

UCC Articles 1 and 7 Work Group

**MODERNIZING THE
GENERAL AND DOCUMENTS-OF-TITLE PROVISIONS
OF THE
UNIFORM COMMERCIAL CODE
SB 558**

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UUUUI. Introduction

The Uniform Commercial Code (“UCC”), which has been the law throughout the United States for several decades, has the principal purpose of encouraging the free flow of commerce across state borders. The UCC helps to accomplish this by freeing buyers and sellers, borrowers and lenders, payors and payees, etc., from the uncertainty or high research costs that would result from each state’s laws differing from the laws of other states. The UCC is sponsored by the National Conference of Commissioners on Uniform State Laws (“NCCUSL”) and the American Law Institute (the “ALI”), which occasionally recommend revisions or amendments to portions of the UCC for enactment by the states.

The substance of the present bill originated with two of these NCCUSL and ALI-recommended amendments. It consists of (a) a revision of UCC Article 1, which generally acts as an “umbrella” in that it provides definitions and general principles that apply throughout the other UCC articles; and (b) a set of amendments to UCC Article 7, which applies to warehouse receipts, bills of lading and other documents of title.¹

The bill is designed to preserve Oregon’s participation in the uniform statutory framework that is shared by the other states, and by the same token to bring Oregon law up to date with the advances in certain commercial practices over the past few decades. Specifically (in addition to other much more minor updates), the bill would (a) extend the concept of course of performance so that it applies to contracts other than for the sale of goods, (b) amend the concept of good faith as set forth in UCC Article 1 to include the observance of reasonable commercial standards of fair dealing, (c) repeal a statute of frauds for sales of personal property other than goods, and (d) provide a framework for the issuance and transfer of documents of title in electronic form

II. History of the project

The substance of the bill’s proposed revision and amendments were first promulgated by NCCUSL and the ALI in 2001 (for Article 1) and 2003 (for Article 7). The standard NCCUSL and ALI process was followed in both cases, and this process is

¹ Other articles of the UCC are affected by the current bill only in two limited ways. First, because of its umbrella nature, changes made to Article 1 can have effects in other articles. And second, the changes to Articles 1 and 7 are accompanied by a handful of small direct amendments to the other articles, designed to keep terminology and policy consistent across the full UCC.

The other articles of the UCC are as follows: Article 2 regarding sales of goods; Article 2A regarding leases of goods; Article 3 regarding negotiable instruments such as promissory notes; Article 4 regarding the bank/customer relationship; Article 4A regarding wire transfers; Article 5 regarding letters of credit, Article 8 regarding investment securities, and Article 9 regarding secured transactions. UCC Article 6, regarding bulk sales, has been repealed in most jurisdictions including Oregon.

quite thorough. First, for each Article, a Study Group was created for the purpose of determining whether revisions to current law were needed. Following the Study Group's affirmative report, a Drafting Committee was created for the purpose of crafting the new statutory text. Each Drafting Committee was staffed by representatives of both sponsoring groups and of the American Bar Association, many of them experts in the relevant area of commercial law. The Drafting Committees actively sought the cooperation of affected industry groups across the nation, and worked in depth over the course of numerous weekend meetings across the country. The Drafting Committee's work, when final, was approved not only by both NCCUSL and the ALI but also by the American Bar Association.

Since then, the proposed amendments to both Article 1 and Article 7 have been widely adopted by other states and U.S. territories. For Article 1 there have been 35 adoptions to date, including California, Idaho and Nevada though not yet Washington.² For Article 7 there have been 31 adoptions to date, including the same neighboring jurisdictions just mentioned.³

The Oregon Law Commission Work Group was first convened in June, 2008 for the purpose of evaluating the suitability for Oregon of the proposed amendments and, if suitable, preparing a draft bill for legislative introduction. Members of the Work Group were as follows: Richard Hagedorn, Willamette University School of Law; Johnston Mitchell, McEwen Gisvold LLP; Douglas Pahl, Perkins Coie LLP; Richard Rasmussen, West Coast Bancorp; Robert Russell, Oregon Trucking Association, Inc.; and Ken Sherman, Sherman, Sherman, Johnnie & Hoyt. Statutory drafting was carried out by Sean Brennan, Oregon Legislative Counsel. OLC support was provided by Deputy Director Wendy J. Johnson and by Legal Assistants Kevin Meherns and Lisa Ehlers. Oregon State Bar advice was provided by David Nebel. The Work Group's Chair was Lane Shetterly, Chair of the OLC. The Work Group's Reporter was Carl S. Bjerre, University of Oregon School of Law.

As is usual in the case of the UCC, the NCCUSL and ALI process resulted in Official Comments for each statutory provision. The Work Group was guided by these Official Comments as well as by the members' knowledge of the applicable law and practice. (The Official Comments are generally and rightly accorded substantial weight by the courts in construing the UCC, and for that reason the legislature should be guided by them as well in considering this bill. The Official Comments to revised Articles 1 and 7 are included as Appendices A and B, respectively.)

III. Statement of the problem areas

During the decades since UCC Articles 1 and 7 were originally promulgated, business practices have naturally evolved in various ways, with the result that some of the corresponding UCC provisions have begun to lose their usefulness as a sound legal foundation. Four principal areas in particular have emerged as problems: the

² See < http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ucc1.asp>

³ See < http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ucc7.asp>

applicability of course of performance; the content of Article 1's general duty of good faith; the presence of statute of frauds for sales of personal property other than goods; and the accommodation of electronic documents of title.

A. *Course of performance.*

The literal words of a contract often cannot accurately interpreted until placed in the context of surrounding facts. To take a very simple example, a contract calling for payment of \$10,000 may mean one thing when made by two parties who reside in the United States, and another thing when made by two parties who reside in Canada. In a long-term contract which calls for repeated actions by one or more parties, "course of performance" is an important category of surrounding facts that should aid in interpretation. UCC Article 2, governing sales of goods, has always provided for course of performance to be used as a tool of contract interpretation (see ORS 72.2080), but the same tool should be equally available to interpret contracts elsewhere in the UCC, and it currently is not.

For example, suppose that a borrower and a secured lender have agreed that the collateral for the borrower's loan includes "all rights to payment owed to the borrower by its Grade A customers," that this agreement has been in place for several years, and that the term "Grade A customer" isn't defined by the terms of the agreement. One natural way to assist a court or other interpreters in determining what "Grade A customer" means – for example, whether the term includes Spring Hill Nursery, a mid-size financially stable retailer that purchases moderate amounts of merchandise from borrower – is to look to the conduct of the borrower and the secured lender of the years in which the agreement has been in place. If the secured lender has repeatedly treated rights to payment from Spring Hill Nursery as collateral (for example, by instructing Spring Hill Nursery to pay the secured lender rather than the borrower), and if the borrower has repeatedly accepted this conduct, then this course of performance is strong evidence of the meaning of the agreement. But at present there is no statutory guidance on this point, outside of UCC Article 2.

B. *Definition of good faith.* Because this topic is fairly complex, its discussion is divided into two parts, with some background being provided before the statement of the problem.

1. *Background: existence of the duty.* UCC Article 1 provides, "Every contract or duty within the Uniform Commercial Code imposes an obligation of good faith in its performance or enforcement." ORS 71.2030. The bill would continue this provision (though it would be relocated to a new ORS 71.3040, as provided by section 17 of the bill). Its effect is to supplement the literal language of each UCC-governed contract and duty with a duty of good faith. For example, under UCC Article 9, the contract between a borrower and a secured lender sometimes includes a "dragnet clause," according to which the borrower's assets are collateral not only for today's obligations, but also for obligations to the lender that the borrower might incur in the future.⁴ UCC Article 9

⁴ See ORS 79.0204(3).

itself says nothing about whether these dragnet clauses must be performed in good faith, but the effect of the above-quoted Article 1 provision makes it clear that they must.⁵

This interaction of Article 9's dragnet clauses and Article 1's duty of good faith shows how Article 1 has what we have called an "umbrella" effect on other UCC articles: the Article 1 provision contributes to determining the effect of a statute contained in another UCC article. (By contrast, and for clarity in the discussion that follows, it is important to distinguish this umbrella effect of Article 1's good faith rule from the "direct" effects of good faith that are stated outside of Article 1. Numerous provisions found in UCC Articles 2, 2A, 3, 4A, 5, 7, 8 and 9 explicitly impose a good-faith requirement by their own terms; for example, Article 3 explicitly provides that the holder of a negotiable promissory note takes free of certain defenses of the maker only if the holder took the note in good faith;⁶ and the operation of these rules has nothing to do with any umbrella effect of Article 1.)

2. *The problem: content of the duty.* The problem is not the existence of Article 1's umbrella duty of good faith, but the content of that duty. Oregon's current version of Article 1 defines "good faith" as including only "honesty in fact in the conduct or transaction concerned." ORS 71.2010(19). However, the strong preference of modern law is to expand the definition to include an additional element: not only "honesty in fact" but also "the observance of reasonable commercial standards of fair dealing." The distinction between Oregon's current Article 1 version and the more modern version can be described as "purely subjective" versus "both subjective and objective," or as "one prong" versus "two prongs," and one-prong duties of good faith such as current ORS 71.2010(19) have sometimes colorfully been called "pure heart, empty head."

In keeping with the strong modern trend toward a two-prong definition of good faith, virtually every past amendment to UCC articles (both in Oregon and elsewhere) has updated the applicable "direct" definitions of good faith to include both prongs. As just one example, in 2001 Oregon amended its version of UCC Article 9 in exactly this way.⁷

These past amendments have kept Oregon in line with modern law to the extent of good faith's "direct" effects, but unless Oregon amends Article 1 to include the objective as well as the subjective element, then Oregon will be out of step for the "umbrella" effects of good faith. In other words, where Article 9 (for example) specifies that good faith is required, Oregon already imposes the two-prong meaning of the duty, but where Article 9 (for example) does not so specify, Oregon would impose only the one-prong meaning of the duty. This would be problematic for at least three reasons.

⁵ This example is adapted from the facts of *Pride Hyundai, Inc. v. Chrysler Financial Company*, 369 F.3d 603 (1st Cir. 2004).

⁶ ORS 73.0302(1)(b)(B), 73.0305.

⁷ See ORS 79.0102(qq) ("'Good faith' means honesty in fact and the observance of reasonable commercial standards of fair dealing."). See also ORS 72.1030(1)(b), 72A.1030(2)(n), 73.0103(1)(d), 74.1040(3)(g), 74A.1050(1)(f), 78.1020(1)(j). The sole notable exception is the amendments to UCC Article 5, governing letters of credit. The drafters of the NCCUSL and ALI amendments to Article 5 retained the one-prong definition because of circumstances that are particular to the letter-of-credit industry, and Oregon has done the same in the interest of cross-border uniformity. ORS 75.1020(1)(g).

(a) Confusion and lack of harmony within Oregon law itself. With the Oregon versions of UCC Articles 2, 2A, 3, 4A, 8 and 9 already providing for a two-prong duty for the “direct” instances of good faith, it is anomalous and needlessly confusing for “umbrella” instances of good faith to remain governed by the old one-prong standard.

(b) Growing loss of uniformity between Oregon and its sister states. As other states continue to adopt Revised Article 1, the clear majority can be expected to impose the two-prong duty, and the difference between those states and Oregon law can be expected to burden cross-border transactions that are governed by the UCC.

(c) Substantive desirability of the two-prong standard. This point is discussed in Part IV.B below.

C. *Statute of frauds.* As most lawyers know, the UCC provides that contracts for the sale of goods at a price of \$500 or more are not enforceable unless in writing and signed by the party to be charged. ORS 72.2010(1). Outside the UCC, certain other contracts such as those of suretyship, or for the sale of real property, etc., are similarly subject to a statute of frauds. ORS 41.5180. Neither of these provisions are at issue in the present bill, but the UCC also contains a further obscure statute of frauds for “sale of personal property” beyond \$5,000, see ORS 71.2060. This latter provision and its uniform counterparts in other states are poorly drafted (without the important and well-established exceptions provided in more mainstream statutes of frauds) and have no strong justification. They create a substantial risk that genuine transactions, such as the provable sale of a half-interest in a securities account, would be unenforceable due only to the lack of a signed writing.

D. *Electronic documents of title.* Warehouse receipts, bills of lading, and other documents of title have traditionally been in paper form, (A “warehouse receipt” is a document that represents the ownership of goods that are being professionally stored, for example, grain that is being stored in a silo. Similarly, a “bill of lading” is a document that represents the ownership of goods that are being professionally transported, for example, timber that is being shipped by railway. In both cases, people that want to buy and sell or otherwise enter large commercial transactions involving the grain or the timber can advantageously do so using the documents as opposed to the goods themselves. UCC Articles 2, 9 and especially 7 treat the goods as being embodied by the documents, much as UCC Article 3 treats a creditor’s right to be paid as being embodied by a negotiable promissory note.)

However, during the past several years businesses have begun conducting transactions with documents of title in electronic form, and there is currently no Oregon legal foundation for these transactions. The law’s accommodation of electronic documents of title would enhance commerce in two related ways. (a) It would allow for the quick carrying out of transactions. Buyers, secured lenders and others would be able

to acquire their documents in a matter of moments rather than a matter of days, and because time equals risk, this quickness would reduce the risk of the transferor becoming insolvent or otherwise unable to perform. (b) It would deepen the potential pool of transferors and transferees. An Oregon bank could use a warehouse receipt for Hawaiian flowers as collateral just as easily as could a Hawaiian bank, and conversely, a Japanese bank would be able to use a bill of lading for Oregon timber for collateral just as easily as could an Oregon bank. Unless Oregon joins other states in providing a strong foundation for transactions in electronic documents of title, this branch of commerce within our state or involving our businesses will be hampered.

IV. The objectives of the proposal

The bill provides resolutions for each of the above problems that (a) the Work Group, by consensus, agrees are substantively desirable on their own terms, and (b) also serve the more general goal of keeping Oregon's commercial law consistent with those of its sister states.

A. Course of performance.

The bill relocates the existing provisions on course of performance from Article 2 to Article 1, where they will accordingly apply throughout the UCC in umbrella fashion. See section 16(1) of the bill (adding the provisions to Article 1) and section 116 of the bill (repealing ORS 72.2080, in which the provisions are currently limited to Article 2, as well as other sections). This point has not been controversial either within the Work Group or nationally.

B. Definition of good faith.

The bill defines good faith for purposes of Article 1 as "honesty in fact and the observance of reasonable commercial standards of fair dealing." See section 8(2)(t) of the bill. In conjunction with the continuation of current ORS 71.2030, which as discussed above imposes the obligation of good faith as an umbrella provision, the result will be that the two-prong duty of good faith would generally apply throughout the UCC.⁸

The consensus of the Work Group is that this two-prong standard is the more desirable rule of law, because it fills the gaps of an agreement in the fullest way. When two parties make a contract, they generally draft explicit answers to the potential future questions that they can foresee arising; however, not even the most foresighted and skilled draftsman can foresee and draft protection for all future questions that might arise. The implied duty of good faith, with an objective as well as a subjective prong, has been carefully developed by common-law judges over many decades precisely in order to help address this problem, and Article 1's umbrella duty of good faith fulfills a parallel role within the UCC. Crucially, it is well accepted in common-law cases that the implied

⁸ The above-noted exception for UCC Article 5, governing letters of credit, would continue to apply.

duty of good faith includes the observance of reasonable commercial standards,⁹ and at least one Oregon Supreme Court case expressly imposes a reasonableness obligation as part of the common-law implied duty of good faith.¹⁰ With a two-prong definition of good faith, any party to any contract can have assurance that the other party will be prevented not only from acting dishonestly, but also from acting arbitrarily or unreasonably. As a result, parties who are entering into ongoing commercial relationships will benefit from an enhanced degree of upfront confidence in terms of what they can expect from their counterparties.

There can, to be sure, be some costs to the two-prong standard. The reasonableness portion of the standard, by its nature, can be difficult and fact-sensitive to apply, and in the event of a courtroom dispute, the party whose good faith is being challenged would naturally have an easier time prevailing on summary judgment under the current one-prong standard than under the two-prong standard. Nonetheless, the prevailing view in the Work Group, as at the NCCUSL and ALI level, is that these costs are outweighed by the benefits of the two-prong standard.

C. *Statute of frauds.*

The bill repeals the existing statute of frauds for sales of personal property. See section 13 of the bill. This point has not been controversial either within the Work Group or nationally.

D. *Electronic documents of title.*

The bill recognizes that documents of title can be issued in electronic form. See section 8(2)(p)(C) of the bill (defining “electronic document of title” and subjecting them to most of Article 7’s existing rules).

Correspondingly, the bill also provides for electronic equivalents to two of Article 7’s other traditional concepts, i.e. possession and holder. These two concepts, details of which appear below, help to implement the negotiability principle which is the linchpin of Article 7. The negotiability principle, which may be familiar to many lawyers from other areas including UCC Article 3’s treatment of promissory notes, provides generally that an innocent purchaser of property can acquire its rights free of conflicting claims of ownership. In the context of Article 7, this means that an innocent purchaser of a negotiable document of title can acquire rights to the good that are being stored in the warehouse, or transported by the carrier, without concern that the goods may already

⁹ See Restatement (Second) of Contracts § 205, comment a:

Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving ‘bad faith’ because they violate community standards of decency, fairness *or reasonableness*.

(Emphasis added).

¹⁰ Best v. United States National Bank of Oregon, 303 Or. 557, 739 P.2d 554, 565 (1987) (whether bank’s NSF fees violate the duty of good faith “should be decided by the reasonable contractual expectations of the parties”).

have been sold to granted as collateral to an unknown third party. This rule greatly enhances the robustness of commerce in documents of title.

In order to qualify for this protection under Article 7, the purchaser of the document of title has traditionally been required to “possess” it. For a paper document of title, it is easy to determine who has possession because there is only one genuine original of the document at any time. By contrast, electronic data can be infinitely and perfectly reproduced, which leads to a conundrum on the subject of who possesses the original of an electronic document of title. The bill resolves this issue by creating the new concept of “control” of an electronic document of title,¹¹ which serves as the equivalent of possession in Article 7. Specifically, a person has control of an electronic document of title if an electronic transfer system “reliably establishes that person as the person to which the electronic document was issued or transferred.”¹² See section 54 of the bill.

The concept of “holder” is closely related to that of possession and, now, control. In order to qualify for protection under Article 7’s negotiability principle, the purchaser must be the holder, which has traditionally required being in possession of a tangible document of title. The bill retains this concept, but also expands it so that the person in control of an electronic document of title is also the holder. See section 8(2)(u)(C) of the bill.

Finally, in order to enhance the flexibility of the new electronic medium, the bill provides for documents of title that were originally issued in paper form to be reissuable in electronic form, and vice versa. See section 53 of the bill.

None of these points have been controversial either within the Work Group or nationally.

E. Choice of Law

One topic was briefly discussed within the Work Group but does not appear in the bill: a revision of Article 1’s choice-of-law rules. The reason that this revision does not appear in the bill is that the revision has been rejected nationally, and the Work Group did not believe it would be productive to pursue the topic.

ORS 71.1050 currently provides that if a transaction bears a reasonable relation both to Oregon and to a different jurisdiction, then the parties to that contract have the

¹¹ The concept of “control” in the bill is borrowed from other parts of the UCC and other law in which control is already a useful concept for other kinds of assets. See, e.g., ORS 78.1060 (control of securities accounts with a broker or other intermediary), ORS 79.0104 (control of a savings, checking or other deposit account), ORS 79.0105 (control of electronic chattel paper), ORS 79.0106 (control of commodity contracts), ORS 84.046 (Uniform Electronic Transactions Act’s provision for control of transferable records such as electronic promissory notes).

¹² This definition of “control” is deliberately open-ended, because any more specific reference to currently existing technology would risk becoming quickly outdated and thereby could hamper the evolution of business practices. We understand, however, that systems are already in place today that are accepted as meeting the applicable “control” criteria.

autonomy to effectively specify that their contract will be governed either by Oregon law of Oregon or by the law of the other jurisdiction. For example, if an Oregon resident and a Texas resident agree on the sale of timber to be shipped from Oregon to Texas, their contract may effectively provide that it is governed either by Oregon law or by Texas law. However, if the contract purports to provide that it is governed by Massachusetts law and the transaction bears no relation to Massachusetts, such a choice of law is ineffective.

At one time the NCCUSL and ALI proposal included a substantial revision of this rule, which generally speaking would have enhanced the parties' autonomy so that, in the above example, the choice of Massachusetts law would have been effective even in the absence of a reasonable relationship to that jurisdiction. However, this proposal met with severe controversy, and of the 35 jurisdictions adopting Revised Article 1, all but one of them (the U.S. Virgin Islands, which acted even before the Article 1 revision was finally approved) rejected the new choice-of-law rule, and instead retained the rule reflected in ORS 71.1050. As a result, by May 2008 both NCCUSL and the ALI had withdrawn the proposed amendment, replacing it with a new proposal that retains current law subject only to stylistic changes.

Accordingly, the interest in keeping Oregon law uniform is clearly best served by retaining the substance of ORS 71.1050. The bill does so, though it relocates this substance to what will be a new ORS 71.3010. See section 14 of the bill. The retention of the existing choice-of-law rules has not been controversial within the Work Group or, since May 2008, nationally.

V. Review of legal solutions existing or proposed elsewhere

As noted above, the bill's provisions are largely consistent with the revisions to Article 1 and the amendments to Article 7 that have already been adopted by 35 and 31 U.S. jurisdictions, respectively.

On the subject of good faith, a clear minority of U.S. jurisdictions (11 of the 35 that have adopted Revised Article 1 to date)¹³ have declined to expand the definition of good faith to include the second (reasonableness) prong. As discussed above, the prevailing opinion of the Work Group was that this approach should be rejected and that Oregon should join the clear and likely-growing majority of jurisdictions.

¹³ See Keith A. Rowley, *The Often Imitated, But (Still) Not Duplicated, Revised UCC Article 1*, < <http://www.law.unlv.edu/faculty/rowley/RA1.090108.pdf> >

VI. The proposal

The substantively significant sections of the bill, discussed above, are presented here in list form with a cross-reference to the above discussions:

- SECTION 8(2)(p)(C): defines “electronic document of title” and subjects these documents to most of Article 7’s existing rules. See Parts III.D and IV.D above.
- SECTION 8(2)(t): expands duty of good faith to include the observance of reasonable commercial standards of fair dealing. See Parts III.B and IV.B above.
- SECTION 8(2)(u)(C): defines “holder” of an electronic document of title as being the person in control of it. . See Parts III.D and IV.D above.
- SECTION 13: repeals statute of frauds for sale of personal property other than goods. See Parts III.C and IV.C above.
- SECTION 14: retains current contractual choice of law rule with reasonable relationship test. See Part IV.E above.
- SECTION 16(1): adds course of performance to Article 1 as umbrella. See Parts III.A and IV.A above.
- SECTION 17: preserves umbrella duty of good faith. See Parts III.B and IV.B above.
- SECTION 53: Provides for electronic reissuance of paper documents of title, and vice versa. See Parts III.D and IV.D above.
- SECTION 54: provides for “control” of electronic documents of title. See Parts III.D and IV.D above.
- SECTION 116: repealing Article 2’s course of performance provisions, among others. See Parts III.A and IV.A above.

The other sections of the bill represent (a) conforming changes prompted by sections already discussed above, (b) changes that relate only to gender-neutrality, medium-neutrality as between traditional writings or signatures and their electronic equivalents, or other stylistic matters, or (c) comparably very minor updates. Because of its nature as a code, many sections of the UCC are interrelated, so that a single substantive change can require numerous conforming amendments; hence the overall length of the bill.

VII. Conclusion

The bill should be adopted because it modernizes Oregon's law of commercial transactions. It provides for course of performance to be applied to all contracts within the UCC; it expands the Article 1 duty of good faith; it repeals a poorly designed statute of frauds; and it provides for the issuance and transfer of documents of title in electronic form. At the same time, the bill keeps Oregon's law of commercial transactions substantially uniform with those of its sister states, which benefits the economy of the state and the nation.

VIII. Appendices

Appendix A: Text and Official Comments to Revised UCC Article 1

Appendix B: Text and Official Comments to Revised UCC Article 7