Professional Perspective

UCC Article 2 and How It Applies to You

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Every day, there are hundreds of thousands of Uniform Commercial Code Article 2 transactions, but few companies consider Article 2 beyond the purchase of simple consumer goods, like automobiles, clothing, and electronics. But Article 2 reaches transactions beyond those for simple consumer goods, encompassing transactions that routinely implicate millions of dollars. It's not until companies are in the throes of a dispute, pursuing or defending against claims, do they realize the importance of Article 2.

This article provides a non-industry-specific introductory guide to understanding the importance of Article 2 of the UCC from a commercial disputes perspective by reviewing why an understanding of UCC Article 2 matters, when UCC Article 2 applies, contract formation under the UCC, contractual interpretation under UCC Article 2, and two key provisions applicable to most UCC disputes—warranties and remedies.

Why You Need to Understand UCC Article 2

Without a proper understanding of the UCC, companies unknowingly enter into binding agreements. In doing so, they agree to unknown terms, waive unknown remedies, and breach unknown obligations. In other circumstances, otherwise sophisticated companies enter into multi-million-dollar transactions governed by nothing more than a one-page purchase order that does not consider Article 2's implications.

As a result, companies have found themselves agreeing to obligations to perform in good faith, provide specific types of notice, provide an opportunity to cure, or other requirements that could foreclose remedies. And while these requirements may not appear in the four corners of an agreement, they are no less binding because UCC Article 2 applies. Simply put, failure to understand Article 2's implications have cost companies millions of dollars.

Article 2 Applies to Transactions of 'Goods'

Article 2 of the UCC is a code that governs transactions for goods, which most states (Louisiana being the major exception) have statutorily codified in some form. Article 2 applies to transactions for goods, which "means 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 … things in action … [and] 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…."

In other words, it applies to transactions involving most things that are moveable. This includes sales of electronics, large-pieces equipment—rigs, pumps, and compressors, aircrafts, engines, food products, crops, and hydrocarbons. It also includes financing arrangements for any of those goods. This global statement is subject to two important caveats: leases of goods are covered by an analogous but different code—Article 2A of the UCC—and certain states like Texas have excluded certain provisions of UCC Article 2 from take-or-pay contracts.

How Article 2 UCC Contracts Arise

One of the distinguishing features of UCC Article 2 is that it creates binding agreements between sophisticated parties in ways that would otherwise be unenforceable. These rules apply to most companies operating within their sphere of business because they will be considered "merchants," which generally means companies or individuals that deal in the type of goods subject to the transaction. A company is a merchant not only because it has the requisite sophistication in the area, but also if it hires an agent or consultant with the requisite sophistication.

There are at least six different ways that merchants can become parties to a contract. Most companies are familiar with the first two. The most straightforward way is for the parties to sit down and execute the same document. In addition, Section 2.206 allows a seller to create a binding contract after a buyer sends an offer to purchase goods—typically a purchase order—by promising to ship the requested goods or by shipping the requested goods.

But there are four other methods of creating a binding contract that are less familiar, three of which exist in Section 2.201.

- Section 2.201(b) creates a contract for the sale of goods if the parties discuss a transaction, one of the parties sends a written confirmation of that discussion, and the recipient of the confirmation is aware of the contents of the confirmation and does not object in writing within ten days after it receives the confirmation.
- Section 2.201(c)(1) creates a binding contract if a buyer orders specially manufactured goods, repudiates the order, the seller had substantially begun making those goods by either manufacturing or procuring, and the seller cannot sell the goods in the ordinary course of its business.
- Section 2.201(c)(3) creates a binding contract where a buyer has accepted delivered goods or where a seller has accepted payment for goods.
- Section 2.207(c) (discussed in more detail below) enforces contracts if "[c]onduct by both parties … recognizes the existence of a contract … although the writings of the parties do not otherwise establish a contract."

Disputes Over UCC Article 2 Contract Terms

Because UCC Article 2 contracts can arise in various ways, when a problem occurs, parties often dispute the terms of the contract—not whether a contract exists. Unlike many contracts, a UCC Article 2 contract may consist of more or less than the terms on the papers exchanged between the parties because the UCC has its own default rules. UCC Article 2 contracts consist of statutory terms and certain terms from the parties' papers.

Beware of the 'Battle of the Forms:' Section 2.207

Section 2.207, colloquially called the "battle of the forms," seeks to reconcile conflicting terms in opposing parties' papers to still create a commercial transaction. While Section 2.207 appears to be straightforward, it is not. Numerous states have various common law rules that alter Section 2.207, and even within the same state, different trial courts may apply Section 2.207 in materially different ways.

Does that mean whenever Section 2.207 applies that the outcome is unpredictable? No. There are certain things that companies can do so that they will be well positioned for a favorable, or at least a predicable outcome.

There are two things that companies should do in every situation. First, companies should always make their assent to the other side's terms subject to their express approval. While there are no magic words that a company must use to make its acceptance expressly conditional to its terms, the wording should be clear enough that it is not easily disputed in front of the judge or arbitrator who will be deciding the fate of a contract. Second, companies should also expressly object to terms that they do not want. Failure to do these two things does not sink a future claim or defense; however, it may make arguments that a particular company's favorable terms should apply in a given circumstance.

Important Provisions Across Industries

While there are various provisions that companies should consider, two areas often relevant to complex UCC disputes are warranties and remedies.

Warranties

Unlike warranties for a car or home, warranties in the UCC context generally define what the parties are buying or selling. There are express warranties—warranties stated by the parties' agreement—and implied warranties—warranties that are a part of the default statutory framework. The reason that warranties are important is because if the good is delivered and something is wrong, a buyer's claim is a claim for breach of warranty and not breach of contract.

In commercial transactions, one of the most important things for the buyer to do is to ensure that whatever it is purchasing contains the warranties that will be sufficient to protect the buyer. The buyer will always want a warranty that the seller has clear title to the good it is purchasing and that the good is also free from liens. The buyer will also want to ensure that the good is accurately described. A buyer should consider performance warranties; that is, a warranty that the item will perform how the buyer wants it to perform. The last thing the buyer wants to do is buy an expensive piece of equipment that matches all of the dimensions and other specifications but does not work.

There are also two implied warranties relevant to commercial transactions—the implied warranty of merchantability and the implied warranty for fitness for particular purpose. These implied warranties, if applicable, broaden the seller's obligations to ensure that the goods are fit for the buyer's particular purpose in buying the good or are merchantable. Sellers should try to disclaim implied warranties because implied warranties generally increase a seller's obligations, making them somewhat ambiguous at the time of contracting.

Remedies

Provisions governing remedies may be the most important provisions in the dispute context because the amount and extent of damages, or other remedies, will often determine whether there is a dispute. After all, a company will not generally go through the trouble of litigating a dispute unless there is enough monetary value to justify the risk.

Section 2.719 allows parties to limit remedies, including the amount of damages. But, if a party wants to make a remedy the sole remedy, it must state so. Otherwise, Section 2.719(a)(2) considers the listing of a remedy as "optional." Like most modifications of UCC Article 2's default rules, remedy limitations must be reasonable. Section 2.719 will disregard purported limitations of remedies if "an exclusive or limited remedy … fail[s] of its essential purpose" and where a limitation of consequential damages is "unconscionable."

In addition, both buyers and sellers should consider liquidated damages provisions. Liquidated damages not only provide a mechanism to limit risk, but they also provide a mechanism for buyers to quantify damages that may not be easily quantifiable. This is especially true for certain consequential damages. For example, in the chemical and industrial gas industries, it is often difficult for a buyer of feedstock to quantify its losses even though that buyer knows it will have substantial losses if a supplier fails to deliver needed feedstock that would cause a plant to curtail production.

Like other limitations on damages, liquidated damages must also be "reasonable." Failure to make a reasonable liquidated damages provision implicates Section 2.718, which provides that "[a] term fixing unreasonably large liquidated damages is void as a penalty." In such a case, the unreasonable provision is not made more reasonable, but is instead stricken, leaving the buyer to prove damages at trial or in an arbitration.

Conclusion

In high stakes disputes no business likes to be surprised. Thus, it is critical for any business that transacts in items covered by UCC Article 2 to have an appreciation for its impact long before a dispute arises so that it can put itself in the best position possible. Not only will this help to limit exposure or preserve claims, but it will also provide the company with peace of mind.