Commercial Law

4

SALES CONTRACTS

Under the UCC, a sales contract is a legally enforceable agreement by which a seller and a buyer transfer, or agree to transfer, ownership of property for a fixed sum. Article 2 of the UCC governs the law of sales of goods. General contractual terms and concepts also apply to these sales.

A sales contract is an agreement between a seller and a buyer that involves the transfer of the ownership of goods for a price. Sales contracts are governed by the Uniform Commercial Code (UCC) Article 2, which defines "goods" as property that is tangible and movable, other than money.

Three specialized types of sales contracts are sale on approval, sale and return, and auction sales.

A valid sales contract requires agreement (offer and acceptance) and consideration and can be either oral or written. However, certain contracts that are not written and not properly signed are unenforceable under the UCC's Statute of Frauds. Performance as described in a sales contract is necessary for successful contract completion.

A sales contract is breached when one of the parties to the contract fails to carry out the performance it has promised under the contract. Both buyer and seller have remedies when a sales contract is breached.

UCC Article 2

The Uniform Commercial Code applies to commercial transactions such as the sale of goods, leases, contracts, and negotiable instruments. It is not a federal law but rather a model code to be considered for adoption as law by each state. Its purpose is to provide a consistent legal basis for business transactions throughout the United States and its territories. Because business is often conducted across state boundaries, it is important for all parties that relative uniformity exists among the laws regulating these business dealings, including sales.

The National Conference of Commissioners on Uniform State Laws and the American Law Institute collaborated over many years to create the UCC. In 1952, these two private nongovernmental organizations published the first edition of the UCC with the recommendation that the state governments adopt it. Since then, a number of updated UCC editions have been published. Today, all fifty states, the District of Columbia, and the U.S. territories have adopted the UCC in whole or in part; states and territories are free to modify the code to meet the needs of their citizens. For example, Louisiana adopted the code minus Articles 2 and 2A.

The UCC contains articles that relate to specific areas of commercial law. Article 2 governs the laws relating to the sale of goods. The UCC defines a sales contract as a legally enforceable agreement by which a seller and a buyer transfer, or agree to transfer, ownership of property for consideration. Article 2 defines "goods" as property that is tangible and movable, other than money. Growing crops and timber, for example, are goods, as are things that are part of or emanate from land, such as minerals, oil and gas, structures, or parts of structures—if a sales contract provides that they are to be severed from land.

The UCC provisions regarding sales contain many rules for merchants. A merchant is a person who deals in goods, or a professional, such as an agent, who purports to have special knowledge or skills concerning those goods.

Types of Sales Contracts

Sales contracts can be unilateral or bilateral:

- Under a unilateral contract, a promise is exchanged for an act. For example, Jack, the owner of the Old Saw Mill, offers to pay Bob $500 per thousand board feet for logs delivered to the mill. Jack has a unilateral contract with Bob. When (and if) Bob delivers the logs, his act will both form the contract and perform his duty under the contract.
- A bilateral contract is an exchange of promises of future action. A bilateral sales contract requires the agreement of both buyer and seller. For example, Billy promises to sell Jack five thousand board feet of oak logs at a price of $750 per thousand board feet, and Jack promises to pay that price for delivery of the logs by a specified date. A bilateral contract is formed under which both parties have a duty to perform in the future.

Sales contracts usually involve the exchange of specified goods at a specified price to be delivered at or within a specified time. There are, however, specialized categories of sales contracts:

- Sale on approval—Sale to a consumer who wants to try the goods before buying them. A buyer who is not satisfied with the goods can return them at the seller's risk. Title and risk of loss remain with the seller until acceptance. The seller will most likely obtain insurance coverage for the goods until their acceptance by the buyer.
- Sale or return—Sale to a person who intends to resell the goods but who has the right to return them if they do not sell. The buyer must pay for any goods not returned. The seller retains title until payment or resale. However, the buyer's creditors can attach the goods, that is, seize them under legal authority, if the creditors are not on notice of the seller's interest in the goods. For example, if a creditor knows that the buyer is in the

business of selling other people's goods, the creditor cannot seize them. Return of the goods is at the buyer's risk.

- Auction sales—Public offering of goods for sale. At auctions "with reserve," the auctioneer's chant is the invitation to make an offer; the auctioneer reserves the right to reject offers. The bid is the offer, and the auctioneer's agreement to take the highest bid is the acceptance of an offer. Auction sales of goods without a set minimum bid must be advertised as "without reserve," and the highest bidder must get the article. Without reserve, the auctioneer's chant is a continuous offer, and the highest bid becomes acceptance. For some auction sales, the auctioneer sets a minimum bid for the goods, and if all bids are under the minimum, withdraws the goods from bidding. In any type of auction sale, the bidder can retract the bid at any time before the auctioneer announces completion of the sale. The bidder's retraction does not revive any prior bid. Instead, bidding begins again.

Formation of Sales Contracts

A contract requires an agreement, defined as an offer and an acceptance, and consideration. General contract principles apply to contracts for the sale of goods, unless superseded by a provision of the UCC. The general rules of fraud, mistake, duress, and undue influence also apply to contracts for the sale of goods.

Offer

An offer is the act of presenting to another the opportunity to purchase or acquire goods under certain conditions. The UCC requires that an offer must be definite enough that the parties understand their obligations. However, an offer may have one or more terms left open and still form a valid agreement to contract as long as the parties intended to form a contract and there is a reasonable basis on which a remedy for breach can be calculated.

Acceptance

An acceptance of an offer is the act of agreeing with or taking what is offered. The manner of acceptance may affect the validity of the contract. Under general contract law, if the offer says the offer may be accepted only by mail addressed to a specific person, the acceptance must comply with those terms. If the offer is silent as to how acceptance is to be communicated, the UCC allows the acceptance to be made in any manner that is reasonable under the circumstances.

If a definite expression of acceptance of an offer to buy or sell goods contains additional or different terms, it is still an acceptance of the original offer unless it is expressly conditioned on the seller's consent to the new terms. Whether the new terms become a part of the contract depends on two variables:

- If one of the parties is a nonmerchant, the new terms become part of the contract only if the nonmerchant party expressly agrees to them.
- If both parties are merchants, the new terms become part of the contract unless they would materially alter the contract or unless the other party objects within a reasonable time.

Consideration

Consideration is essential to sales contracts. If a contract leaves the price open or provides a method of determining the price, the price becomes the reasonable price at delivery time. However, contrary to general contract law, the parties' agreement to modify a contract for the sale of goods is binding even without new consideration.

Statute of Frauds

Statutes of fraud
A collection of laws that help prevent parties from becoming involved in fraudulently formed contracts.

The UCC contains **statute of fraud** provisions that deal with the unenforceability of certain contracts that are not written and not properly signed. The writing required as evidence of a contract can be in any form and can consist of several communications, so long as it provides evidence of the contract's existence. A written memorandum created by the parties sometime after the original negotiations can be sufficient to satisfy the statute's requirement, provided it reflects the essential elements of the contract.

The UCC Statute of Frauds[1] requires that the writing be signed by the party or parties to a contract against whom the other party or parties bring action to enforce the contract. Signing can consist of signatures, initials, typewritten names, electronic signatures, or any marks that appropriately identify the parties acknowledging the memorandum or communications as their writing.

Under the UCC, a contract for the sale of goods for $500 or more is not enforceable unless it is in writing. The $500 limit applies to the total price of all the goods the contract purports to sell. The written contract does not need to set forth all the material terms of the contract, only the term relating to the quantity of goods for sale. In addition, even if the quantity term is inaccurate, the contract is enforceable up to the quantity so stated. The plaintiff need not have signed the contract; only the defendant must have signed.

The UCC provides that oral contracts for the sale of goods for $500 or more are enforceable in two situations:

- The buyer accepts and receives part of the goods.
- The buyer makes partial or full payment for the goods.

Each of these conditions reflects the parties' acknowledgment that a contract does exist. Therefore, written evidence of a contract is not necessary.

Another situation in which an oral contract for the sale of goods for $500 or more can be enforceable involves goods manufactured specifically for the buyer. Under the UCC, such an oral contract is enforceable in these circumstances:

- The goods are not suitable for resale to others in the ordinary course of business.
- The seller either has made a substantial beginning in manufacturing the goods or has made commitments to procure them.

The seller must establish the contract's terms as part of the proof of claim that a contract exists.

Performance

Performance is the activity (or activities) necessary to successfully complete a contract. For example, in a sales contract, A agrees to sell B 500 items for $1,000, to be delivered in thirty days. A delivers the 500 items to B on the twenty-ninth day, and B pays A the $1,000 owed. The terms of the contract have been fulfilled; therefore, contract performance has occurred.

A and B could delegate their performance to someone else. Thus, rather than A manufacturing the items, A could have C manufacture them and arrange for D to deliver them to B as agreed. A would still have contract performance.

Title and Risk of Loss

As a practical matter, under the UCC, the **risk** transfers with the title to the goods except when the goods remain at the seller's residence or place of business and the buyer is to pick them up. If the seller is a merchant, risk of loss does not pass to the buyer until the buyer receives the goods. If the seller is not a merchant, risk of loss passes to the buyer when the seller tenders delivery.

Risk
The chance of financial loss.

When a buyer rejects delivered goods because they do not conform to the contract, the risk of loss remains with the seller until the seller remedies the deficiency or until the buyer accepts the goods.

The parties can agree that the risk of loss will pass at some other time than the UCC specifies, and the parties' prior practice, trade usage, or circumstances of the case also can change the time that the transfer of risk occurs.

Delivery Terms

Buyers and sellers have several options as to where goods will be delivered and which party bears the risk and expense of delivery. Common delivery and shipping terms in sales contracts, many of which are used in marine insurance, are these:

- FOB (free on board) place of shipment—The seller delivers goods to the carrier at the seller's risk and expense, and the ownership then shifts to the buyer.
- FOB (free on board) place of destination—Ownership passes from the seller to the buyer when the carrier delivers the goods to the buyer's premises.
- FAS (free alongside) vessel—Ownership passes from the seller to the buyer when the seller delivers the goods alongside a vessel for loading onto that vessel.
- FOB (free on board) vessel—Goods are loaded on board the vessel at the seller's risk and expense, and then ownership passes to the buyer.
- CIF (cost-insurance-freight)—The seller is obligated to pay for the insurance and freight charges for delivery to the buyer.
- CAF (cost and freight)—The seller is obligated to pay for the freight charges but not for the insurance for delivery to the buyer.

Inspection

Upon delivery, the buyer usually has the right to inspect the goods as a condition to acceptance and payment. The inspection can include reasonable testing at the buyer's expense. If a buyer rejects the goods for failure to conform, the buyer can recover the testing cost from the seller.

Buyers do not have a right to inspect in two situations:

COD (collect on delivery)
A shipping condition under which the buyer pays when the goods are delivered and has no right to inspect the goods as a condition to acceptance and payment.

- When the carrier delivers the goods **COD (collect on delivery)**
- When a contract requires the buyer to pay at the time of delivery of the document of title (unless the contract also requires payment only after the goods are available for inspection)

Time for Delivery

If the time for delivery is not set in or cannot be implied from the contract or the parties' past practices, delivery must occur within a reasonable time. Unless a seller assumes a greater obligation, such as by agreeing in the contract that time is of the essence, delay in delivery or nondelivery is not a breach of contract if performance becomes impracticable because of an occurrence unforeseen by both parties.

Conforming and Nonconforming Goods

Article 2 of the UCC defines conforming and nonconforming goods. To conform is to be in accordance with the obligations of the contract. Conforming goods are goods stipulated in the contract or those that fall within trade usage or the parties' prior course of dealing. Those goods that do not meet the contract obligations are considered nonconforming goods. Generally, the shipment of nonconforming goods is a breach of contract; however, Article 2 provides two exceptions to that rule:

- A shipment of nonconforming goods is neither an acceptance nor a breach of contract if the seller notifies the buyer that the shipment is only an accommodation to the buyer. An example would be the seller providing a product for the buyer's temporary use until delivery of the goods specified in the sales contract.
- If a buyer rejects goods as nonconforming, the seller can notify the buyer of its intention to "cure" the nonconformity of the shipment by delivering conforming goods. This notification must be made before the time for contractual performance has expired. If the performance time has expired, and if the seller has reasonable grounds to believe that the goods conformed to the contract, the seller still has a reasonable time to substitute conforming goods. An example of reasonable grounds would be the buyer's acceptance of the same kind or condition of goods as conforming in prior transactions.

Express and Implied Warranties

A warranty is a promise that something is true. Contracts for the sale of goods can contain statutory warranties, as well as the sellers' express or implied warranties. A seller's overt words or actions can create an express warranty. The law may infer the existence of an implied warranty because of the circumstances of the sale.

If a statement forms the basis of the sale, it is an express warranty. There are three kinds of express warranties:

- An affirmation of fact about the goods, such as the seller's promise that the goods conform to a certain standard, is a warranty. For example, a statement about a car's gas mileage is a warranty even without the words "warranty" or "guarantee."
- Any description of goods in a contract is a warranty that the goods conform to the description. For example, a contract to sell a new hay baler is an express warranty that the hay baler is new.
- A contract based on a sample or model is a warranty that the goods will conform to the sample or model.

Implied warranties in sales of goods fall into two categories:

- Implied warranty of merchantability
- Implied warranty of fitness for a particular purpose

Implied warranty of merchantability
An implied warranty that a product is fit for the ordinary purpose for which it is used.

An **implied warranty of merchantability** applies only to transactions in which the seller is a merchant. The goods sold must meet the following five qualifications:

- The goods must pass without objection in the trade under the contract description.
- Fungible goods, such as grain, must be indistinguishable and interchangeable and must be of average quality for the kind of goods sold.
- The goods must be fit for the ordinary purpose for which they will be used.
- All goods in a lot must be approximately like kind and quality.
- The goods must conform to the specifications, if any, on the container or label.

In addition, implied warranties can arise from the parties' course of dealings or from the usages of a particular trade.

Implied warranty of fitness for a particular purpose
An implied warranty that a product is fit for a particular purpose; applies if the seller knows about the buyer's purpose for the product.

An **implied warranty of fitness for a particular purpose** applies to both merchants and nonmerchants. For example, suppose that John has never been deep-sea fishing but wants to fish for marlin. He asks a sporting goods dealer to recommend suitable equipment, and he buys the equipment the dealer recommends. Without negligence on John's part, the equipment breaks while he is using it for marlin fishing because it was unsuited for that purpose. John relied on the dealer's expertise to select the appropriate equipment for deep-sea marlin fishing. The seller has apparently breached a warranty of fitness for a particular purpose.

Implied warranty of title
An implied promise in a contract for the sale of goods that the seller has legal ownership of goods and has no knowledge of any security interest or other lien on the goods other than those disclosed to the buyer.

A common type of implied warranty in contracts for the sale of goods is an **implied warranty of title**. A contract may exclude the warranty of title if the buyer has reason to know that the seller does not have full title. For example, agents sell goods as representatives of their owners, and the agent relationship alerts the buyer that the agent does not have title.

Another type of warranty extends to third parties. Article 2 of the UCC deals with sellers' contractual liability arising from express or implied warranties to third parties who are not the immediate buyers of goods. The UCC provides that a seller's warranty extends to any person in the buyer's family or household, or any guest in the buyer's home, who suffers injury resulting from breach of the warranty, if it is reasonable to believe that the person would either use or be affected by the goods. An express or implied warranty for an appliance, for example, would extend to the buyer's child or to a houseguest. See the exhibit "Exercise: Risk of Loss in a Sales Transaction."

Breach of Sales Contracts and Remedies

If goods do not conform to a contract, the buyer can accept or reject all or part of them. To sue for breach of contract, the buyer must first give reasonable notice of rejection to the seller, stating the particular defect. This notice gives the seller an opportunity to cure the defect. For contracts between merchants, the seller may also make a written request for a written statement of the defects claimed by the buyer.

Exercise: Risk of Loss in a Sales Transaction

Wanda purchased certain bulky goods from Selma. The goods were identified and marked with Wanda's name. Wanda was to pick up the goods within a week and make the full payment at that time. During the week, a fire broke out in Selma's place of business. The fire was not a result of Selma's negligence, but the goods were destroyed.

Did title to the goods transfer to Wanda? If so, when? If not, why not?

Who bears the risk of loss, or, in other words, must Wanda pay Selma for the goods?

Wanda probably has title to the goods because the assumption is that Selma could transfer the title to her, the goods were marked with Wanda's name, and it appears that both parties intended title to the goods to pass to Wanda. The title transferred to Wanda at the time she made partial payment for the goods.

Wanda does not have to pay for the goods. The question of who has title does not affect the risk of loss in this case. Under the UCC, risk of loss passes with title except when the goods remain at the seller's place of business or residence where the buyer is to pick them up. In addition, if the seller is a merchant, risk of loss does not transfer to the buyer until the buyer receives the goods. In this case, Selma is a merchant because she has a place of business, and the goods were at her place of business when the loss occurred.

[DA06325]

If the seller has no agent or place of business in the buyer's market area, the buyer must follow the seller's instructions for what to do with the rejected goods. The buyer can demand indemnity for necessary expenses incurred in holding or shipping the goods. If the goods are perishable, the buyer can sell them on the seller's behalf. If the goods are not perishable, and the buyer does not receive instructions within a reasonable time, the buyer can sell them, store them, or ship them to the seller. In these cases, the buyer's acceptance of nonconforming goods does not waive or forfeit any right to sue for the breach. To sue for breach, however, the buyer must have notified the seller of the nonconformity within a reasonable time and must prove that the goods were nonconforming.

Revocation of Acceptance

A buyer can revoke an acceptance of goods under these circumstances:

- The buyer reasonably assumed that the seller would cure the defect but the seller did not do so.
- The buyer accepted the goods before discovering the nonconformity.
- The buyer accepted the goods in the first place because it would have been difficult to discover the defect and because the seller gave assurances about the quality of the goods.

In each of these situations, the buyer has reasonably relied on the seller's delivery of acceptable goods.

Excuses for Nonperformance

These circumstances provide excuses for nonperformance of a sales contract:

- Loss of identified goods—If specific and identified goods are destroyed before the risk of loss transfers to the buyer, and if neither party was at fault, the contract is void. If the loss is partial, the parties may void the contract or the buyer can accept damaged goods with an allowance in the price for the deficiency. In neither case, however, can the buyer sue the seller for breach of contract.
- Substituted performance—If the agreed-on carrier or berthing, loading, or unloading facilities become unavailable, no matter who was at fault, the buyer must accept any offer by the seller to use a commercially reasonable substitute. If the agreed means of payment fails because of government regulation, the seller may withhold or stop delivery unless the buyer provides a commercially equivalent means of payment.
- Failure of a presupposed condition—Subject to the section on substituted performance, delay in delivery or partial or complete non-delivery by the seller is not a breach of contract if performance is impracticable because of the occurrence of a contingency affecting a basic assumption in the contract. If it is feasible to do so, the seller may allocate production and delivery among customers. The seller must notify the buyer in a reasonable time of the delay or non-delivery, and the quota to be delivered if allocation is used.

Seller's Remedies

If a seller discovers before delivery that the buyer is insolvent, the seller can refuse to deliver the goods. If the goods are en route, the seller can stop delivery unless the buyer has already received a document of title for the goods or unless a carrier or warehouse operator has notified the buyer that it is holding the goods for the buyer. If the seller discovers that the buyer has received the goods on credit while insolvent, the seller can demand their return within a reasonable time period.

When a buyer wrongfully repudiates the contract, fails to make a payment due before delivery, or wrongfully rejects the goods, the seller can sue. If the lawsuit is successful, the seller can recover the difference between the contract and the market price at the time and place of delivery or, under certain circumstances, lost profits, if any.

If the goods are still being manufactured at the time of breach, the seller can complete their manufacture and sell them to another party or stop their manufacture and sell them as they are or for scrap value.

If the buyer fails to pay for goods after accepting them or after the liability passes to the buyer, the seller can sue for the goods' contract price even if the seller still possesses them, but only if the seller cannot sell them to another party at a reasonable price.

Buyer's Remedies

If the seller fails to deliver the goods or repudiates the contract, the buyer is entitled to the difference, if any, between the contract price at the time the buyer learned of the breach and the market price. Alternatively, if the undelivered goods are unique or if the buyer cannot obtain them from another source, the buyer is entitled to specific performance (delivery of goods). Specific performance is also the remedy if a buyer cannot obtain substitute goods to replace the undelivered goods.

Because buyers often need goods immediately, they may purchase substitute goods within a reasonable time after learning of a breach and then recover from the seller any difference between the cost and the contract price. A buyer who rightfully rejects delivery or revokes acceptance and who possesses the goods has all the rights that a seller has when the buyer breaches before delivery. The buyer can hold the goods for the seller's instructions or sell them.

A buyer who accepts nonconforming goods and informs the seller of the nonconformity is entitled to the difference, if any, between the value of the goods accepted and the value they would have had, at the time and place of acceptance, if they were as the seller warranted. In addition, the buyer can recover any loss resulting from the nonconformity that the seller had reason to know might follow from a breach that the buyer could not have prevented.

NEGOTIABLE INSTRUMENTS

Negotiable instruments are written documents that allow parties to pay at a distance or at a future time. They are also used as a convenient substitute for cash.

A basic requirement of commercial paper is that it be negotiable—readily salable—so that the seller does not have to wait for payment. To get immediate payment, the seller can sell the negotiable paper. If the paper is nonnegotiable, a buyer of the instrument would take these two steps before purchasing it:

1. Check the credit rating of the payer
2. Determine whether the payer has any defenses against a seller who sues, such as that full or partial payment was already made

A negotiable instrument avoids these time-consuming steps. The buyer of a negotiable instrument also buys the seller's personal liability and therefore needs to know only the seller's credit rating. In addition, the purchaser of the instrument can sometimes be free and clear of virtually all defenses that the drawer or maker might have against the payee, such as poor quality of delivered goods. These advantages can expedite the transaction. The instrument becomes freely transferable, almost like cash.

To be negotiable, an instrument must be in writing and must meet four requirements under Uniform Commercial Code (UCC) Article 3:

- It must be signed by the maker, or drawer.
- It must contain an unconditional promise or order to pay a certain sum of money and contain no other promise, order, obligation, or power on the part of the drawer or maker except as otherwise provided by Article 3.
- It must be payable on demand or at a definite time.
- It must be payable to order or to bearer.

UCC Article 3

Uniform Commercial Code (UCC)
Legislation for commercial transactions that provides the trade creditor certain rights and legal remedies in a situation in which a buyer defaults.

Article 3 of the **Uniform Commercial Code (UCC)** governs negotiable instruments payable to order (to a designated payee) or to bearer (to the holder of the paper). The UCC Article 3 states that "order" means a written instruction to pay money signed by the person giving the instruction. The instruction may be addressed to any person, including the person giving the instruction, or to one or more persons jointly. An authorization to pay is not an order unless the person authorized to pay is also instructed to pay.

Article 3 does not apply to money, fund transfers, or securities. A negotiable instrument may be used instead of cash. Drafts and notes are the two categories of negotiable instruments. A draft instrument orders a payment to be made. A note instrument promises that a payment will be made.

Types of Commercial Paper

Commercial paper is any written or printed document or instrument, including a negotiable instrument, evidencing a debt. The two most common types of commercial paper are the draft (check) and the promissory note. See the exhibit "Promissory Note."

Promissory Note

$10,000 Anytown, June 1, 20X1

One year after this date I promise to pay to the order of Peter Finch Ten Thousand Dollars ($10,000).

Due June 1, 20X2 (Signed) Mary Chen

[DA04629]

Article 3 of the UCC covers four types of commercial paper:

- Draft (check)—A type of commercial paper containing an unconditional order by the drawer (person making out the draft), requiring the drawee to pay a certain sum to the payee or to the bearer. A check is a draft drawn on a bank.
- Certificate of deposit (CD)—A document issued by a financial institution acknowledging receipt of money and promising to repay it, with interest, at a specific time.
- Promissory note—A type of commercial paper containing a written promise to pay money on demand or at a definite future time.
- Trade acceptance—A two-party draft used when a seller wants cash immediately but when the buyer cannot provide it until the goods are resold. The seller (drawer) orders the buyer (drawee) to pay at some future time, with the seller named as the payee. The seller delivers the goods to the buyer and then sells the trade acceptance at a discount to get immediate cash. The buyer resells the goods and then pays the new holder of the trade acceptance.

Checks are the most familiar negotiable instruments. A bank depositor is a bank's creditor to the extent of the balance in the bank account. The bank is the depositor's agent in making disbursements from that account. See the exhibit "Draft (in the form of a check)."

Draft (in the form of a check)

(Date) June 1, 20XX

Pay to the
order of (Payee) $10.00

Ten and ———————————— 00/100 Dollars

Bank/Drawee (Drawer)

[DA04628]

Common check transactions include these:

- Failure to honor checks—A bank is liable for all damages caused by its failure to honor a check when the depositor's account contains sufficient funds.
- Overdrafts—A bank can honor a check not covered by the depositor's balance, thus creating an overdraft and making the depositor the bank's debtor.
- Altered checks—A bank can charge an altered check to the depositor's account only to the extent of the check's original terms. For example, if a wrongdoer changes $10 on a check to $100 by adding a zero, the bank can charge only $10 to the depositor's account.
- Stop-payment orders—An oral stop-payment order is effective for only fourteen days. A written stop-payment order is effective for only six months, unless renewed in writing.

Transfer

Transfer of a negotiable instrument gives the new holder the same right to enforce payment as the original holder had. For example, Brittany buys goods from Liam and gives Liam a promissory note as payment. Liam gives the promissory note to Kim in payment of a debt he owes her. Brittany fails to pay on the promissory note. Kim has the same right as Liam would have had, had he kept the promissory note, to sue Brittany for payment.

If the original payer has a defense against payment, the new holder is subject to that defense. In the example just given, assume Liam delivered defective goods and Brittany refused to accept them. If Kim, holding the promissory note, sues Brittany for payment, Brittany can use the same defense that would have been used against Liam: that the goods were defective.

Primary and Secondary Liability

Primary liability

The absolute obligation to pay a negotiable instrument according to its terms.

Secondary liability

The obligation to pay a negotiable instrument only if someone else refuses to pay or to accept the instrument.

The maker of a note has **primary liability**. For a draft, the acceptor is primarily liable; the drawer is not primarily liable because a drawer's liability arises only when the drawee refuses to accept or pay the draft. One who endorses a negotiable instrument assumes **secondary liability** only when the maker or drawee rejects (dishonors) the instrument.

Endorsements

An endorsement is a signature or the equivalent of a signature that legally transfers a negotiable instrument. An endorsement must appear in some form of writing, even a rubber stamp, on the instrument, usually on the back, and must transfer the entire sum. (The term "endorsement" here is not the same as an endorsement to an insurance policy.)

As long as a document contains a signature, other words do not affect the endorsement. For example, the words "I hereby assign my interest in this note to Lindsey," signed by Mark, are an effective endorsement. If the payee's or transferee's name is not correct, that person can take one of three actions:

- Endorse the instrument in the name in which it was made out
- Endorse it with the correct name
- Endorse it in both names

These are the major types of endorsements:

- Special endorsement—A signature or the equivalent of a signature that specifies the person to whom a negotiable instrument is payable. For example, the payee of a check can negotiate it to another person by writing "Pay to the order of Richard Roe," or "Pay to Richard Roe," above his or her signature on the back of the check.
- Blank endorsement (general endorsement)—A signature or the equivalent of a signature on a negotiable instrument that names no specific payee, making the instrument payable to the bearer. For example, a business owner might sign several blank checks for a trusted manager to endorse if cash is needed for business operations or to pay a vendor.
- Restrictive, or collection endorsement—A signature or the equivalent of a signature that includes language placing additional limits on further negotiation of a negotiable instrument. For example, "Pay Jill Doe only if she appears on June 23" or "For deposit only."
- Qualified endorsement—A signature or the equivalent of a signature that passes title to a negotiable instrument but limits the endorser's liability to later holders if the instrument is later dishonored. A qualified endorsement is usually made by writing "without recourse" over the signature.
- Unqualified endorsement—A signature or the equivalent of a signature that places no limits on the endorser's liability on the paper. These are more common than qualified endorsements.

Holders in Due Course

Although assignees of negotiable instruments are generally subject to any defenses the original payer may have, some holders can possess negotiable instruments free of all defenses. A holder in due course is the person to whom a negotiable instrument has been issued or endorsed and who possesses it for value, in good faith and without notice that it may not be valid, can be claimed by another, is overdue, or was previously dishonored. A party often must establish qualifications as a holder in due course to attain maximum rights on the instrument. Such proof is important only if the original holder has a legal defense to the instrument— for example, a defense for nonpayment.

One who obtains an instrument in one of these ways does not become a holder in due course:

- Purchasing the instrument at a judicial sale or taking it under legal process
- Acquiring it in taking over an estate
- Purchasing it as part of a bulk transaction (such as the purchase of all the assets of a business), not in the regular course of the transferor's business

Holder in due course status can be sold and transferred with a negotiable instrument. The status does not apply to a transferee who was a party to any fraud or illegality affecting the instrument or who, as a prior transferee, had notice of a defense against or claim to the instrument.

Personal defense

A claim to an instrument by any person and any defense that would be effective in a simple contract transaction.

Real defense

A defense of an obligor of a negotiable instrument that may be asserted even against a holder in due course.

A holder in due course is free of **personal defenses**, such as lack or failure of consideration, misrepresentation, or fraud. **Real defenses** go to the very existence of the obligation. Examples of real defenses are the incapacity of the maker, drawee, or drawer; duress; illegality; and discharge in bankruptcy. For example, the maker's insanity might negate the existence of the obligation in the first place.

DOCUMENTS OF TITLE

A commercial transaction dealing with the sale of goods may also involve the shipment and/or storage of the goods. Documents of title are important in the shipping and storing of commercial goods.

A document of title provides evidence of ownership rights to specific property, which include the elements of ownership, possession, and custody with the right to receive, hold, and dispose of both the document and the goods it covers. Article 7 of the Uniform Commercial Code (UCC) presents uniform standards for documents of title that provide efficiency for marketing and financial systems in the United States.

Warehouse receipt

A legal document that provides title to the goods in storage and assures delivery to the holder of the receipt.

Bill of lading

A document acknowledging receipt of goods from the shipper, given by the carrier which includes the terms of the contract of carriage for the goods.

Carrier

A person or organization in the business of transporting property of others.

Specific documents of title relate to the shipment and storage of goods. An agreement for the storage of the goods is called the **warehouse receipt**. An agreement for the shipment of the goods is called a **bill of lading**.

UCC Article 7

The Uniform Commercial Code (UCC) Article 7—Warehouse Receipts, Bills of Lading and Other Documents of Title addresses the shipment, storage, and delivery procedures and requirements involved in the sale of goods.

During the sales transaction, the owner of goods may hire **carriers** to ship the goods to a buyer or to a warehouse for storage during the shipment process. The goods move out of the owner's control and possession and into the control and possession of the carrier or warehouse operator.

Bailment situations are thus created. The owner who puts the goods in the possession of the carrier to ship or the warehouse operator to store is the **bailor**. The carrier or the warehouse becomes the **bailee**.

Warehouse receipts and bills of lading, when formatted and completed in accordance with Article 7, become documents of title for the goods being shipped or stored. These documents are backed by the goods being shipped or stored and can become negotiable instruments. Therefore, Article 7 also deals with the laws of bailment and negotiable instruments.

Bailment

The temporary transfer of a property's custody.

Bailor

The owner of the personal property in a bailment.

Bailee

The party temporarily possessing the personal property in a bailment.

Documents of Title

A title is a document that meets certain legal standards and shows an entity's ownership rights to a specific property. A title indicates the elements of ownership, possession, and custody. The person who legally possesses the title has the right to control and to dispose of the property.

UCC 1-201 (b) (16) defines a document of title as a bill of lading, dock warrant, dock receipt, warehouse receipt, order for the delivery of goods, or any other document that, in the regular course of business or financing, adequately evidences that the possessor is entitled to receive, hold, and dispose of the document and the goods it covers. UCC Article 7 states that, to be valid, a document of title must be issued by or addressed to a bailee with the purpose of covering goods in the bailee's possession. Therefore, these elements are necessary for a document to be considered a title:

- It is created by the bailee (carrier or warehouse operator) as a receipt for goods received.
- It is a contract to ship or to store the goods.
- If it is negotiable, it contains a statement that: (1) the holder has the right to receive, hold, and dispose of both the goods and the document of title, and (2) the purchaser of the title does so free of claims and defenses of prior parties.

Article 7 of the UCC recognizes both electronic and tangible (such as traditional paper) formats for documents of title.

Warehouse Receipt

During the sale of goods, it may be necessary to store the goods for a time. This is particularly true in the agribusiness sector. For example, farmers harvest corn at one set time of year; therefore, all harvested corn enters the marketplace at about the same time. However, buyers purchase corn as needed throughout the year, so the corn must be stored until purchase. A farmer will store corn for a fee at an area grain elevator, which is considered an agricultural warehouse.

A warehouse operator stores goods for hire. The storage arrangement is a bailment; the warehouse operator is the bailee, and the person/entity storing goods is the bailor.

Warehouse operators provide the goods' owner with a receipt describing the amount, type, and condition of the goods, and the conditions of storage. This receipt can be considered a document of title to the goods, which, if properly worded, becomes a negotiable instrument that can be traded, sold, swapped, or used as collateral for borrowing.

A warehouse operator's negligence and degree of liability are determined according to the terms in its warehouse receipts. Although the UCC Article 7 does not prescribe the format of the receipt, it requires nine items of information:

- The location of the warehouse where goods are stored
- The date the receipt is issued to the bailor
- The receipt number showing a consecutive numbering of all receipts issued by the warehouse operator
- A statement indicating the individual or organization to whom the goods will be delivered at the end of the storage period
- The rate of storage and handling charges
- A description of the goods or their packages
- The warehouse operator's (or an authorized representative's) signature
- A statement of ownership if the warehouse operator is the owner or partial owner of the goods being stored
- A statement indicating the amount of any advances made or liabilities incurred for which the warehouse operator claims a security interest

A warehouse operator can be held legally liable for loss to customer property caused by its own negligence. UCC Article 7 allows a warehouse operator to limit liability through terms in the warehouse receipt or storage agreement. For example, the warehouse receipt may specify an amount per article or item or per unit of weight.

Bill of Lading

The term "bill of lading" is an old English marine term. Historically, the written document acknowledging receipt of goods on a ship for transport was known as a bill. Lading is the act of loading. To send one's goods to customers overseas, the goods were taken to the docks and loaded onto ships. The ship's master issued a document acknowledging that the goods had been loaded along with the type and quantity, the destination, and the party to whom the goods were to be delivered. The term is still used today for the transportation of goods by commercial carriers by rail, air, sea, and road.

The parties to a bill of lading include the **consignor**, the carrier, and the **consignee**. The bill of lading serves these purposes:

- As a contract for the transportation (carriage) of the goods
- As a receipt of the goods by the carrier for delivery
- Under certain circumstances, as title to the goods
- To identify the terms of the agreement, including goods by type and amount, the consignor, the carrier, provisions of the agreement for shipping, any special instructions, the consignee, date shipped, terms of delivery, and freight terms (prepaid, collect, or from third party).

Consignor

The party who is shipping goods.

Consignee

The person or organization that receives property being transported by a carrier.

Among the numerous types of bills of lading are two that are most frequently used:

- A straight bill of lading names a consignee and obligates the carrier to deliver the goods to that named consignee. The consignee cannot transfer the goods to another entity prior to delivery and then instruct the carrier to deliver the goods to that entity. Therefore, a straight bill of lading is nonnegotiable.
- An order bill of lading contains specific wording, such as "delivery to ABC Company or to order or assigns." This wording allows the consignee to transfer the goods to another entity prior to delivery and then, after the bill of lading has been signed, the goods are received, and shipping is underway, instructs the carrier to deliver the goods to that entity. An order bill of lading is negotiable.

UCC Article 7 as adopted by each state regulates bills of lading for goods shipped within the boundaries of the individual states. When shipments cross state boundaries, they also become subject to federal government regulation under the Interstate Commerce Act.

Delivery Order

An order of delivery can be included within or along with the warehouse receipt or bill of lading. UCC Article 7 defines a delivery order as a written order to deliver goods directed to a warehouse operator, a carrier, or another person who in the ordinary course of business issues warehouse receipts or bills of lading.

SECURED TRANSACTIONS

Buyers pay for goods with their own cash, with borrowed cash, or on open credit granted by the seller or a third party. The seller or a third-party lender can require the buyer to give the seller or lender a security interest in the goods sold, creating a secured transaction.

In a secured transaction, a buyer or borrower gives collateral to the seller or lender to guarantee payment of an obligation. Secured transactions have five elements:

- Debtor—The person who is borrowing the money.
- Secured creditor—The person/entity that lends the money to the debtor.
- **Collateral**—The personal property of the debtor that is subject to the creditor's security interest; the debtor guarantees payment to the creditor by giving the creditor a legal interest in the property.
- Security agreement—The agreement between the debtor and creditor that establishes a security interest for the creditor.
- Security interest—The creditor's right to the debtor's personal property.

Collateral
Cash, or near cash assets, that a principal pledges to secure credit, a loan, or other obligation.

Security interest
An interest in property (real or personal) that allows the property to be sold on default to satisfy the debt for which the security interest was given.

A **security interest** authorizes the seller or lender to take the goods that have been designated as collateral or otherwise prevent the buyer from disposing of them if the buyer defaults on payments. The seller or lender is the secured party. The security device affects only recovery of the goods. Even if a security device is ineffective, contract common law still provides relief in the form of damages.

UCC Article 9

UCC Article 9—Secured Transactions: Sales of Accounts and Chattel Paper provides a structure that unifies and simplifies the numerous types of secured-financing transactions in today's commerce environment. It sets out a comprehensive process for regulating security interests in personal property and fixtures, including how to perfect or validate a security interest.

Article 9 treats all security interests in personal property as secured transactions. When a buyer agrees to give a seller or lender a security interest in an article sold, the seller or lender can take the goods or otherwise prevent the buyer from disposing of them.

Forms of Secured Transactions

There are three main forms of secured transactions:

Pledge
A security device by which a borrower guarantees payment by delivering collateral to the lender to hold as security for the debt.

Chattel
Tangible, movable personal property.

- **Pledge**—The debtor delivers goods for the creditor to hold as security until payment has been made or the services performed. For example, Ina asks Jay for a loan of $50. Jay loans Ina the money, takes Ina's ring, and tells Ina that he will give the ring back when she repays him the $50.
- **Chattel** mortgage—The debtor is allowed to retain possession of the property while the creditor retains the right to take ownership of the property. For example, Miguel wants to borrow $1,000 from Chris. Chris agrees to loan Miguel the money but wants Miguel's car as security. Miguel needs his car to get to work; therefore, he has to retain possession of it. Chris is afraid if Miguel keeps his car, he might sell it, leaving no security for his

$1,000 loan. Therefore, Chris takes possession of the title to Miguel's car. Miguel has use of his car but cannot sell it. When Miguel repays Chris in full, Chris will return Miguel's car title.

- Conditional sale—A creditor lends money to a debtor, who uses the money to purchase a particular item. For example, Dameka's refrigerator stops working and needs to be replaced, but she is short of cash. James's Appliance store will sell Dameka a refrigerator on a twelve-month payment plan. In the sales agreement, James's Appliance has a lien on Dameka's refrigerator. If Dameka does not make payments, James can take the refrigerator from her.

Forms of Collateral

While any type of property can be accepted as security by a creditor, most collateral falls into one of five forms:

- Consumer goods—Items used primarily for personal, family, or household purposes.
- Equipment—Items used in business or government that have a value. For example, a computer is equipment, while a pencil is not.
- Farm products—Crops or livestock produced in a farm operation or supplies used in the process of farming.
- Inventory—Business goods held for sale or lease or under service contracts, raw materials for manufacture, goods while in the process of being manufactured, and items used or consumed in the business.
- Property on paper—Stocks, bonds, or chattel paper that serve as evidence of the debtor's rights in personal property. Chattel paper is a document showing that the possessor (holder) is owed money and has a secured interest in goods of value connected to the debt.

Attachment

Attachment is the creation of a security interest in property (collateral). The security interest is attached to the property, giving the creditor the right to the property. Attachment protects the creditor from the debtor's default by giving the creditor legal recourse against the debtor. However, attachment does not protect the creditor against claims that parties other than the debtor might also have on the property. Other creditors may have a security interest in the same property. Which creditor can take possession of the property depends on which one has the better claim.

There are three requirements for an attachment to occur:

- A consensual security agreement between the debtor and creditor—For pledges, oral agreements can be sufficient because the creditor possesses the collateral. Other types of security agreements must be written and include the signature of the debtor and a description of the goods. The creditor's signature is not required because the security agreement will be enforced against the debtor. The collateral may be goods acquired after the agreement is made, or items the creditor currently owns, such as inventory and fixed assets.

- The creditor must give value—Value may be either a new item of value, such as loan of money, or value from a preexisting debt, such as forgiveness of all or a portion of a loan.
- The debtor must have rights in the collateral—One cannot give up something that one has no right to. For example, Jane cannot use stolen jewelry as collateral for a loan to buy new bedroom furniture. Because the jewelry is stolen, Jane has no right to it. Normally the debtor must have possession of the property, or evidence of a right to the property, to create an attachment.

Perfecting a Security Interest

Perfection is the process of validating an attachment, which secures the creditor's rights against property of the debtor. Perfection is preferable to mere attachment, which does not protect the creditor against other creditors' nonperfected claims on the property. Perfection informs everyone else that the creditor has a security interest in the property. The creditor is protected from competing third-party claims against the collateral, including claims from those who buy the collateral from the debtor. Perfection also protects the creditor from other creditors.

Perfected security interest

A security agreement that has been filed with the appropriate court to provide the surety a priority interest over others who may also have security interests in the property.

Constructive notice

Knowledge that a person is assumed by law to have because that knowledge could be gained by reasonable observation or inspection.

Typically, a creditor obtains a **perfected security interest** by submitting a financing statement to the appropriate county office. The filing serves as a **constructive notice** to others that a security interest exists in the collateral. A valid financing statement has three elements:

- Names and addresses of the debtor and creditor
- The debtor's signature
- A general description of the collateral property

Financing statements are valid for five years and can be renewed for another five years. Renewals may be repeated indefinitely.

The security interest is perfected when two events have occurred: (1) the security interest has attached, that is, the goods have been sold and the security agreement has been executed, and (2) the financing statement has been filed. If the seller delays filing the financing statement until after the goods have been delivered to the buyer, the security interest is unperfected, and another security interest might attach to the property in the meantime.

When a debtor has met all obligations under the security agreement, a termination statement should be filed so that the secured party can no longer claim a security interest under the financing statement. If more than one perfected security interest applies to the same collateral, they rank in priority according to time of filing or perfection.

Another method of perfecting a security interest is for the creditor to obtain possession of the property. This can occur when the debtor transfers possession of the collateral to a secured party or when the creditor physically seizes the property. Any competing claim for the collateral must go through the creditor who has possession of the collateral. Physical attachment does not require filing a financing statement.

Transferring actual possession is the only way to perfect a security interest in a negotiable instrument, such as a bearer bond, because delivery transfers ownership.

Rights of Perfected and Unperfected Security Interests

A perfected security interest is superior to a later perfected security interest and to the interests of most subsequent lien creditors with limited exceptions, such as these:

- A **holder in due course** takes a negotiable instrument free of any perfected security interest in that instrument.
- An artisan's **lien** for services or materials with respect to the collateral takes priority over a perfected security interest in that collateral.

Holder in due course
The person to whom a negotiable instrument has been issued or endorsed and who possesses it for value, in good faith and without notice that it may not be valid, can be claimed by another, is overdue, or was previously dishonored.

Lien
A creditor's legal right or interest in another's property, usually lasting until satisfaction of the specific debt or duty that the lien secures.

Even if a security interest is not perfected, it is a valid agreement between the parties and against a third party who buys the goods from a person who deals in them. However, the secured party's rights are subordinate to these parties' rights:

- One who obtains a perfected security interest
- A lien creditor, assignee, bankruptcy trustee, or receiver
- One who buys the property from a person who does not deal in that type of goods, if the buyer does not know about the unperfected security interest

Satisfaction of a Secured Debt

Once a debtor has repaid the secured debt, full satisfaction has been obtained. The debtor can send a written request to the creditor for a termination statement and then file a termination statement with all offices that hold the financing statement. A termination statement is evidence that the debt has been paid in full.

Once the creditor receives the debtor's written request for the termination statement, the creditor has ten days to comply. If the debtor does not request the termination statement, the creditor or secured party must send the termination statement to the offices holding the financing statement within thirty days of the debt being paid in full.

Default

Nonpayment is the most obvious form of default. However, a security agreement may define other events as defaults, such as failure to insure the collateral, the debtor's bankruptcy, loss or destruction of the collateral, or removal of the collateral to another place.

If the debtor does not fulfill his/her obligations for a secured transaction, the secured creditor or secured party has the right to foreclose on the security interest. The creditor has the right to foreclose in several ways:

- Right to sue on the underlying debt—The secured party calculates the amount of the debt outstanding and sues the debtor for the amount owed but does not take possession of the secured property.
- Right to strict foreclosure—When the secured party has retained possession of the collateral, it can foreclose the debtor's interest in the collateral by retaining the collateral in full satisfaction of the debt. The secured party must send written notice to the debtor. When the collateral is other than consumer goods, notice must also be sent to any other parties having a security interest in the collateral. If anyone with a security interest objects to another secured party retaining possession, then the collateral must be sold or otherwise disposed of.
- Right to regain possession—The secured party has the right to regain possession of collateral through the courts or by other legal means, such as lawful repossession. The majority of states allow the secured party to regain possession without going to court if the collateral can be repossessed in a legal manner. For example, a bank cannot go into an auto loan debtor's personal garage to repossess the auto. This would be unlawful breaking and entering. However, if the auto is parked on the street or in a public garage, the bank can take the auto without a court order. Also, most states require that if the debtor has paid 60 percent or more on the debt, the creditor is required to go to court to sue for the remaining balance or return part of the money paid if the creditor takes possession of the collateral.
- Right to sell the collateral—The secured party elects to sell or lease the collateral and apply the proceeds to satisfy the claim. If the value received is not enough to satisfy the debt in full, the secured party can sue the debtor for the remainder. The secured party is allowed to charge the debtor for the expenses incurred in the sale or lease. Expenses must be reasonable. Expenses can include such items as attorneys' fees and court costs. If the value received exceeds the debt amount owed plus reasonable expenses, then the secured creditor is required to first distribute the additional amount to any other creditors who have an interest in the property and then give the remainder to the debtor.
- Right to dispose of the collateral as desired—The secured party may sell or lease the collateral at a public or private sale with notification to the debtor. The purchaser at such a sale takes the goods free of the security interest and any subordinate security interests or liens.

When the collateral is in the possession of the defaulting debtor, unless otherwise stated in the secured transaction, the debtor has the right to redeem the collateral prior to any action being taken. The debtor can pay the unpaid portion of the debt plus reasonable expenses incurred by the secured party. The debtor does not have to pay the entire remaining debt but only the amount that is in default, bringing the debt current. Some security agreements have an acceleration clause making all payments due immediately upon default. The debtor may request the court to determine that the acceleration clause is not enforceable if the debtor has brought it current.

The debtor or any other person subject to a security interest in the collateral can redeem the collateral at any time before its sale by tendering full performance of the contract.

CONSUMER PROTECTION LAWS

Consumer protection laws include federal and state legislation intended to ensure fair treatment of consumers in dealings with suppliers of goods and services.

In the commercial sale of goods, the most important transaction is the final sale of the goods to the consumer. Policymakers have deemed it important to protect the consumer in the purchase of goods in a number of ways.

Fair trade laws at both the federal and state levels protect the consumer by limiting restraints on trade to ensure a competitive marketplace. For example, these laws prohibit agreements among businesses within an industry that would limit competition by restricting the supply or cost of goods. Competition benefits the consumer by encouraging lower prices, higher product quality, and better distribution of products and by providing information and enforceable warranties. Fair trade laws include the Federal Trade Commission Act, state deceptive trade practices acts, and the Magnuson-Moss Act, which deals with consumer warranties.

State and federal laws seek to protect consumers by requiring full disclosure of information to consumers and fair treatment by credit providers. Consumer credit laws include the federal Truth in Lending Act, Fair Credit Reporting Act, Fair Debt Collections Practices Act, and Equal Credit Opportunity Act. The Bankruptcy Act allows debtors who are unable to pay their creditors to divide their assets among their creditors and discharge their debts in an orderly and legal process.

Fair Trade Laws

Both states and the federal government have enacted fair trade laws, including these:

- The Federal Trade Commission Act—Consumers benefit when there is free competition in the marketplace. When businesses in an industry have an agreement or understanding to control the supply of goods available to the consumer and/or to fix the price at a set amount, marketplace competition no longer exists. In the late 1800s, the United States marketplace was controlled by a few large businesses in major industries that restricted competition. In response, Congress enacted the Sherman Anti-Trust Act in 1890 and the Federal Trade Commission Act in 1914.
- State unfair trade practice acts—To protect their citizens from anti-competitive business practices within a state, state governments passed their own deceptive trade practices acts.
- State and federal consumer warranty laws—A warranty is the seller's assurance to the buyer that a product is fit for the purposes for which the product will be used. The buyer relies on the seller's assurances in deciding to purchase the goods. A seller's knowledge about a product is assumed to be greater than the buyer's. The Magnuson-Moss Warranty Act of 1975 was passed to protect consumers against deceptions and breaches of warranty by sellers. The law sets standards for warranties to make them more easily understood. States have passed similar warranty laws.

Federal Trade Commission Act

The Federal Trade Commission (FTC) Act of 1914 prohibits unfair methods of competition and unfair or deceptive acts or practices that affect interstate commerce. It is not strictly an antitrust act, although it overlaps with the Sherman Anti-Trust Act of 1890. The purpose of the Sherman Anti-Trust Act was to prevent companies from acting in ways that would hinder free competition by outlawing practices such as unlawful restraints of trade, price discrimination, price fixing, and unlawful monopolies.

The FTC Act is broader than the antitrust acts in that it prohibits unfair or deceptive acts that have no relationship to competition. For example, restraint of trade is a violation of the Sherman Act and also an unfair method of competition. However, misrepresentation is not usually a violation of the Sherman Act but is an unfair act affecting commerce within the meaning of the FTC Act.

The FTC Act does not apply to the insurance industry. Under the McCarran-Ferguson Act, the federal government generally does not regulate the business of insurance because it is subject to state regulation. States usually apply their own antitrust and trade laws to insurance. However, if a state does not have antitrust legislation applicable to insurance, federal antitrust laws apply. Even if states do regulate insurance antitrust matters, federal antitrust laws can apply in cases of insurance practices involving boycott, coercion, or intimidation.

The FTC Act established a five-member commission to oversee the enforcement of the act. The commission takes action against unfair or deceptive practices in three ways:

- Cease-and-desist orders are issued to violating parties after a hearing.
- Trade practice conferences deal with a subject, such as false and misleading advertising in a given industry, by devising a set of trade practice rules. The industry has the opportunity to help write its own regulatory rules.
- Informal settlements and consent orders are used to settle cases arising from violations of the act. Informal settlement is used in cases involving unintentional violations of the act. The accused party executes a stipulation agreeing to stop the challenged practice. Consent orders are similar to pretrial settlements in lawsuits; they are issued to settle a case after a complaint has been filed and a call for a formal hearing has been issued.

State Unfair Trade Practices Acts

In addition to federal laws, states have their own deceptive trade practices acts. State laws vary, but they generally prohibit one or more of these practices:

- Unfair acts (oppressive or bad-faith conduct)
- Deceptive acts (fraud, deceit, and misrepresentation)
- Unfair methods of competition (including antitrust violations such as price fixing and group boycotts)

State laws are designed to compensate for perceived inadequacies in the FTC Act. For example, some acts extend rights to sue that the FTC Act does not provide. Many of the state acts apply to insurance, unlike the FTC Act.

Many states also have unfair trade practices acts and unfair claim settlement practices acts specific to insurance. These generally follow the National Association of Insurance Commissioners (NAIC) model Insurance Fair Trade Practices Act. These are examples of unfair and deceptive insurance industry acts or practices:

- Misrepresentation and false advertising of policies
- Defamation of competitors
- Boycott, coercion, and intimidation
- Creation of false financial statements
- Unfair discrimination
- Use of rebates
- Issuing capital stock, certificates, or securities or using advisory board or similar contracts that promise returns or profits as an inducement to purchase insurance, a sophisticated form of rebate

Under the model act, a state insurance commissioner who believes an act is unfair or deceptive under the law can call a hearing and may order the person or organization to cease the act.

Magnuson-Moss Warranty Act

This act deals with consumer warranties. For many years, the Uniform Commercial Code (UCC) provisions relating to express and implied warranties governed consumer warranties. The UCC codified implied warranties of merchantability and fitness for a particular purpose and described the creation of express warranties. However, under the UCC, only consumers could enforce these warranties, and consumers could also unwittingly waive them. Inadequate controls led to increasing deception in product warranties and resulted in the 1975 passage of the Magnuson-Moss Warranty Act, which supplements the FTC Act and the antitrust laws. The FTC enforces Magnuson-Moss on the federal level. Many states have also passed their own warranty laws.

Under Magnuson-Moss, a producer of goods is not required to provide a warranty; however, if the producer does provide a written warranty, it must conform to certain standards. The law applies to consumer products, defined as tangible personal property for personal, family, or household use, including fixtures. The regulations require these disclosures in a written warranty:

- How to obtain redress under the warranty
- What it will and will not cover
- When it expires
- To whom it applies
- What the warrantor will do if a malfunction occurs
- What service and parts are free

When the product costs more than specified dollar limits, the warranty must be either "full" or "limited":

- A full warranty (also known as the "lemon provision") is a promise to remedy a product defect within a reasonable time and without charge and to refund the purchase price or replace the product if the repairs fail.
- A limited warranty contains the required disclosures with some limitations on the consumer's rights.

The term "lemon provision" is derived from slang describing a product that never seems to be right, no matter how often it is repaired. A lemon law applies to full warranties. If repeated efforts to repair the product fail, lemon provisions require that consumers of such products must have a choice of a full refund or a replacement without charge. To avoid this requirement, some manufacturers call their warranties limited, even though they could otherwise constitute full warranties. Many states have adopted their own lemon laws.

The UCC provides for implied warranties of merchantability and fitness for a particular purpose but permits sellers to disclaim them. Magnuson-Moss does not permit disclaimers of implied warranties but allows a limited warranty to apply the same time restriction to implied warranties as that specified in the express warranty. Under a full warranty, implied warranties cannot be limited in any way.

Consumer Credit Laws

Today's consumers use credit extensively in purchasing goods as varied as shelter, vehicles, food, clothing, travel, electronics, and entertainment. Credit is important to both individual consumers and the general economy. As a result, the protection of consumer credit is a significant area addressed and regulated by legislation. Such legislation endeavors to provide consumers these protections:

- Fair access to credit
- The right to know and understand the terms and interest of a loan prior to agreeing to take on the credit obligation
- Access to their credit reports and the means to correct and/or repair them
- Methods for resolving credit disputes and discrepancies

Consumer credit laws address truth in lending, credit reporting, debt collection practices, and equal credit opportunity.

Truth in Lending Act

In 1968, Congress passed the Consumer Credit Protection Act (the Truth in Lending Act). The purpose of this legislation was to ensure that consumers knew the terms and interest rates of their credit transactions. This act does not replace or preempt state credit disclosure laws unless they are clearly inconsistent with the act, and then only to the extent of the inconsistency.

The Truth in Lending Act applies to personal credit and to credit transactions for personal and real property purchased for personal, family, household, or agricultural purposes. It does not apply to transactions between commercial entities.

The act applies to individuals or organizations that regularly extend credit or make finance charges in connection with installment purchases. It also applies when the purchaser can pay for the item in more than four installments, whether or not there is a credit or a finance charge. It applies to any insurance premium financing plan in which the insured pays premium charges plus a finance charge and to any plan in which the premium is payable in more than four installments, regardless of charges.

Creditors must disclose finance charges. Costs incidental to real estate transactions are not finance charges. However, loan fees, finders' fees, charges for credit reports, and service or carrying charges are considered finance charges in connection with sales of personal property or consumer loans. These are examples of how the act applies to different types of credit transactions:

- Ordinary credit transaction for the sale of goods—The seller must disclose all the finance charges, the cash price, the down payment including trade-in, other charges not part of the finance charge, and the annual percentage rate (APR) of interest charged. The terms of the payment must be stated clearly, including any charge for delinquent payments, and must give a description of any security interest in the goods sold.
- Closed-end plan consumer loan—It has a definite amount and definite time payment. The creditor must provide the same information as in an ordinary credit transaction for the sale of goods.
- Open-end plan consumer loan—The seller must state the conditions of making a charge, the method of calculating the balance due, the method of determining the amount of the finance charge, and any different rates for different balances. The seller must disclose the conditions when other charges could be made and under which the creditor retains a security interest. The debtor can request the average effective annual rate or a projected rate of return.

Congress amended the Truth in Lending Act in 1970 to cover the issuance of credit cards and the liability of credit card holders. The amendment contains these provisions:

- Prohibits companies from issuing credit cards to people who do not request or apply for them
- Limits a cardholder's liability only for its authorized use
- Limits a cardholder's liability to $50 if the card is lost or stolen and used without permission
- Allows the cardholder to withhold payment without incurring a finance charge until the settlement of disputes over the price or quality of goods purchased

Under the Fair Credit Billing Act, an amendment to the Truth in Lending Act, a person who is dissatisfied with property or services purchased with a credit card has the right not to pay the remaining amount due if he or she first tries in good faith to return the property or give the merchant a chance to correct the problem. The credit cardholder's bank usually charges the bill back to the bank servicing the merchant, which in turn charges the merchant, who must make good or sue for the bill.

The Fair Debt Collection Practices Act, another amendment to the Truth in Lending Act, prohibits unfair and oppressive collection practices by agencies that collect debt for creditors. Collection practices prohibited include using violent or criminal acts, using profane language, publishing lists of debtors, calling debtors repeatedly or in the middle of the night, threatening legal action with no intent to follow through, and contacting a debtor at work or at any unusual time or place except with the debtor's consent.

The act also prohibits contacting the debtor's employer, neighbors, or friends, except for the limited purpose of locating the debtor, and even then, no information can be revealed concerning the agent's role in the collection process. The collection agency can send a written notice to the debtor. A debtor who wants to prevent further communications by the collection agency may indicate in writing the desire to stop all further contact, in which case the collector can choose to sue.

Electronic Fund Transfer Act

The Electronic Fund Transfer (EFT) Act was passed by Congress in 1978 and implemented by Regulation E of the Federal Reserve Board to define the rights and responsibilities of parties using electronic transfer of funds. An example of electronic transfer of funds is the use of a bank debit card to pay for a purchase. At the point of purchase, the seller instantly transfers the sales amount from the buyer's account to the seller's account. Buyers do not have the right to stop payment on an electronic fund transfer. However, liability in general is limited to $50 if the card is lost or stolen and the card owner reports the loss within two business days.

Fair Credit Reporting Act

The Fair Credit Reporting Act requires consumer-reporting agencies to exercise their responsibilities with fairness, impartiality, and respect for consumers' rights. It applies only to consumer reporting agencies that for money or on a cooperative non-profit basis regularly assemble or evaluate consumer credit information or other consumer information into reports furnished to third parties. Improper use of consumer credit reports can result in both criminal and civil liability.

A consumer report is a consumer-reporting agency's communication on the consumer's creditworthiness, credit standing, financial capacity, general reputation, personal character, or mode of living, used in whole or in part in establishing the consumer's eligibility for one or more of these:

- Credit or insurance primarily for personal, family, or household purposes
- Employment
- A business transaction involving the consumer, for personal, family, or household purposes

The agency can furnish a credit report only in three circumstances:

- In response to a court order
- Under written instructions of the subject of the report
- To a person who, it has reason to believe, intends to use the information in connection with a credit transaction, for employment purposes, in connection with insurance underwriting, to determine eligibility for a business license if the applicant's financial status is relevant, or for a legitimate business need for information in connection with a business transaction

The law requires that the consumer receive notice of refusal of credit or insurance for personal, family, or household purposes or employment. The consumer also must receive notice of the consumer-reporting agency's name and address.

Equal Credit Opportunity Act

The Equal Credit Opportunity Act prohibits credit discrimination based on age, race, color, religion, national origin, or receipt of welfare benefits. It also prohibits treating married applicants more favorably than unmarried applicants, such as by failing to consider alimony payments as income.

A lender who rejects an application or withholds credit must either give the applicant specific reasons for the rejection or advise the applicant of the right to obtain those reasons. Married people can have separate credit histories so that they can develop credit histories and references under their own names, which is valuable if they become divorced, separated, or widowed.

Bankruptcy

Bankruptcy law
The body of federal law that allows debtors who are unable to pay their creditors to divide their assets among their creditors to discharge the debts.

Bankruptcy law provides two avenues for relief:

- Liquidation of the debtor's assets and distribution of the proceeds to the creditors
- Reorganization of the debtor's affairs, free of creditors' claims during that process, and partial or full repayment of the debts

The federal Bankruptcy Act and federal bankruptcy courts control bankruptcy in the U.S. States do not govern bankruptcy matters. Insurance companies, however, are unique in that they are not subject to federal bankruptcy law and are governed by state laws when they become insolvent.

Federal Bankruptcy Act

The Bankruptcy Act has several chapters. The two chapters that typically apply to consumers are Chapter 7 and Chapter 13.

- Chapter 7 is the last resort chapter. Under a successful Chapter 7 bankruptcy, the bankrupt entity's nonexempt assets are distributed to its various creditors, and the balance of the debtor's obligations are forgiven or discharged. This chapter applies to consumers (individuals and married couples) in addition to corporations and partnerships.
- Chapter 13 gives small business operators or wage earners the same reorganization opportunities available to corporations, partnerships, and certain individuals with large amounts of debt under Chapter 11. This chapter permits the consumer to set up a plan for paying a portion, or possibly all, of the creditors without the threat of creditors' lawsuits. (Chapter 12 provides similar relief to small farm operations.)

Any person or entity can apply voluntarily for Bankruptcy Act relief. Any creditor who believes that a bankrupt person or entity favors other creditors or who continues to dispute the remaining assets of a bankrupt estate, can petition the federal bankruptcy court for involuntary bankruptcy. The alleged bankrupt party can contest the proceeding. The bankruptcy court, after a hearing, determines whether the bankruptcy action will proceed or be dismissed. If dismissed in the debtor's favor, the debtor is entitled to costs and expenses arising out of the court proceedings.

These are the parties to a federal bankruptcy proceeding:

- The debtor
- The creditors (both secured and unsecured)
- A trustee
- A bankruptcy judge
- Attorneys for any or all of the parties

Creditors can be represented by creditors' committees and can have more than one committee for each class of creditor. Usually, secured creditors have priority interests in secured property up to the value of the security interest in that property.

The trustee must inventory the bankrupt person's assets and either conserve them or dispose of them economically. The bankruptcy judge will sort out the various creditor and trustee claims and suggest the equitable payments under the law. All parties have a right to legal representation.

Federal law exempts a limited number of the debtor's assets from the bankruptcy estate. Exempt assets are the debtor's property that cannot be sold or dissipated in the bankruptcy proceedings. Examples are tools of the bankrupt person's trade, a limited homestead exemption for the bankrupt person's home, and life insurance.

Liquidation Proceedings

In a Chapter 7 liquidation proceeding, the bankrupt entity usually does not have enough assets to pay all creditors. Therefore, those creditors are prioritized by the six types of claims they have:

- Administrative expenses of the bankruptcy proceeding
- Unsecured business debts
- A limited amount of wage claims
- Contributions to employee benefits plans
- Claims of unsecured individuals
- Unsecured claims of governmental units

The goal is to eventually discharge the debtor from all debts prior to the court's order for relief and to give the individual (or married couple) debtor a fresh start. A corporation or a partnership is not eligible for discharge in liquidation because the organization will not continue in business and thus has no need for a fresh start. In reorganization, full performance of the plan discharges the debtor. Bankruptcy does not discharge some debts, including these:

- Certain tax claims
- Money, property, or services obtained by fraud
- Claims for willful and malicious injury to people or property
- Alimony or support
- Most education loans
- Debts incurred in court actions arising from drunk driving

Discharge is not automatic. The act sets penalties for debtors who intentionally hinder, defraud, or delay creditors; who unjustifiably conceal, destroy, mutilate, falsify, or fail to keep or preserve records; or who knowingly and fraudulently make false oaths. Prior bankruptcy within the past six years will usually result in the denial of a discharge.

SUMMARY

A sales contract is an agreement with consideration between a buyer and a seller to transfer goods. The Uniform Commercial Code (UCC), Article 2 applies to sales contracts. There are three specialized types of sales contracts—sale on approval, sale and return, and auction sales.

Formation of a sales contract requires an agreement, consisting of an offer and acceptance, and consideration. The Statute of Frauds in the UCC specifies the conditions for the enforceability of written and unwritten sales contracts.

Performance of a sales contract may require the fulfillment of terms and conditions regarding delivery of goods, transfer of title, conforming and nonconforming goods, and express or implied warranties.

A breach of sales contract occurs when one of the parties (seller or buyer) to the contract fails to perform the obligations specified in the contract. The remedies for breach of contract depend on whether the breach occurs before or after delivery of the goods.

UCC Article 3 governs negotiable instruments considered commercial paper. Types of commercial paper include drafts (checks), certificates of deposit, promissory notes, and trade acceptance.

When a negotiable instrument is transferred, the new holder has the same right to enforce payment as the original holder. An endorsement is a signature, or the equivalent of a signature, that legally transfers a negotiable instrument. It must appear in some form of writing, even a rubber stamp, on the instrument, usually on the back, and must transfer the entire sum.

A holder in due course is one to whom a negotiable instrument has been issued or endorsed and who possesses it free of personal, but not real, defenses to the obligation.

Article 7 of the UCC addresses the shipment, storage, and delivery procedures and requirements during the sale of commercial goods. Article 7 also deals with documents of title used in this process, including warehouse receipts and bills of lading. Under certain circumstances, such documents may be negotiable instruments.

A security interest authorizes the seller or lender to take the goods or otherwise prevent the buyer from disposing of them if the buyer defaults on payments. A secured transaction has five elements: debtor, secured creditor, collateral, security agreement, and security interest.

Attachment is the creation of a security interest in the property. Attachment gives the debtor legal recourse against the debtor if the debtor defaults. Perfection secures a creditor's rights against the property of the debtor by validating the attachment. Perfection can be achieved by the public filing of a financing statement, the transfer of collateral, or the seizure of collateral.

Nonpayment is the most obvious form of default of a security agreement. However, a security agreement may define other events as defaults, such as failure to insure the collateral, the debtor's bankruptcy, loss or destruction of the collateral, or removal of the collateral to another place. If the debtor defaults, the secured creditor or party has the right to foreclose on the security interest.

Consumer protection laws include fair trade laws, consumer credit laws, and bankruptcy laws. Fair trade laws include the Federal Trade Commission (FTC) Act that supplemented the antitrust acts, the states' own deceptive trade practices acts, and the Magnuson-Moss Warranty Act in 1975 that supplements the FTC Act and antitrust laws by addressing consumer warranties. Consumer credit laws include the Truth in Lending Act, Fair Credit Reporting Act, Fair Debt Collections Practices Act, and the Equal Credit Opportunity Act. The federal Bankruptcy Act governs most bankruptcies, although it does not apply to insurance companies, whose insolvencies are subject to state regulation.

ASSIGNMENT NOTE

1. Uniform Commercial Code, §2-201.