custom completely. Lord Mansfield recognized commercial realities and successfully sought to free commercial law from many of the common law restraints. The essential objective was to allow commercial law to reflect commercial practices. Tremendous advances were made in this respect, but the English experience has often been characterized by formal methods required to establish trade custom.

The Law Merchant re-emerged as a more powerful influence in the United States. Trade practices have been recognized as a primary source of U.S. commercial law, and legal rules in the area have generally been premised on business practices. The constraints of formality have also been rejected in American law. Current commercial legislation, particularly the Uniform Commercial Code (UCC), continues these traditions. The UCC recognizes trade usages and courses of dealing; it does not follow the English approach of requiring custom to have been established since time immemorial to be effective.

§ 1.02 INITIAL PROMULGATION OF THE UNIFORM COMMERCIAL CODE

The Uniform Commercial Code was not the initial codification of commercial law in the United States. The National Conference of Commissioners on Uniform State Laws (NCCUSL) sponsored several uniform acts that encompassed areas of commercial law. The Uniform Sales Act, drafted by Professor Samuel Williston, was promulgated in 1906 and was ultimately adopted by about two-thirds of the states.

Interest in commercial law reform became pronounced by 1940. The various uniform acts were no longer sufficient. Commercial law practices and activities had changed, leaving the acts inadequate to resolve new issues. Uniformity among the states was also undercut by the failure of some states to enact some of the acts and by differing approaches taken in various enacting jurisdictions. The National Conference of Commissioners on Uniform State Laws sponsored a bold plan to prepare a single commercial code. The American Law Institute agreed in 1944 to co-sponsor the project, and Professor Karl Llewellyn was appointed as the Chief Reporter.

The first Official Text of the Code was promulgated in 1951. It consisted of nine Articles, including Article 2 on sales. Although Pennsylvania in 1953 became the first state to enact the Code, further enactments bogged down when the legislature and governor in New York referred it to the New York State Law Revision Commission. Based on recommendations of the New York Commission and other authorities, the Editorial Board for the Code studied and revised it. State enactments followed quickly after the promulgation of the 1962 Official Text. By 1968, all of the states except Louisiana,²

² Louisiana enacted some of the other articles of the UCC. Adhering to its French civil law tradition, Louisiana has not enacted Article 2.

as well as the District of Columbia and the Virgin Islands, had adopted the Code.

The advance of time and the evolution of new business practices have led the Editorial Board to undertake a revision of Article 2. Under the leadership of Professor Richard E. Speidel of Northwestern University as the Reporter for the project, the revision process is currently under way. The first draft of the revision was presented at the 1994 annual meeting of the NCCUSL. Following refinement of the draft and final approval by the sponsoring bodies, the revision will be promulgated and available for adoption by state legislatures.

§ 1.03 SCOPE OF ARTICLE 2 [2-102]

[A] Sales

[1] Direct Application

The scope provision of Article 2 states that the Article “applies to transactions in goods,” with the only stated exception being transactions in the form of sales that are intended to operate only as security transactions.³ The range of applicable transactions appears to be very broad. Additional transactions in goods include leases, bailments, gifts, storage, and transit of goods. The range of these transactions in goods certainly extends beyond the scope suggested by the short title of Article 2, “Uniform Commercial Code— Sales.”⁴ The scope of Article 2 is restricted to transactions involving sales of goods through the language of the substantive provisions of Article 2. Most of the provisions are written in terms of “contract for sale,”⁵ “sale,”⁶ “buyer,”⁷ or “seller.”⁸ Section 2-106(1) further states that “[i]n this Article unless the context otherwise requires ‘contract’ and ‘agreement’ are limited to those relating to the present or future sale of goods.”⁹

Despite the fact that none of these terms can apply to any transactions other than sales, some courts have ignored the substantive sections and held that transactions in goods other than sales are also within the scope

³ UCC § 2-102.

⁴ UCC § 2-101.

⁵ “‘Contract’ for sale includes both a present sale of goods and a contract to sell goods at a future time.” UCC § 2-106(1).

⁶ “A ‘sale’ consists in the passing of title from the seller to the buyer for a price.” UCC § 2-106(1).

⁷ “‘Buyer’ means a person who buys or contracts to buy goods.” UCC § 2-103(1)(a).

⁸ “‘Seller’ means a person who sells or contracts to sell goods.” UCC § 2-103(1)(d).

⁹ The comments undercut any attempt to give an expansive construction to the reference to context in order to apply Article 2 directly to transactions other than the sale of goods. “‘Contract for sale’ is used as a general concept throughout this Article, but the rights of the parties do not vary according to whether the transaction is a present sale or a contract to sell unless the Article expressly so provides.” UCC § 2-106, Comment 1.

of Article 2.¹⁰ Most courts, however, have restricted the direct application of Article 2 to sales.¹¹ A sale is a distinct transaction that is easy to ascertain under Article 2. It is defined to consist “in the passing of title from the seller to the buyer for a price.”¹² The signature feature of a sale is that the seller does not retain any tie to the goods upon completing his or her performance. Most of the provisions of Article 2 apply irrespective of the location of title to the goods.¹³ Basing issues such as the allocation of risk of loss on the moment of passing of title, which was the approach under the Uniform Sales Act,¹⁴ proved to be too complicated and uncertain under prior law and was thus largely abandoned as the relevant determinant in Article 2. The essence of a sale nevertheless continues to be the passing of title from the seller to the buyer for a price.

[2] Application by Analogy

Some of the provisions of Article 2, even though directly applicable only to sales, might be applied by analogy to other types of transactions. Application by analogy is not, however, a magic wand that simply dispenses with the scope limitations. An appropriate base for the analogy must be established before a court should apply a statute by analogy.¹⁵ Two basic approaches have been followed in applying Article 2 by analogy. Some courts have addressed the policies that support individual Code sections to determine whether they also apply to the transaction in question. In *Baker v. City of Seattle*,¹⁶ the court refused to uphold the liability disclaimer provision on the rental of a golf cart. It applied provisions of Article 2 on the grounds that such provisions state public policy with respect to disclaimers of liability in commercial transactions.¹⁷ Other courts have applied Article 2 by analogy only when the transaction in question is analogous to a sale. The court in *Glenn Dick Equipment Co. v. Galey Construction, Inc.*,¹⁸ stated, “[w]e will use Article 2 as ‘a premise for

¹⁰ *Murphy v. McNamara*, 27 UCC Rep. Serv. 911 (Conn. Super. Ct. 1979) (applied unconscionability provision to a lease of goods); *Owens v. Patent Scaffolding Co.*, 354 N.Y.S.2d 778, 14 UCC Rep. Serv. 610 (Sup. Ct. 1974), *rev'd on other grounds*, 376 N.Y.S.2d 948, 18 UCC Rep. Serv. 699 (App. Div. 1975) (applied warranty and statute of limitations provisions to a lease).

¹¹ Cases denying direct applicability of Article 2 to contracts for the lease of goods include *W. R. Weaver Co. v. Burroughs Corp.*, 580 S.W.2d 76, 27 UCC Rep. Serv. 64 (Tex. Civ. App. 1979); *Bona v. Graefe*, 264 Md. 69, 285 A.2d 607, 10 UCC Rep. Serv. 47 (Md. Ct. App. 1972).

¹² UCC § 2-106(1).

¹³ UCC § 2-401.

¹⁴ Uniform Sales Act § 22.

¹⁵ For an excellent discussion of argument by analogy with respect to the Code, see *Murray, Under the Spreading Analogy of Article 2 of the Uniform Commercial Code*, 39 *Fordham L. Rev.* 447 (1971).

¹⁶ 79 Wash. 2d 198, 484 P.2d 405, 9 UCC Rep. Serv. 226 (1971).

¹⁷ The court applied sections 2-316(2) and 2-719(3). See also *W. E. Johnson Equip. Co. v. United Airlines, Inc.*, 238 So. 2d 98, 8 UCC Rep. Serv. 533 (Fla. 1970) (warranty of fitness for a particular purpose imposed because public policy requires consumers who lease to be given protection equivalent to consumers who purchase).

¹⁸ 97 Idaho 216, 541 P.2d 1184, 18 UCC Rep. Serv. 340 (1975).

reasoning only when the case involves the same considerations that gave rise to the Code provisions and an analogy is not rebutted by additional antithetical considerations.’¹⁹ It determined that the same considerations that supported the creation of implied warranties in a sales transaction were present in the lease in the case before it: the lessor was a merchant specializing in both sales and leases of goods, the lessor placed the goods into the stream of commerce, and the lessee relied on the lessor’s expertise.

The court in *Wivagg v. Duquesne Light Co.*²⁰ similarly concluded that the policies underlying the implied warranty of merchantability would be furthered if the warranty were applied to a public utility that provided electricity service. It found the basis for liability grounded in the social policies that support the imposition of liability on entities that make or market defective products. The court emphasized that the utility was in complete control of the electricity service until its entry into the plaintiff’s building, so that the consumer could not have protected itself against a power surge that caused a fire. In addition, the superior position of the utility to absorb the resulting loss further justified imposing enterprise liability that underlies the implied warranty of merchantability.

[B] Goods

Even with respect to sales transactions, Article 2 is limited to sales of goods. “Goods” are defined as “all things (including specially manufactured goods) which are moveable at the time of identification to the contract for sale other than money in which the price is to be paid, investment securities (Article 8) and things in action.”²¹ Essentially, goods are any form of tangible, personal property whose value is ascertained by its own physical properties. Real property is excluded, as is intangible personal property, such as contract rights or patents. Personal property that is reified in the form of indispensable paper, such as negotiable instruments or negotiable documents, is tangible and moveable in the form of a writing, but its actual value is ascertained by the rights embodied in the writing. A negotiable instrument, which includes checks and promissory notes, has value because of the obligation to pay money that it evidences.²² A negotiable document, which could be a bill of lading or a warehouse receipt, establishes title to the goods covered, so its value is based on the value of the goods.²³ The value of goods, on the other hand, is based on the attributes of the goods themselves.

¹⁹ 541 P.2d at 1190, 18 UCC Rep. Serv. at 348, citing Note, *The Uniform Commercial Code as a Premise for Judicial Reasoning*, 65 Colum. L. Rev. 880, 888 (1965).

²⁰ 73 Pa. D. & C. 2d 694, 20 UCC Rep. Serv. 597 (1975).

²¹ UCC § 2-105(1). “‘Goods’ also includes the unborn young of animals and growing crops and other identified things attached to realty as described in the section on goods to be severed from realty (Section 2-107).” *Id.*

²² Negotiable instruments are covered under Article 3 of the UCC.

²³ Negotiable documents are covered under Article 7 of the UCC and, in some cases of interstate commerce, under federal law.

The reference to identification in the definition of goods is included in recognition that parties sometimes enter a contract for the sale of goods that have not yet been produced.²⁴ Goods must be moveable at the time of their identification to the contract. Before any interest in goods can pass from the seller to the buyer, the goods must be both existing and identified.²⁵ Identification occurs essentially at the earliest point in time when the specific goods that the seller will tender to the buyer in fulfillment of the contract are so designated. When the buyer selects the specific goods at the time of contract formation, identification occurs.²⁶ The parties might contract, however, for goods that the seller has yet to mass produce. Identification might not result until the distant delivery date, at which time the specific units for delivery to the buyer are selected for the first time from the seller's subsequently manufactured stock of goods.²⁷

[C] Hybrid Transactions

The most difficult aspect of the scope provision is to determine the applicability of Article 2 to hybrid transactions. These contracts involve a sale of goods, but they include additional categories of transactions as well. For example, a contract can include both a sale of goods and a service. Hybrid transactions are illustrated by the contract in *Cumberland Farms, Inc. v. Drehan Paving & Flooring Co.*²⁸ to sell and install bricks and the contract in *Federal Express Corp. v. Pan American World Airways, Inc.*²⁹ to sell aircraft and provide the initial training for the crews. Another type of hybrid transaction involves the sale of other items together with a sale of goods. The contract in *Dehahn v. Innes*³⁰ included the sale of both goods and real property, whereas *Dravo Corp. v. White Consolidated Industries, Inc.*³¹ involved the sale of goods and intangibles.

To determine whether a hybrid transaction is within the scope of Article 2, most courts apply the primary purpose test. If the court determines that

²⁴ "Goods which are not both existing and identified are 'future' goods. A purported present sale of future goods or of any interest therein operates as a contract to sell." UCC § 2-105(2).

²⁵ UCC § 2-105(2).

²⁶ In the absence of explicit agreement, identification occurs

(a) when the contract is made if it is for the sale of goods already existing and identified. UCC § 2-501(1)(a).

²⁷ In the absence of explicit agreement, identification occurs

(b) if the contract is for the sale of future goods other than those described in paragraph (c), when goods are shipped, marked or otherwise designated by the seller as goods to which the contract refers.

UCC § 2-501(1)(b).

²⁸ 25 Mass. App. 530, 520 N.E.2d 1321, 7 UCC Rep. Serv. 2d 747 (1988).

²⁹ 623 F.2d 1297, 29 UCC Rep. Serv. 778 (8th Cir. 1980).

³⁰ 356 A.2d 711, 19 UCC Rep. Serv. 407 (Me. 1976) (sale of heavy road-building equipment and a gravel pit).

³¹ 602 F. Supp. 1136, 40 UCC Rep. Serv. 362 (W.D. Pa. 1985) (sale of business included drawings that represented ideas and an agreement not to compete for five years).

the sale of goods was the primary or dominant purpose motivating the parties to enter the contract, the entire contract is governed by Article 2. Conversely, if the sale of goods aspect of the contract is considered secondary to the overall transaction, Article 2 is held not to cover any part of the agreement. Applying this test, the court in *Bonebrake v. Cox*³² found that Article 2 applied to the sale of used bowling alley equipment and lane beds, even though the contract also involved substantial amounts of labor to install the goods.³³ In contrast, the court in *Cork Plumbing Co. v. Martin Bloom Associates, Inc.*³⁴ found that the materials supplied were only incidental in a plumbing construction contract that required the contractor to assemble and connect different plumbing materials into a completed system.³⁵ Courts have often focused on the percentage of the total contract price that could be allocated to the purchase of the goods in applying the primary purpose test.³⁶ Other courts have indicated that the primary purpose of a hybrid transaction is controlled by the intent of the parties.³⁷

Some courts determine the applicability of Article 2 to a hybrid transaction by separating out the sale of goods aspect and applying Article 2 only to that part of the transaction. Thus, in *Foster v. Colorado Radio Corp.*,³⁸ the court applied Article 2 to a contract for the sale of a radio station as a going concern only insofar as the sale covered office equipment and furnishings. The bulk of the assets under the contract, covering items such as the license, goodwill, real estate, and transmission equipment, were not goods. Most jurisdictions have not followed this approach.³⁹ Even though the goods in a transaction are severable, these courts stress that the parties did not contemplate severance, but rather a transaction in which the various elements were combined.⁴⁰

³² 499 F.2d 951, 14 UCC Rep. Serv. 1318 (8th Cir. 1974).

³³ See also *Neibarger v. Universal Cooperatives, Inc.*, 439 Mich. 512, 486 N.W.2d 612, 18 UCC Rep. Serv. 2d 729 (1992) (installation and servicing obligations were incidental to the sale of automatic milking system).

³⁴ 573 S.W.2d 947, 25 UCC Rep. Serv. 1245 (Mo. Ct. App. 1978).

³⁵ See also *Geotech Energy Corp. v. Gulf States Telecommunications & Information Systems, Inc.*, 788 S.W.2d 386, 12 UCC Rep. Serv. 2d 41 (Tex. Ct. App. 1990) (installation of telephone system and creation of software to customize it predominated).

³⁶ *Baker v. Compton*, 455 N.E.2d 382, 38 UCC Rep. Serv. 10 (Ind. Ct. App. 1983) (predominant purpose measured in part by relationship of cost of the goods to the total contract price); *Monetti, S.P.A. v. Anchor Hocking Corp.*, 931 F.2d 1178, 14 UCC Rep. Serv. 2d 706 (7th Cir. 1991) (contemplated sales volume outweighed intangibles sold in exclusive distributorship agreement).

³⁷ *Urban Indus. of Ohio, Inc. v. Tectum, Inc.*, 81 Ohio App. 3d 768, 612 N.E.2d 382, 20 UCC Rep. Serv. 2d 1193 (1992); *Standard Structural Steel Co. v. Debron Corp.*, 515 F. Supp. 803, 32 UCC Rep. Serv. 393 (D. Conn. 1980).

³⁸ 381 F.2d 222, 4 UCC Rep. Serv. 446 (10th Cir. 1967).

³⁹ *Insul-Mark Midwest, Inc. v. Modern Materials, Inc.*, 612 N.E.2d 550, 21 UCC Rep. Serv. 2d 219 (Ind. 1993) (bifurcation approach followed by a lower court is rejected in favor of the "predominant thrust" test).

⁴⁰ *Field v. Golden Triangle Broadcasting, Inc.*, 451 Pa. 410, 304 A.2d 689, 12 UCC Rep. Serv. 1037 (1973) (sale of two radio stations as a going concern); *McClanahan v. American Gilsonite Co.*, 494 F. Supp. 1334, 30 UCC Rep. Serv. 21 (D. Colo. 1980) (sale of a crude oil refinery).

§ 1.04 PROMULGATION OF ARTICLE 2A

The initial UCC project understandably did not include lease of goods transactions because leasing activity was relatively insignificant during the late 1940s and the 1950s. Leasing of personal property simply was not sufficiently developed to be included in a project codifying commercial law.

The modern leasing industry is entirely different. Approximately one-third of new capital invested in equipment in this country is now invested through leasing.⁴¹ Business leasing of equipment grew twice as fast as overall business investment in equipment during the 1980s.⁴² The leasing of personal property has become a significant economic activity both nationally and inter-nationally.⁴³

The law of personal property leasing did not keep pace with the growth of leasing activity. It was found in scattered fragments in the ancient law of bailments, isolated statutory provisions, arguments by analogy to Article 2 and real property law, and private agreements between the contracting parties. The need for a comprehensive body of law to govern the transactions became increasingly apparent.

Following an initial study by the American Bar Association in 1980, the National Conference of Commissioners on Uniform State Laws (NCCUSL) appointed a Drafting Committee in 1982.⁴⁴ The Drafting Committee responded with the Uniform Personal Property Leasing Act. It was later decided to incorporate the new act into the UCC, so the drafting committee revised the act into new Article 2A. Article 2A was promulgated with approval of the Permanent Editorial Board in March 1987. This new article was the first expansion of subject matter within the scope of the Uniform Commercial Code since the Code was originally promulgated in 1951.

Article 2A is based in large part on Article 2 and to a lesser extent on Article 9. Unlike the drafters of other articles of the Code, the drafters of Article 2A did not have a predecessor statute on which they could base their work. They wisely decided, therefore, to draw on Articles 2 and 9 to the extent that their provisions are compatible with lease transactions,⁴⁵ but to deviate from the statutory analogues when necessary.⁴⁶ Article 2 was used as the primary analogue because of the similarity of many aspects

⁴¹ U.S. Dep't of Commerce, *U.S. Industrial Outlook 1993— Equipment Leasing* 53-1 (1992).

⁴² U.S. Dep't of Commerce, *U.S. Industrial Outlook 1990— Equipment Leasing* 56-1 (1989).

⁴³ An international convention was adopted in final form in 1988. UNIDROIT, Convention on International Financial Leasing, App. I, 27 *Int'l Legal Materials* 931 (1988).

⁴⁴ A more extensive discussion of the initial development of Article 2A is provided in A. Boss, *The History of Article 2A: A Lesson for Practitioner and Scholar Alike*, 39 Ala. L. Rev. 575 (1988).

⁴⁵ For a discussion of the major policy decisions facing the drafters, including the decision to use statutory analogues, see W. Lawrence & J. Minan, *Resolved: That the Kansas and Other State Legislatures Should Enact Article 2A of the Uniform Commercial Code*, 39 U. Kan. L. Rev. 95 (1990).

⁴⁶ The differences are highlighted in W. Lawrence & J. Minan, *Deviations from the Statutory Analogues: The New U.C.C. Article 2A*, 40 U. Kan. L. Rev. 531 (1992).

of sales and lease transactions, the bilateral nature of both types of transactions, and the desire of the drafters to perpetuate the freedom of contract principle embodied in Article 2.⁴⁷ The drafters, however, did not deviate from the analogues to the full extent necessary to differentiate lease transactions. The California State Bar Association Committee prepared a preliminary draft report that identified several areas in which the text of Article 2A needed revisions to better conform to lease transactions.⁴⁸ The drafters were reluctant to reopen debate on the text and simply made explanatory changes in the Official Comments. The California Committee rejected this inadequate approach,⁴⁹ and California ultimately enacted a version of Article 2A with several revisions.

Recognizing that a number of states were prepared to follow California's lead, the NCCUSL relented and proposed amendments to the text of Article 2A that reflected much of the California criticism.⁵⁰ Final approval of the amendments followed in December 1990. Thirty-nine states and the District of Columbia had enacted Article 2A as of March 1994.⁵¹

§ 1.05 SCOPE OF ARTICLE 2A [2A-102]

[A] Lease Defined [2A-103(1)(j)]

[1] Generally

Scope is established much more directly in Article 2A than it is in Article 2. The scope section simply states that the article "applies to any transaction, regardless of form, that creates a lease."⁵² The definition of lease limits applicability to leases of goods.⁵³ The range of applicable transactions extends from the rental of a tool or a punch bowl for a few hours to

⁴⁷ "This codification was greatly influenced by the fundamental tenet of the common law as it has developed with respect to leases of goods: freedom of the parties to contract." UCC § 2A-101, Comment (Relationship of Article 2A to Other Articles).

⁴⁸ Preliminary Draft Report of the Uniform Commercial Code Committee of the Business Law Section of the State Bar of California on Proposed California Commercial Code Division 10 (Article 2A) (May 18, 1987).

⁴⁹ Report of the Uniform Commercial Code Committee of the Business Law Section of the State Bar of California on Proposed California Commercial Code Division 10 (Article 2A) (Dec. 18, 1987).

⁵⁰ NCCUSL Amendments to Uniform Commercial Code Article 2A, Leases (with Drafting Notes)(July 13-20, 1990).

⁵¹ Article 2A has been enacted in Alabama, Alaska, Arizona, Arkansas, California, Colorado, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Kansas, Kentucky, Maine, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, Wisconsin, Wyoming, and the District of Columbia.

⁵² UCC § 2A-102.

⁵³ UCC § 2A-103(1)(j).

sophisticated leases of industrial equipment for a number of years.⁵⁴ Article 2A defines a lease as “a transfer of the right to possession and use of goods for a term in return for consideration, but a sale or retention of a security interest is not a lease.”⁵⁵ The definition thus requires two determinations: That the appropriate type of transfer has been made and that the result is neither a sale nor a secured transaction. Additional code provisions defining these other transactions therefore must also be consulted.

[2] Distinguishing Sales

A sale is easy to distinguish from a lease. A sale transfers title to the goods from the seller to the buyer.⁵⁶ The seller does not retain any ties to the goods. If the buyer does not pay for the goods, the seller has an action for the price but does not have the right to pursue the goods themselves.⁵⁷ A lessee acquires only the right to the use and enjoyment of the goods for a limited period of time. Title to the goods does not pass; rather, the seller retains it in the form of a residual interest in the goods. The goods revert back to the lessor at the end of the lease term. The lessor can recover the goods sooner if the lessee breaches during the term of the lease.

[3] Distinguishing Secured Transactions [1-201(37)]

The essential characteristics of secured transactions and leases are also easy to distinguish. A secured party who retains a security interest in goods sold essentially passes conditional title to the buyer/debtor: the buyer can retain the goods if the payment obligations are satisfied. In the event of default, the secured party can repossess the goods.⁵⁸ Generally, however, the secured party must dispose of the goods and apply the proceeds to the outstanding indebtedness.⁵⁹ Any surplus proceeds belong to the buyer/debtor.⁶⁰ A seller's retained security interest is thus only a limited contingent interest. A lessor, on the other hand, always retains a residual interest in the leased goods. A lessor can also retake the goods following a default by the lessee.⁶¹ Unlike the secured party, however, the lessor is not required to dispose of the goods and need not distribute any proceeds of disposition to the lessee.⁶²

Distinguishing leases from secured transactions in actual practice has proved to be a more difficult endeavor. The issue has led to some of the most pervasive litigation under the Code.⁶³ The greater similarity of

⁵⁴ UCC § 2A-102, Comment.

⁵⁵ UCC § 2A-103(1)(j).

⁵⁶ UCC § 2-106(1).

⁵⁷ For a limited exception to this principle, see § 9.09 [A], *infra*.

⁵⁸ UCC § 9-503.

⁵⁹ UCC § 9-504(1).

⁶⁰ UCC § 9-504(2).

⁶¹ UCC § 2A-525(2). For discussion of this provision, see § 9.09[B], *infra*.

⁶² UCC § 2A-527. For discussion of this provision, see § 9.01 [B], *infra*.

⁶³ See the extensive case law citations in W. Lawrence & J. Minan, *The Law of Personal Property Leasing* 2-6 to 2-21 (1993).

attributes of these two transactions, compared with leases and unconditional sales, contributes to the problem. Even more responsible is the fact that, for a variety of reasons related to taxes, accounting, or bankruptcy, parties sometimes disguise a secured transaction to appear in the form of a lease. Inadequate legal standards have also played a significant role. The original Code definition of “security interest” includes a sentence directed toward distinguishing sales and secured transactions.⁶⁴ It has proved to be woefully inadequate.⁶⁵

With the promulgation of Article 2A, the drafters also extensively amended the Article 1 definition of security interest.⁶⁶ The resulting definition is extremely long and complex, but it does provide an effective definition based on functional considerations. Rather than continuing the approach of the predecessor definition of relying on the unworkable central standard of the intent of the parties, the new definition focuses on the economics of the transaction. The basic economic reality of a lease is that the lessor has retained a meaningful residual interest. The new definition thus is directed toward a determination of whether the terms of the transaction actually compensate the purported lessor for the residual interest, as well as for the use of the goods during the lease term.

The revised definition includes a two-part test for determining a security interest. The first part of the test provides that “a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee.”⁶⁷ When the lessee can terminate the lease, the lessor clearly retains the residual interest in the leased goods and the lessee is not obligated for the term of the lease. The transaction thus creates a true lease and not a security interest.

If the lessee is not allowed under the terms of the agreement to terminate the transaction, a security interest is created if any of the factors enumerated in the second part of the two-part test is present. One of these factors is that the original term of the lease equals or exceeds the remaining economic life of the goods. The economic reality of such a transaction is that the purported lessor has not retained any residual interest in the goods, but rather has sold the goods and retained a security interest in them against the outstanding payment of installments. Under an agreement that extends to the end of the economic life of the goods, the consideration paid compensates the purported lessor for the full economic interest in the goods. When the lessee cannot terminate the agreement, the lessee is contractually bound to pay this full measure of compensation. The lack of any meaningful residual interest means that a transaction is a disguised lease, which is recognized for the security interest that it really is.

⁶⁴ UCC § 1-201(37) (last sentence) (original version).

⁶⁵ For a critique of the inadequacies of the original definition, see W. Lawrence & J. Minan, *The Law of Personal Property Leasing* 2-15 to 2-21 (1993).

⁶⁶ UCC § 1-201(37)(1987).

⁶⁷ UCC § 1-201(37)(second para.).

The practical effect is precisely the same if a lessee who cannot terminate the lease is bound to renew the lease to the end of the economic life of the goods or is bound to become the owner of the goods. The lessee is contractually obligated to pay for the remaining economic life of the goods, leaving no residual interest in the purported lessor. These factors, therefore, are sufficient to satisfy the second part of the test in the revised definition.

The remaining factors of the second part of the test address the role of options. They cover the circumstances in which a lessee, upon compliance with the terms of the lease, has the option to become the owner of the goods or to renew the lease for the remaining economic life of the goods. If the lessee can exercise either option for no additional consideration or for only nominal consideration, the transaction is not a true lease but is rather a security interest. The purported rental payments in such a transaction obviously compensated the lessor not only for the lessee's use of the goods during the lease term but also for the residual value that remained in the goods following the lease term. Despite the labels applied by the parties to the transaction, the economic reality is that a lessor willing to allow the lessee to retain the goods for nominal or even no additional consideration has not retained any meaningful residual interest. Conversely, the lessor has retained the requisite interest for a true lease when the lessee must pay more than nominal additional consideration in order to exercise an option to purchase the goods or to renew the lease until the end of the goods' economic life.

[B] Finance Leases [2A-103(1)(g)]

The lessor serves a unique role in some lease transactions. Rather than supplying the lessee with goods from an inventory maintained by the lessor, the lessor sometimes serves merely as a financing conduit, facilitating the lessee's acquisition of the goods from a supplier. The lessor in these transactions is comparable to a purchase-money secured party who finances a buyer/debtor's acquisition of goods by lending the buyer the purchase price and retaining a security interest in the goods. In the lease transaction, the lessor purchases or leases goods that the lessee desires and in turn leases or subleases the goods to the lessee.

Because lease agreements of this type result in a tripartite relationship, they do not fit into the statutory analogue of Article 2. They pose several special circumstances that cannot be resolved through the bipartite provisions of the Sales Article. On the other hand, these leases are quite significant in modern commercial transactions. They cover approximately 88 percent of the total original cost of leased equipment.⁶⁸

The drafters of Article 2A recognized the importance of these leases. They designated them "finance leases" and included several provisions

⁶⁸ U.S. Dep't of Commerce, *U.S. Industrial Outlook 1993 — Equipment Leasing* 52-2 (1992). The leasing in this study does not include short-term equipment rentals from retail outlets. The leases in the study are longer-term operating leases in which equipment is leased directly from a lessor's inventory without the lessor playing a role as a financing intermediary.

throughout Article 2A to deal with them. Several of these provisions represent some of the most significant departures from the statutory analogue.

To qualify as a finance lease under Article 2A, an agreement must, in addition to qualifying as a true lease,⁶⁹ satisfy three specific requirements.⁷⁰ First, the lessor cannot participate in selecting, manufacturing, or supplying the goods. The essential function of the finance lessor is to facilitate the finance lessee's acquisition of the goods from the supplier, rather than having anything to do with supplying the goods. Consequently, the finance lessee selects the desired goods. The finance lessor enters into a supply agreement with the supplier and then enters into a separate lease agreement with the finance lessee. The supplier often ships the goods directly to the finance lessee.

Isolating the finance lessor from direct participation in selecting or supplying the goods prompts the finance lessee to look directly to the manufacturer or supplier for recourse if there are problems with the goods. Article 2A relieves a finance lessor of any liability for implied warranties of quality with respect to the goods, and such a lessor is unlikely to extend express warranties with respect to goods that he or she did not supply. The lack of involvement in selecting and supplying the goods provides the basis for relieving finance lessors from this warranty responsibility.⁷¹

The second requirement in Article 2A for a lease to qualify as a finance lease is that the finance lessor's acquisition of the goods must be "in connection with the lease."⁷² This means that the lessor cannot acquire goods from a supplier and then later decide to lease them. It thus further restricts the finance lessor to a financing function and further ensures that the finance lessee dealt with the supplier and will look to the supplier for satisfaction of any products liability claims.

The final requirement for a finance lease is that one of four stated methods must be used to give the lessee advance notification of applicable warranties and promises by the supplier. Since a finance lessee will have to turn to the supplier, rather than the finance lessor, with respect to any dissatisfaction with the goods, this requirement is designed to apprise the finance lessee of the extent of available warranties. The requirement is logical because the supplier's contract is with the finance lessor rather than the finance lessee, and the finance lessee might not otherwise be adequately informed about available warranties against the supplier.

In addition to eliminating warranties that otherwise would apply to a finance lessor, Article 2A includes other provisions that are needed to further the tripartite relationship envisioned in a finance lease. A finance lessee is expected to turn to the supplier for warranty protection, but the

⁶⁹ See § 1.05[A] *supra*.

⁷⁰ UCC § 2A-103(1)(g).

⁷¹ UCC § 2A-103, Comment (g).

⁷² UCC § 2A-103(1)(g)(ii).

absence of contractual privity between the finance lessee and the supplier poses a conceptual obstacle to any warranty claim asserted by a finance lessee. This obstacle is overcome in Article 2A through a provision that makes the finance lessee the beneficiary of any promises and warranties that are extended to the finance lessor in the supply agreement.⁷³ This provision effectively gives the finance lessee a direct cause of action against the manufacturer or supplier for a breach of warranty.

A finance lessee does lose something in exchange for the benefit of becoming a beneficiary of third-party promises and warranties. If the finance lease is not also a consumer lease,⁷⁴ the lessee's promises under the lease contract "become irrevocable and independent upon the lessee's acceptance of the goods."⁷⁵ This provision deprives a lessee of any right to set off rents due under the lease, even though the goods are nonconforming. It has the effect of an express "hell or high water" clause,⁷⁶ which makes the party against whom it operates irrevocably committed to perform its obligations. A finance lessor is simply the financial conduit through which the finance lessee acquires goods from the supplier. Once the finance lessee accepts the goods, any complaints are between it and the supplier. The finance lessor is thus entitled to the rent payments, irrespective of any problems the finance lessee may subsequently experience.

[C] Consumer Leases [2A-103(1)(e)]

Most of the drafting of Article 2 was accomplished in the late 1940s, long before the consumer protection movement that developed during the 1960s. Consequently, it is not surprising that Article 2 contains very few provisions that could be characterized as consumer-oriented in tone.

Even though, by the time Article 2A was drafted, consumer protection was a much greater concern, the drafters faced a major policy decision. They ultimately decided to adhere for the most part to the Article 2 statutory analogue, but to add a sprinkling of provisions with a consumer protection orientation. Because of political implications, they wisely chose not to make wholesale additions. State legislatures have always been free to enact any consumer protection measures they consider appropriate. Although some states have enacted extensive protection measures,⁷⁷ others have declined

⁷³ "The benefit of a supplier's promises to the lessor under the supply contract and of all warranties, whether express or implied, including those of any third party provided in connection with or as part of the supply contract, extends to the lessee to the extent of the lessee's leasehold interest under a finance lease related to the supply contract, but is subject to the terms of the warranty and of the supply contract and all defenses or claims arising therefrom." UCC § 2A-209(1).

⁷⁴ See § 1.05[C] *infra*.

⁷⁵ UCC § 2A-407(1).

⁷⁶ The clause is so called because of its initial use in ship charter contracts.

⁷⁷ See California Song-Beverly Consumer Warranty Act, Cal. Civ. Code §§ 1790-1795.8; Ann. Cal. Codes, Civil §§ 1790-1795.8 (1985) and (Supp. 1992); Kansas Consumer Protection Act, Kan. Stat. Ann. §§ 50-623 to 50-644 (1983 & Supp. 1991). Eleven states have enacted the Uniform Consumer Credit Code (UCCC), which includes several provisions of consumer protection. UCCC (revised Official Text with Comments), 7A ULA 1 (1974).

to pursue this option. The drafters were concerned that the addition of several consumer protection measures in Article 2A could create problems integrating those provisions with more general consumer protection measures in some states. Even more problematic, they feared it could result in legislative rejection of the entire Article in jurisdictions that had not previously adopted comparable consumer protection measures.⁷⁸ Except for the few modest extensions included in Article 2A, the ultimate policy choice of the extent of consumer protection is thus left to the individual discretion of each state.

Article 2A includes a definition of “consumer lease” that draws heavily on the definition in the federal Consumer Leasing Act.⁷⁹ “Consumer lease” is defined to mean “a lease that a lessor regularly engaged in the business of leasing or selling makes to a lessee who is an individual and who takes under the lease primarily for a personal, family or household purpose, if the total payments to be made under the lease contract, excluding payments for options to renew or buy, do not exceed \$_____].”⁸⁰

§ 1.06 SUPPLEMENTING PROVISIONS OF THE UNIFORM COMMERCIAL CODE [1-103]

Articles 2 and 2A are not the exclusive sources of the law of sales and leases of goods. An important provision in Article 1 recognizes the continuing viability of general principles of law and equity. It provides in its entirety as follows:

Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.⁸¹

The Code was drafted against the existing backdrop of the common law. Many of the provisions of Articles 2 and 2A were adopted to change the common-law approach or at least to provide a consistent approach to certain issues on which some jurisdictions varied. Unless a Code provision displaces a principle of law or equity, however, those principles are equally relevant to transactions covered by the Code. Sale and lease transactions in particular draw heavily on the common law of contracts.

Many essential aspects of contract law are covered only partially or not at all in Articles 2 and 2A. The drafters did not intend to change the law in these omitted areas, so the Code draws on the common law for continued

⁷⁸ See F. Miller, *Consumer Leases Under Uniform Commercial Code Article 2A*, 39 Ala. L. Rev. 957, 962 (1988).

⁷⁹ 15 U.S.C. § 1667(1)(1982).

⁸⁰ UCC § 2A-103(1)(e). The language in brackets is provided for states that wish to impose a monetary limitation to qualify as a consumer transaction.

⁸¹ UCC § 1-103. The listing provided in this section is not exhaustive. UCC § 1-103, Comment 3.

applicability. Students of Articles 2 and 2A should note the interplay of the Code provisions with other principles of law and equity.