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not a consumer lease, and further subject to an enforceable "hell or high water" clause in the lease agreement. Section 2A-407 official comment. No attempt is made to state how the set-off should occur; this is to be determined by the facts of each case.

There is no special treatment of the finance lease in this section. Absent supplemental principles of law and equity to the contrary, in the case of most finance leases, following the lessee's acceptance of the goods the lessee will have no rights or remedies against the lessor, because the lessor's obligations to the lessee are minimal. Sections 2A-210 and 2A-211(1). Since the lessee will look to the supplier for performance, this is appropriate. Section 2A-209.

Cross References:

Sections 1-102(2), 1-103, 1-106(1), Article 2, esp. Sections 2-711, 2-717 and Sections 2A-103(4), 2A-209, 2A-210, 2A-211(1), 2A-407, 2A-501(2), 2A-501(4), 2A-509 through 2A-522, 2A-511(3), 2A-517(3), 2A-527(5) and Section 9-113.

Definitional Cross References:

"Conforming". Section 2A-103(1)(d).
"Delivery". Section 1-201(14).
"Good faith". Sections 1-201(19) and 2-103(1)(b).
"Goods". Section 2A-103(1)(h).
"Installment lease contract". Section 2A-103(1)(i).
"Lease contract". Section 2A-103(1)(l).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Notifies". Section 1-201(26).
"Receipt". Section 2-103(1)(c).
"Remedy". Section 1-201(34).
"Rights". Section 1-201(36).
"Security interest". Section 1-201(37).
"Value". Section 1-201(44).

§ 2A-509. LESSEE'S RIGHTS ON IMPROPER DELIVERY; RIGHTFUL REJECTION.

(1) Subject to the provisions of Section 2A-510 on default in installment lease contracts, if the goods or the

tender or delivery fail in any respect to conform to the lease contract, the lessee may reject or accept the goods or accept any commercial unit or units and reject the rest of the goods.

(2) Rejection of goods is ineffective unless it is within a reasonable time after tender or delivery of the goods and the lessee seasonably notifies the lessor.

OFFICIAL COMMENT

Uniform Statutory Source: Sections 2-601 and 2-602(1).

Changes: Revised to reflect leasing practices and terminology.

Definitional Cross References:

"Commercial unit". Section 2A-103(1)(c).
"Conforming". Section 2A-103(1)(d).
"Delivery". Section 1-201(14).
"Goods". Section 2A-103(1)(h).
"Installment lease contract". Section 2A-103(1)(i).
"Lease contract". Section 2A-103(1)(l).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Notifies". Section 1-201(26).
"Reasonable time". Section 1-204(1) and (2).
"Rights". Section 1-201(36).
"Seasonably". Section 1-204(3).

§ 2A-510. INSTALLMENT LEASE CONTRACTS: REJECTION AND DEFAULT.

(1) Under an installment lease contract a lessee may reject any delivery that is nonconforming if the nonconformity substantially impairs the value of that

delivery and cannot be cured or the nonconformity is a defect in the required documents; but if the nonconformity does not fall within subsection (2) and the lessor or the supplier gives adequate assurance of its cure, the lessee must accept that delivery.

(2) Whenever nonconformity or default with respect to one or more deliveries substantially impairs the value of the installment lease contract as a whole there is a default with respect to the whole. But, the aggrieved party reinstates the installment lease contract as a whole if the aggrieved party accepts a nonconforming delivery without seasonably notifying of cancellation or brings an action with respect only to past deliveries or demands performance as to future deliveries.

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-612.

Changes: Revised to reflect leasing practices and terminology.

Definitional Cross References:

"Action". Section 1-201(1)
"Aggrieved party". Section 1-201(2).
"Cancellation". Section 2A-103(1)(b).
"Conforming". Section 2A-103(1)(d).
"Delivery". Section 1-201(14).
"Installment lease contract". Section 2A-103(1)(i).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Notifies". Section 1-201(26).
"Seasonably". Section 1-204(3).

"Supplier". Section 2A-103(1)(x).
"Value". Section 1-201(44).

§ 2A-511. MERCHANT LESSEE'S DUTIES AS TO RIGHTFULLY REJECTED GOODS.

(1) Subject to any security interest of a lessee (Section 2A-508(5)), if a lessor or a supplier has no agent or place of business at the market of rejection, a merchant lessee, after rejection of goods in his [or her] possession or control, shall follow any reasonable instructions received from the lessor or the supplier with respect to the goods. In the absence of those instructions, a merchant lessee shall make reasonable efforts to sell, lease, or otherwise dispose of the goods for the lessor's account if they threaten to decline in value speedily. Instructions are not reasonable if on demand indemnity for expenses is not forthcoming.

(2) If a merchant lessee (subsection (1)) or any other lessee (Section 2A-512) disposes of goods, he [or she] is entitled to reimbursement either from the lessor or the supplier or out of the proceeds for reasonable expenses of caring for and disposing of the goods and, if the expenses include no disposition commission, to such commission as is usual in the trade, or if there is none, to a reasonable sum not exceeding 10 percent of the gross proceeds.

(3) In complying with this section or Section 2A-512, the lessee is held only to good faith. Good faith

conduct hereunder is neither acceptance or conversion nor the basis of an action for damages.

(4) A purchaser who purchases in good faith from a lessee pursuant to this section or Section 2A-512 takes the goods free of any rights of the lessor and the supplier even though the lessee fails to comply with one or more of the requirements of this Article.

OFFICIAL COMMENT

Uniform Statutory Source: Sections 2-603 and 2-706(5).

Changes: Revised to reflect leasing practices and terminology. This section, by its terms, applies to merchants as well as others. Thus, in construing the section it is important to note that under this Act the term good faith is defined differently for merchants (Section 2-103(1)(b)) than for others (Section 1-201(19)). Section 2A-103(3) and (4).

Definitional Cross References:

"Action". Section 1-201(1).
"Good faith". Sections 1-201(19) and 2-103(1)(b).
"Goods". Section 2A-103(1)(h).
"Lease". Section 2A-103(1)(j).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Merchant lessee". Section 2A-103(1)(t).
"Purchaser". Section 1-201(33).
"Rights". Section 1-201(36).
"Security interest". Section 1-201(37).
"Supplier". Section 2A-103(1)(x).
"Value". Section 1-201(44).

§ 2A-512. LESSEE'S DUTIES AS TO RIGHTFULLY REJECTED GOODS.

(1) Except as otherwise provided with respect to goods that threaten to decline in value speedily (Section 2A-511) and subject to any security interest of a lessee (Section 2A-508(5)):

(a) the lessee, after rejection of goods in the lessee's possession, shall hold them with reasonable care at the lessor's or the supplier's disposition for a reasonable time after the lessee's seasonable notification of rejection;

(b) if the lessor or the supplier gives no instructions within a reasonable time after notification of rejection, the lessee may store the rejected goods for the lessor's or the supplier's account or ship them to the lessor or the supplier or dispose of them for the lessor's or the supplier's account with reimbursement in the manner provided in Section 2A-511; but

(c) the lessee has no further obligations with regard to goods rightfully rejected.

(2) Action by the lessee pursuant to subsection (1) is not acceptance or conversion.

OFFICIAL COMMENT

Uniform Statutory Source: Sections 2-602(2)(b) and (c) and 2-604.

Changes: Substantially rewritten.

Purposes: The introduction to subsection (1) references goods that threaten to decline in value speedily and not perishables, the reference in Section 2-604, the statutory analogue. This is a change in style, not substance, as the first phrase includes the second. Subparagraphs (a) and (c) are revised versions of the provisions of Section 2-602(2)(b) and (c). Subparagraph (a) states the rule with respect to the lessee's treatment of goods in its possession following rejection; subparagraph (b) states the rule regarding such goods if the lessor or supplier then fails to give instructions to the lessee. If the lessee performs in a fashion consistent with subparagraphs (a) and (b), subparagraph (c) exonerates the lessee.

Cross References:

Sections 2-602(2)(b), 2-602(2)(c) and 2-604.

Definitional Cross References:

"Action". Section 1-201(1).
"Goods". Section 2A-103(1)(h).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Notification". Section 1-201(26).
"Reasonable time". Section 1-204(1) and (2).
"Seasonably". Section 1-204(3).
"Security interest". Section 1-201(37).
"Supplier". Section 2A-103(1)(x).
"Value". Section 1-201(44).

§ 2A-513. CURE BY LESSOR OF IMPROPER TENDER OR DELIVERY; REPLACEMENT.

(1) If any tender or delivery by the lessor or the supplier is rejected because nonconforming and the time for performance has not yet expired, the lessor or the supplier may seasonably notify the lessee of the lessor's or the supplier's intention to cure and may then make a conforming delivery within the time provided in the lease contract.

(2) If the lessee rejects a nonconforming tender that the lessor or the supplier had reasonable grounds to believe would be acceptable with or without money allowance, the lessor or the supplier may have a further reasonable time to substitute a conforming tender if he [or she] seasonably notifies the lessee.

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-508.

Changes: Revised to reflect leasing practices and terminology.

Definitional Cross References:

"Conforming". Section 2A-103(1)(d).
"Delivery". Section 1-201(14).
"Lease contract". Section 2A-103(1)(l).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Money". Section 1-201(24).
"Notifies". Section 1-201(26).
"Reasonable time". Section 1-204(1) and (2).
"Seasonably". Section 1-204(3).
"Supplier". Section 2A-103(1)(x).

§ 2A-514. WAIVER OF LESSEE'S OBJECTIONS.

(1) In rejecting goods, a lessee's failure to state a particular defect that is ascertainable by reasonable inspection precludes the lessee from relying on the defect to justify rejection or to establish default:

(a) if, stated seasonably, the lessor or the supplier could have cured it (Section 2A-513); or

(b) between merchants if the lessor or the supplier after rejection has made a request in writing for a full and final written statement of all defects on which the lessee proposes to rely.

(2) A lessee's failure to reserve rights when paying rent or other consideration against documents precludes recovery of the payment for defects apparent on the face of the documents.

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-605.

Changes: Revised to reflect leasing practices and terminology.

Purposes: The principles applicable to the commercial practice of payment against documents (subsection 2) are explained in official comment 4 to Section 2-605, the statutory analogue to this section.

Cross Reference:

Section 2-605 official comment 4.

Definitional Cross References:

"Between merchants". Section 2-104(3).
"Goods". Section 2A-103(1)(h).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Rights". Section 1-201(36).
"Seasonably". Section 1-204(3).
"Supplier". Section 2A-103(1)(x).
"Writing". Section 1-201(46).

§ 2A-515. ACCEPTANCE OF GOODS.

(1) Acceptance of goods occurs after the lessee has had a reasonable opportunity to inspect the goods and

(a) the lessee signifies or acts with respect to the goods in a manner that signifies to the lessor or the supplier that the goods are conforming or that the lessee will take or retain them in spite of their nonconformity; or

(b) the lessee fails to make an effective rejection of the goods (Section 2A-509(2)).

(2) Acceptance of a part of any commercial unit is acceptance of that entire unit.

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-606.

Changes: The provisions of Section 2-606(1)(a) were substantially rewritten to provide that the lessee's conduct may signify acceptance. Further, the provisions of Section 2-606(1)(c) were not incorporated as irrelevant given the lessee's possession and use of the leased goods.

Cross References:

Sections 2-606(1)(a) and 2-606(1)(c).

Definitional Cross References:

"Commercial unit". Section 2A-103(1)(c).
"Conforming". Section 2A-103(1)(d).
"Goods". Section 2A-103(1)(h).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Supplier". Section 2A-103(1)(x).

§ 2A-516. EFFECT OF ACCEPTANCE OF GOODS; NOTICE OF DEFAULT; BURDEN OF ESTABLISHING DEFAULT AFTER ACCEPTANCE; NOTICE OF CLAIM OR LITIGATION TO PERSON ANSWERABLE OVER.

(1) A lessee must pay rent for any goods accepted in accordance with the lease contract, with due allowance for goods rightfully rejected or not delivered.

(2) A lessee's acceptance of goods precludes rejection of the goods accepted. In the case of a finance lease, if made with knowledge of a nonconformity, acceptance cannot be revoked because of it. In any other case, if made with knowledge of a nonconformity, acceptance cannot be revoked because of it unless the acceptance was on the reasonable assumption that the nonconformity would be seasonably cured. Acceptance does not of itself impair any other remedy provided by this Article or the lease agreement for nonconformity.

(3) If a tender has been accepted:

(a) within a reasonable time after the lessee discovers or should have discovered any default, the lessee shall notify the lessor and the supplier, or be barred from any remedy;

(b) except in the case of a consumer lease, within a reasonable time after the lessee receives notice of litigation for infringement or the like (Section 2A-211) the lessee shall notify the lessor or be barred from any

remedy over for liability established by the litigation; and

(c) the burden is on the lessee to establish any default.

(4) If a lessee is sued for breach of a warranty or other obligation for which a lessor or a supplier is answerable over:

(a) The lessee may give the lessor or the supplier written notice of the litigation. If the notice states that the lessor or the supplier may come in and defend and that if the lessor or the supplier does not do so he [or she] will be bound in any action against him [or her] by the lessee by any determination of fact common to the two litigations, then unless the lessor or the supplier after seasonable receipt of the notice does come in and defend he [or she] is so bound.

(b) The lessor or the supplier may demand in writing that the lessee turn over control of the litigation including settlement if the claim is one for infringement or the like (Section 2A-211) or else be barred from any remedy over. If the demand states that the lessor or the supplier agrees to bear all expense and to satisfy any adverse judgment, then unless the lessee after seasonable receipt of the demand does turn over control the lessee is so barred.

(5) The provisions of subsections (3) and (4) apply to any obligation of a lessee to hold the lessor or the supplier harmless against infringement or the like (Section 2A-211).

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-607.

Changes: Substantially revised.

Purposes: Subsection (2) creates a special rule for finance leases, precluding revocation if acceptance is made with knowledge of nonconformity with respect to the lease agreement, as opposed to the supply agreement; this is not inequitable as the lessee has a direct claim against the supplier. Section 2A-209(1). Revocation of acceptance of a finance lease is permitted if the lessee's acceptance was without discovery of the nonconformity (with respect to the lease agreement, not the supply agreement) and was reasonably induced by the lessor's assurances. Section 2A-517(1)(b). Absent exclusion or modification, the lessor under a finance lease makes certain warranties to the lessee. Sections 2A-210 and 2A-211(1). Revocation of acceptance is not prohibited even after the lessee's promise has become irrevocable and independent. Section 2A-407 official comment. Where the finance lease creates a security interest, the rule may be to the contrary. General Elec. Credit Corp. of Tennessee v. Ger-Beck Mach. Co., 806 F.2d 1207 (3rd Cir. 1986).

Subsection (3)(a) requires the lessee to give notice of default, within a reasonable time after the lessee discovered or should have discovered the default. In all cases, notice of default must be given to the lessor. In the case of a finance lease, notice of defualt must be given to the lessor and the supplier. The definition of supplier is a person from whom a lessor buys or leases goods to be leased under a finance lease. Section 2A-103(1)(x). Thus, not all sellers or lessors of goods to be leased are included within the set of persons to be given notice of default, as suppliers.

Subsection (3)(b) requires the lessee to give the lessor notice of litigation for infringement or the like.

There is an exception created in the case of a consumer lease. While such an exception was considered for a finance lease, it was not created because it was not necessary - the lessor in a finance lease does not give a warranty against infringement. Section 2A-211(2). Even though not required under subsection (3)(b), the lessee who takes under a finance lease should consider giving notice of litigation for infringement or the like to the supplier, because the lessee obtains the benefit of the suppliers' promises subject to the suppliers' defenses or claims. Sections 2A-209(1) and 2-607(3)(b).

Cross References:

Sections 2-607(3)(b), 2A-209(1), 2A-210, 2A-211(1), 2A-211(2), 2A-407 official comment and 2A-517(1)(b).

Definitional Cross References:

"Action". Section 1-201(1).
"Agreement." Section 1-201(3).
"Burden of establishing". Section 1-201(8).
"Conforming". Section 2A-103(1)(d).
"Consumer lease". Section 2A-103(1)(e).
"Delivery". Section 1-201(14).
"Discover". Section 1-201(25).
"Finance lease". Section 2A-103(1)(g).
"Goods". Section 2A-103(1)(h).
"Knowledge". Section 1-201(25).
"Lease agreement". Section 2A-103(1)(k).
"Lease contract". Section 2A-103(1)(l).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Notice". Section 1-201(25).
"Notifies". Section 1-201(26).
"Person". Section 1-201(30).
"Reasonable time". Section 1-204(1) and (2).
"Receipt". Section 2-103(1)(c).
"Remedy". Section 1-201(34).
"Seasonably". Section 1-204(3).
"Supplier". Section 2A-103(1)(x).
"Written". Section 1-201(46).

§ 2A-517. REVOCATION OF ACCEPTANCE OF GOODS.

(1) A lessee may revoke acceptance of a lot or commercial unit whose nonconformity substantially impairs its value to the lessee if he [or she] has accepted it:

(a) except in the case of a finance lease, on the reasonable assumption that its nonconformity would be cured and it has not been seasonably cured; or

(b) without discovery of the nonconformity if the lessee's acceptance was reasonably induced either by the lessor's assurances or, except in the case of a finance lease, by the difficulty of discovery before acceptance.

(2) Revocation of acceptance must occur within a reasonable time after the lessee discovers or should have discovered the ground for it and before any substantial change in condition of the goods which is not caused by the nonconformity. Revocation is not effective until the lessee notifies the lessor.

(3) A lessee who so revokes has the same rights and duties with regard to the goods involved as if the lessee had rejected them.

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-608.

Changes: Revised to reflect leasing practices and terminology. Note that in the case of a finance lease the lessee retains a limited right to revoke acceptance. Sections 2A-517(1)(b) and 2A-516 official comment.

Cross References:

Sections 2A-516 official comment and 2A-517(1)(b).

Definitional Cross References:

"Commercial unit". Section 2A-103(1)(c).
"Conforming". Section 2A-103(1)(d).
"Discover". Section 1-201(25).
"Finance lease". Section 2A-103(1)(g).
"Goods". Section 2A-103(1)(h).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Lot". Section 2A-103(1)(s).
"Notifies." Section 1-201(26).
"Reasonable time". Section 1-204(1) and (2).
"Rights". Section 1-201(36).
"Seasonably". Section 1-204(3).
"Value". Section 1-201(44).

§ 2A-518. COVER; SUBSTITUTE GOODS.

(1) After default by a lessor under the lease contract (Section 2A-508(1)), the lessee may cover by making any purchase or lease of or contract to purchase or lease goods in substitution for those due from the lessor.

(2) Except as otherwise provided with respect to damages liquidated in the lease agreement (Section 2A-504) or determined by agreement of the parties (Section 1-102(3)), if a lessee's cover is by lease agreement substantially similar to the original lease agreement and the lease agreement is made in good faith and in a commercially reasonable manner, the lessee may recover from the lessor as damages (a) the present value, as of the date of default, of the difference between the total rent for the lease term of the new lease

agreement and the total rent for the remaining lease term of the original lease agreement and (b) any incidental or consequential damages less expenses saved in consequence of the lessor's default.

(3) If a lessee's cover is by lease agreement that for any reason does not qualify for treatment under subsection (2), or is by purchase or otherwise, the lessee may recover from the lessor as if the lessee had elected not to cover and Section 2A-519 governs.

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-712.

Changes: Substantially revised.

Purposes: Subsection (1) allows the lessee to take action to fix its damages after default by the lessor. Such action may consist of the purchase or lease of goods. The decision to cover is a function of commercial judgment, not a statutory mandate replete with sanctions for failure to comply. Cf. Section 9-507.

Subsection (2) states a rule for determining the amount of lessee's damages provided that there is no agreement to the contrary. The lessee's damages will be established using the new lease agreement as a measure if the following three criteria are met: (i) the lessee's cover is by lease agreement, (ii) the lease agreement is substantially similar to the original lease agreement, and (iii) such cover was effected in good faith, and in a commercially reasonable manner. Thus, the lessee will be entitled to recover from the lessor the present value, as of the date of default, of the difference between the rent reserved under the new lease and the original lease, together with incidental or consequential damages less expenses saved in consequence of the lessor's default. Note that the reference in Section 2A-518(2)(a) is to the date of default not to the date of an event of default. An event of default under a lease agreement becomes a default under a lease agreement only

after the expiration of any relevant period of grace and compliance with any notice requirements under this Article and the lease agreement. American Bar Foundation, Commentaries on Indentures, § 5-1, at 216-217 (1971). Section 2A-501(1). This conclusion is also a function of whether, as a matter of fact or law, the event of default has been waived, suspended or cured. Sections 2A-103(4) and 1-103. If the lessee's cover does not satisfy the criteria of subsection (2), Section 2A-519 governs.

Two of the three criteria to be met by the lessee are familiar, but the concept of the new lease agreement being substantially similar to the original lease agreement is not. Given the many variables facing a party who intends to lease goods and the rapidity of change in the market place, the policy decision was made not to draft with specificity. It was thought unwise to seek to establish certainty at the cost of fairness. Thus, the decision of whether the new lease agreement is substantially similar to the original will be determined case by case.

While the section does not draw a bright line, it is possible to describe some of the factors that should be considered in finding that a new lease agreement is substantially similar to the original. First, the goods subject to the new lease agreement should be examined. For example, in a lease of computer equipment the new lease might be for more modern equipment. However, it may be that at the time of the lessor's breach it was not possible to obtain the same type of goods in the market place. Because the lessee's remedy under Section 2A-519 is intended to place the lessee in essentially the same position as if he had covered, if goods similar to those to have been delivered under the original lease are not available, then the computer equipment in this hypothetical should qualify as a commercially reasonable substitute. See Section 2-712(1).

Second, the various elements of the new lease agreement should also be examined. Those elements include the term of the new lease (because the damages are calculated under subsection (2) as the difference between the total rent payable for the entire term of the new lease agreement and the remaining term of the original lease); the presence or absence of options to purchase or release; the lessor's representations, warranties and covenants to the lessee, as well as those to be provided by the lessee to the lessor; and the services, if any, to be provided by the lessor or by the lessee. All of these factors allocate cost and risk between the lessor and the lessee and thus affect the amount of rent to be paid.

Having examined the goods and the agreement, the test to be applied is whether, in light of these comparisons, the new lease agreement is substantially similar to the original lease agreement. These findings should not be made with scientific precision, as they are a function of economics, nor should they be made independently with respect to the goods and each element of the agreement, as it is important that a sense of commercial judgment pervade the finding. To establish the new lease as a proper measure of damage under subsection (2), these factors, taken as a whole, must result in a finding that the new lease agreement is substantially similar to the original.

Cross References:

Sections 2-712(1), 2A-519 and 9-507.

Definitional Cross References:

"Agreement". Section 1-201(3).
"Contract". Section 1-201(11).
"Good faith". Sections 1-201(19) and 2-103(1)(b).
"Goods". Section 2A-103(1)(h).
"Lease". Section 2-103(1)(j).
"Lease agreement". Section 2A-103(1)(k).
"Lease contract". Section 2A-103(1)(l).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Party". Section 1-201(29).
"Present value". Section 2A-103(1)(u).
"Purchase". Section 2A-103(1)(v).

§ 2A-519. LESSEE'S DAMAGES FOR NON-DELIVERY, REPUDIATION, DEFAULT AND BREACH OF WARRANTY IN REGARD TO ACCEPTED GOODS.

(1) Except as otherwise provided with respect to damages liquidated in the lease agreement (Section 2A-504) or determined by agreement of the parties (Section 1-102(3)), if a lessee elects not to cover or a lessee elects to cover and the cover is by lease agreement that for any reason does not

qualify for treatment under Section 2A-518(2), or is by purchase or otherwise, the measure of damages for non-delivery or repudiation by the lessor or for rejection or revocation of acceptance by the lessee is the present value as of the date of the default of the difference between the then market rent and the original rent, computed for the remaining lease term of the original lease agreement together with incidental and consequential damages, less expenses saved in consequence of the lessor's default.

(2) Market rent is to be determined as of the place for tender or, in cases of rejection after arrival or revocation of acceptance, as of the place of arrival.

(3) If the lessee has accepted goods and given notification (Section 2A-516(3)), the measure of damages for non-conforming tender or delivery by a lessor is the loss resulting in the ordinary course of events from the lessor's default as determined in any manner that is reasonable together with incidental and consequential damages, less expenses saved in consequence of the lessor's default.

(4) The measure of damages for breach of warranty is the present value at the time and place of acceptance of the difference between the value of the use of the goods accepted and the value if they had been as warranted for the lease term, unless special circumstances show proximate damages of a different amount, together with incidental and

consequential damages, less expenses saved in consequence of the lessor's default or breach of warranty.

OFFICIAL COMMENT

Uniform Statutory Source: Sections 2-713 and 2-714.

Changes: Substantially revised.

Purposes: Subsection (1), a revised version of the provisions of Section 2-713(1), states the basic rule governing the measure of lessee's damages for non-delivery or repudiation by the lessor or for rightful rejection or revocation of acceptance by the lessee. This measure will apply, absent agreement to the contrary, if the lessee does not cover or if the cover does not qualify under Section 2A-518. There is no sanction for cover that does not qualify.

The measure of damage is the present value, as of the date of default, of the difference between market rent and original rent for the remaining term of the lease, less expenses saved in consequence of the default. Note that the reference in Section 2A-519(1) is to the date of default not to the date of an event of default. An event of default under a lease agreement becomes a default under a lease agreement only after the expiration of any relevant period of grace and compliance with any notice requirements under this Article and the lease agreement. American Bar Foundation, Commentaries on Indentures, § 5-1, at 216-217 (1971). Section 2A-501(1). This conclusion is also a function of whether, as a matter of fact or law, the event of default has been waived, suspended or cured. Sections 2A-103(4) and 1-103.

Subsection (2), a revised version of the provisions of Section 2-713(2), states the rule with respect to determining market rent.

Subsection (3), a revised version of the provisions of Section 2-714(1) and (3), states the measure of damages where goods have been accepted and acceptance is not revoked. The measure in essence is the loss, in the ordinary course of events, flowing from the default.

Subsection (4), a revised version of the provisions of Section 2-714(2), states the measure of damages for breach of warranty. The measure in essence is the present value of

the difference between the value of the goods accepted and of the goods if they had been as warranted.

Cross References:

Sections 2-713(1), 2-713(2), 2-714 and Section 2A-518.

Definitional Cross References:

"Conforming". Section 2A-103(1)(d).
"Delivery". Section 1-201(14).
"Goods". Section 2A-103(1)(h).
"Lease". Section 2A-103(1)(j).
"Lease agreement". Section 2A-103(1)(k).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Notification". Section 1-201(26).
"Present value". Section 2A-103(1)(u).
"Value". Section 1-201(44).

§ 2A-520. LESSEE'S INCIDENTAL AND CONSEQUENTIAL DAMAGES.

(1) Incidental damages resulting from a lessor's default include expenses reasonably incurred in inspection, receipt, transportation, and care and custody of goods rightfully rejected or goods the acceptance of which is justifiably revoked, any commercially reasonable charges, expenses or commissions in connection with effecting cover, and any other reasonable expense incident to the default.

(2) Consequential damages resulting from a lessor's default include:

(a) any loss resulting from general or particular requirements and needs of which the lessor at the time of

contracting had reason to know and which could not reasonably be prevented by cover or otherwise; and

(b) injury to person or property proximately resulting from any breach of warranty.

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-715.

Changes: Revised to reflect leasing terminology and practices.

Purposes: Subsection (1), a revised version of the provisions of Section 2-715(1), lists some examples of incidental damages resulting from a lessor's default; the list is not exhaustive. Subsection (1) makes clear that it applies not only to rightful rejection, but also to justifiable revocation.

Subsection (2), a revised version of the provisions of Section 2-715(2), lists some examples of consequential damages resulting from a lessor's default; the list is not exhaustive.

Cross References:

Section 2-715.

Definitional Cross References:

"Goods". Section 2A-103(1)(h).
"Knows". Section 1-201(25).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Person". Section 1-201(30).
"Receipt". Section 2-103(1)(c).

§ 2A-521. LESSEE'S RIGHT TO SPECIFIC PERFORMANCE OR REPLEVIN.

(1) Specific performance may be decreed if the goods are unique or in other proper circumstances.

(2) A decree for specific performance may include any terms and conditions as to payment of the rent, damages, or other relief that the court deems just.

(3) A lessee has a right of replevin, detinue, sequestration, claim and delivery, or the like for goods identified to the lease contract if after reasonable effort the lessee is unable to effect cover for those goods or the circumstances reasonably indicate that the effort will be unavailing.

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-716.

Changes: Revised to reflect leasing practices and terminology, and to expand the reference to the right of replevin in subsection (3) to include other similar rights of the lessee.

Definitional Cross References:

"Delivery". Section 1-201(14).
"Goods". Section 2A-103(1)(h).
"Lease contract". Section 2A-103(1)(l).
"Lessee". Section 2A-103(1)(n).
"Rights". Section 1-201(36).
"Term". Section 1-201(42).

§ 2A-522. LESSEE'S RIGHT TO GOODS ON LESSOR'S INSOLVENCY.

(1) Subject to subsection (2) and even though the goods have not been shipped, a lessee who has paid a part or all of the rent and security for goods identified to a lease contract (Section 2A-217) on making and keeping good a tender

of any unpaid portion of the rent and security due under the lease contract may recover the goods identified from the lessor if the lessor becomes insolvent within 10 days after receipt of the first installment of rent and security.

(2) A lessee acquires the right to recover goods identified to a lease contract only if they conform to the lease contract.

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-502.

Changes: Revised to reflect leasing practices and terminology.

Definitional Cross References:

"Conforming". Section 2A-103(1)(d).
"Goods". Section 2A-103(1)(h).
"Insolvent". Section 1-201(23).
"Lease contract". Section 2A-103(1)(l).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Receipt". Section 2-103(1)(c).
"Rights". Section 1-201(36).

C. DEFAULT BY LESSEE

§ 2A-523. LESSOR'S REMEDIES.

(1) If a lessee wrongfully rejects or revokes acceptance of goods or fails to make a payment when due or repudiates with respect to a part or the whole, then, with respect to any goods involved, and with respect to all of the

goods if under an installment lease contract the value of the whole lease contract is substantially impaired (Section 2A-510), the lessee is in default under the lease contract and the lessor may:

(a) cancel the lease contract (Section 2A-505(1));

(b) proceed respecting goods not identified to the lease contract (Section 2A-524);

(c) withhold delivery of the goods and take possession of goods previously delivered (Section 2A-525);

(d) stop delivery of the goods by any bailee (Section 2A-526);

(e) dispose of the goods and recover damages (Section 2A-527), or retain the goods and recover damages (Section 2A-528), or in a proper case recover rent (Section 2A-529).

(2) If a lessee is otherwise in default under a lease contract, the lessor may exercise the rights and remedies provided in the lease contract and this Article.

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-703.

Changes: Substantially revised.

Purposes: This section is an index to Sections 2A-524 through 2A-531 and their effect on the lessor's rights and remedies upon the lessee's default. The lessor and the lessee can agree otherwise; thus, the parties can, among other things, raise or lower the threshold that gives rise to lessee's default or create a new scheme of rights and

remedies triggered by the occurrence of the default. Sections 2A-103(4) and 1-102(3).

Subsection (1), a substantially rewritten version of Section 2-703, lists various cumulative remedies of the lessor where the lessee wrongfully rejects or revokes acceptance, fails to make a payment when due, or repudiates. Section 2A-501(4). This Article rejects the doctrine of election of remedy. Whether, in a particular case, one remedy bars another, is a function of whether lessor has been put in as good a position as if the lessee had fully performed the lease contract. Sections 2A-103(4) and 1-106(1).

Hypothetical: 1. To better understand the application of subparagraphs (a) through (e), it is useful to review a hypothetical. Assume that A is a merchant in the business of selling and leasing new bicycles of various types. B is about to engage in the business of subleasing bicycles to summer residents of and visitors to an island resort. A, as lessor, has agreed to lease 60 bicycles to B. While there is one master lease, deliveries and terms are staggered. 20 bicycles are to be delivered by A to B's island location on June 1; the term of the lease of these bicycles is 4 months. 20 bicycles are to be delivered by A to B's island location on July 1; the term of the lease of these bicycles is three months. Finally, 20 bicycles are to be delivered by A to B's island location on August 1; the term of the lease of these bicycles is two months. B is obligated to pay rent to A on the 15th day of each month during the term for the lease. Rent is $50 per month, per bicycle. B has no option to purchase or release and must return the bicycles to A at the end of the term, in good condition, reasonable wear and tear excepted. Since the retail price of each bicycle is $400 and bicycles used in the retail rental business have a useful economic life of 36 months, this transaction creates a lease. Sections 2A-103(1)(j) and 1-201(37).

2. A's current inventory of bicycles is not large. Thus, upon signing the lease with B in February, A agreed to purchase 60 new bicycles from A's principal manufacturer, with special instructions to drop ship the bicycles to B's island location in accordance with the delivery schedule set forth in the lease.

3. The first shipment of 20 bicycles was received by B on May 21. B inspected the bicycles, accepted the same as conforming to the lease and signed a receipt of delivery

and acceptance. However, due to poor weather that summer, business was terrible and B was unable to pay the rent due on June 15. Pursuant to the lease A sent B notice of default and proceeded to enforce his rights and remedies against B.

4. A's counsel first advised A that under Section 2A-510(2) and the terms of the lease B's failure to pay was a default with resp to the whole. Thus, to minimize A's continued exposur was advised to take possession of the bicycles. If A had possession of the goods A could refuse to deliver. Section 2A-525(1). However, the facts here are different. With respect to the bicycles in B's possession, A has the right to take possession of the bicycles, without breach of the peace. Section 2A-525(2). If B refuses to allow A access to the bicycles, A can proceed by action, including replevin or injunctive relief.

5. With respect to the 40 bicycles that have not been delivered, this Article provides various alternatives. First, assume that 20 of the remaining 40 bicycles have been manufactured and delivered by the manufacturer to a carrier for shipment to B. Given the size of the shipment, the carrier was using a small truck for the delivery and the truck had not yet reached the island fa y when the manufacturer (at the request of A) instructed the carrier to divert the shipment to A's place of business. A's right to stop delivery is recognized under these circumstances. Section 2A-526(1). Second, assume that the 20 remaining bicycles were in the process of manufacture when B defaulted. A retains the right (as between A as lessor and B as lessee) to exercise reasonable commercial judgment whether to complete manufacture or to dispose of the unfinished goods for scrap. Since A is not the manufacturer and A has a binding contract to buy the bicycles, A elected to allow the manufacturer to complete the manufacture of the bicycles, but instructed the manufacturer to deliver the completed bicycles to A's place of business. Section 2A-524(2).

6. Thus, so far A has elected to exercise the remedies referred to in subparagraphs (b) through (d) in subsection (1). None of these remedies bars any of the others because A's election and enforcement merely resulted in A's possession of the bicycles. Had B performed A would have recovered possession of the bicycles. Thus A is in the process of obtaining the benefit of his bargain.

7. A's counsel next would determine what action, if any, should be taken with respect to the goods. As stated in subparagraph (e) and as discussed fully in Section 2A-527(1)

the lessor may, but has no obligation to, dispose of the goods by lease, sale or otherwise. In this case, since A is in the business of leasing and selling bicycles, A will probably inventory the 60 bicycles for its retail trade.

8. A's counsel then will determine which of the various, alternate means of ascertaining A's claim for damages against B will be computed. Subparagraph (2) catalogues each relevant section. First, under Section 2A-527(2) the amount of A's claim will be computed by comparing the original lease between A and B with any subsequent lease of the bicycles but only if the subsequent lease is substantially similar to the lease contract. While the section does not define this term, the official comment does establish some parameters. If, however, A elects to lease the bicycles to his retail trade, it is unlikely that the resulting lease will be substantially similar to the original, as leases to retail customers are considerably different from leases to wholesale customers like B. If, however, the leases were substantially similar, the damage claim is for accrued and unpaid rent, the present value of the difference between the rent reserved under both leases for the balance of their terms, together with incidental damages less expenses saved in consequence of the lessee's default.

9. If the new lease is not substantially similar or if A elects to sell the bicycles or to hold the bicycles, damages are computed under Section 2A-528 or 2A-529.

10. If A elects to pursue his claim under Section 2A-528(1) the damage rule is the same as that stated in Section 2A-527(2) except that the standard of comparison is not the rent reserved under a substantially similar lease entered into by the lessor but a market rent, as defined in Section 2A-507. Further, if the facts of this hypothetical were more elaborate A may be able to establish that the measure of damage under subsection (1) is inadequate to put him in the same position that B's performance would have, in which case A can claim his lost profits.

11. Yet another alternative for computing A's damage claim against B is prescribed by Section 2A-529. However, to use this formula A must, among other things, hold the bicycles identified in the lease contract for B. Since this would include all 60 bicycles and A is a merchant, it is unlikely to occur. Further, subsection (1)(a), which in essence allows A to receive the present value of the rent reserved under the lease, would in this case apply only to

the 20 bicycles accepted by B in May. With respect to the remaining 40 bicycles, subsection 1(b) will apply only if A is unable to dispose of them, or circumstances indicate the effort will be unavailing, in which case the damage formula identical to the one set forth in (1)(a) will apply. At any time up to collection of a judgment by A against B, A may dispose of the bicycles. In such case A's claim for damages against B is governed by Section 2A-527 or 2A-528. Section 2A-529(3). The resulting recalculation of claim should reduce the amount recoverable by A against B. However, the nature of the post-judgment proceedings to resolve this issue, and the sanctions for abuse, if any, will be determined by other law.

12. Finally, if the lease agreement had provided, A's claim against B would not be determined under any of these statutory formulae, but pursuant to a liquidated damages clause. Section 2A-504(1).

13. These various methods of computing A's damage claim against B are alternatives. However, the pursuit of any one of these alternatives is not a bar to, nor has it been barred by, A's earlier action to obtain possession of the 60 bicycles. These formulae, which vary as a function of an overt or implied mitigation of damage theory, focus on allowing A a recovery of the benefit of his bargain with B. Had B performed, A would have received the rent as well as the return of the 60 bicycles at the end of the term.

14. Finally, A's counsel should also advise A of his right to cancel the lease contract under subparagraph (a). Section 2A-505(1). Cancellation will discharge all existing obligations but preserve A's rights and remedies.

15. Subsection (2) is new and allows the lessor access to the remedy scheme of this Article as well as that contained in the lease contract if the lessee is in default for reasons other than those stated in subsection (1). Note that the reference to this Article includes supplementary principles of law and equity, e.g., fraud, misrepresentation and duress. Sections 2A-103(4) and 1-103.

16. There is no special treatment of the finance lease in this section. Absent supplementary principles of law to the contrary, in most cases the supplier will have no rights or remedies against the defaulting lessee. Section 2A-209(2)(b). Given that the supplier will look to the lessor for payment, this is appropriate. However, there is a specific exception to this rule with respect to the right to

identify goods to the lease contract. Section 2A-524(2). The parties are free to create a different result in a particular case. Sections 2A-103(4) and 1-102(3).

Cross References:

Sections 1-102(3), 1-103, 1-106(1), 1-201(37), 2-703, 2A-103(1)(j), 2A-103(4), 2A-209(2)(b), 2A-501(4), 2A-504(1), 2A-505(1), 2A-507, 2A-510(2), 2A-524 through 2A-531, 2A-524(2), 2A-525(1), 2A-525(2), 2A-526(1), 2A-527(1), 2A-527(2), 2A-528(1) and 2A-529(3).

Definitional Cross References:

"Delivery". Section 1-201(14).
"Goods". Section 2A-103(1)(h).
"Installment lease contract". Section 2A-103(1)(i).
"Lease contract". Section 2A-103(1)(l).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Remedy". Section 1-201(34).
"Rights". Section 1-201(36).
"Value". Section 1-201(44).

§ 2A-524. LESSOR'S RIGHT TO IDENTIFY GOODS TO LEASE CONTRACT.

(1) A lessor aggrieved under Section 2A-523(1) may:

(a) identify to the lease contract conforming goods not already identified if at the time the lessor learned the default they were in the lessor's or the supplier's possession or control; and

(b) dispose of goods (Section 2A-527(1)) that demonstrably have been intended for the particular lease contract even though those goods are unfinished.

(2) If the goods are unfinished, in the exercise of reasonable commercial judgment for the purposes of avoiding

loss and of effective realization, an aggrieved lessor or the supplier may either complete manufacture and wholly identify the goods to the lease contract or cease manufacture and lease, sell, or otherwise dispose of the goods for scrap or salvage value or proceed in any other reasonable manner.

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-704.

Changes: Revised to reflect leasing practices and terminology.

Definitional Cross References:

"Aggrieved party". Section 1-201(2).
"Conforming". Section 2A-103(1)(d).
"Goods". Section 2A-103(1)(h).
"Learn". Section 1-201(25).
"Lease". Section 2A-103(1)(j).
"Lease contract". Section 2A-103(1)(l).
"Lessor". Section 2A-103(1)(p).
"Rights". Section 1-201(36).
"Supplier". Section 2A-103(1)(x).
"Value". Section 1-201(44).

§ 2A-525. LESSOR'S RIGHT TO POSSESSION OF GOODS.

(1) If a lessor discovers the lessee to be insolvent, the lessor may refuse to deliver the goods.

(2) The lessor has on default by the lessee under the lease contract the right to take possession of the goods. If the lease contract so provides, the lessor may require the lessee to assemble the goods and make them available to the lessor at a place to be designated by the

lessor which is reasonably convenient to both parties. Without removal, the lessor may render unusable any goods employed in trade or business, and may dispose of goods on the lessee's premises (Section 2A-527).

(3) The lessor may proceed under subsection (2) without judicial process if that can be done without breach of the peace or the lessor may proceed by action.

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-702(1) and 9-503.

Changes: Substantially revised.

Purposes: Subsection (1), a revised version of the provisions of Section 2-702(1), allows the lessor to refuse to deliver goods if the lessee is insolvent. Note that the provisions of Section 2-702(2), granting the unpaid seller certain rights of reclamation, were not incorporated in this section. Subsection (2) made this unnecessary.

Subsection (2), a revised version of the provisions of Section 9-503, allows the lessor, on default by the lessee, the right to take possession of or reclaim the goods; since the lessee's insolvency is an event of default in a standard lease agreement, subsection (2) is the functional equivalent of Section 2-702(2). Further, subsection (2) sanctions the classic crate and delivery clause obligating the lessee to assemble the goods and to make them available to the lessor. Finally, the lessor may leave the goods in place, render them unusable (if they are goods employed in trade or business), and dispose of them on the lessee's premises.

Subsection (3), a revised version of the provisions of Section 9-503, allows the lessor to proceed under subsection (2) without judicial process, absent breach of the peace, or by action. Sections 2A-501(3), 2A-103(4) and 1-201(1). In the appropriate case action includes injunctive relief. Clark Equip. Co. v. Armstrong Equip. Co., 431 F.2d 54 (5th Cir. 1970), cert. denied, 402 U.S. 909 (1971). This

Section, as well as a number of other Sections in this Part, are included in the Article to codify the lessor's common law right to protect the lessor's reversionary interest in the goods. Section 2A-103(1)(q). These Sections are intended to supplement and not displace principles of law and equity with respect to the protection of such interest. Sections 2A-103(4) and 1-103. Such principles apply in many instances, e.g., loss or damage to goods if risk of loss passes to the lessee, failure of the lessee to return goods to the lessor in the condition stipulated in the lease, and refusal of the lessee to return goods to the lessor after termination or cancellation of the lease.

Cross References:

Sections 1-106(2), 2-702(1), 2-702(2), 2A-103(4), 2A-501(3) and 9-503.

Definitional Cross References:

"Action". Section 1-201(1).
"Delivery". Section 1-201(14).
"Discover". Section 1-201(25).
"Goods". Section 2A-103(1)(h).
"Insolvent". Section 1-201(23).
"Lease contract". Section 2A-103(1)(l).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Party". Section 1-201(29).
"Rights". Section 1-201(36).

§ 2A-526. LESSOR'S STOPPAGE OF DELIVERY IN TRANSIT OR OTHERWISE.

(1) A lessor may stop delivery of goods in the possession of a carrier or other bailee if the lessor discovers the lessee to be insolvent and may stop delivery of carload, truckload, planeload, or larger shipments of express or freight if the lessee repudiates or fails to make a payment due before delivery, whether for rent, security or

otherwise under the lease contract, or for any other reason the lessor has a right to withhold or take possession of the goods.

(2) In pursuing its remedies under subsection (1), the lessor may stop delivery until

(a) receipt of the goods by the lessee;

(b) acknowledgment to the lessee by any bailee of the goods, except a carrier, that the bailee holds the goods for the lessee; or

(c) such an acknowledgment to the lessee by a carrier via reshipment or as warehouseman.

(3) (a) To stop delivery, a lessor shall so notify as to enable the bailee by reasonable diligence to prevent delivery of the goods.

(b) After notification, the bailee shall hold and deliver the goods according to the directions of the lessor, but the lessor is liable to the bailee for any ensuing charges or damages.

(c) A carrier who has issued a nonnegotiable bill of lading is not obliged to obey a notification to stop received from a person other than the consignor.

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-705..

Changes: Revised to reflect leasing practices and terminology.

Definitional Cross References:

"Bill of lading". Section 1-201(6).
"Delivery". Section 1-201(14).
"Discover". Section 1-201(25).
"Goods". Section 2A-103(1)(h).
"Insolvent". Section 1-201(23).
"Lease contract". Section 2A-103(1)(1).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Notifies" and "Notification". Section 1-201(26).
"Person". Section 1-201(30).
"Receipt". Section 2-103(1)(c).
"Remedy". Section 1-201(34).
"Rights". Section 1-201(36).

§ 2A-527. LESSOR'S RIGHTS TO DISPOSE OF GOODS.

(1) After a default by a lessee under the lease contract (Section 2A-523(1)) or after the lessor refuses to deliver or takes possession of goods (Section 2A-525 or 2A-526), the lessor may dispose of the goods concerned or the undelivered balance thereof by lease, sale or otherwise.

(2) Except as otherwise provided with respect to damages liquidated in the lease agreement (Section 2A-504) or determined by agreement of the parties (Section 1-102(3)), if the disposition is by lease agreement substantially similar to the original lease agreement and the lease agreement is made in good faith and in a commercially reasonable manner, the lessor may recover from the lessee as damages (a) accrued and unpaid rent as of the date of default, (b) the present value as of the date of default of the difference between the total rent for the remaining lease term of the original lease

agreement and the total rent for the lease term of the new lease agreement, and (c) any incidental damages allowed under Section 2A-530, less expenses saved in consequence of the lessee's default.

(3) If the lessor's disposition is by lease agreement that for any reason does not qualify for treatment under subsection (2), or is by sale or otherwise, the lessor may recover from the lessee as if the lessor had elected not to dispose of the goods and Section 2A-528 governs.

(4) A subsequent buyer or lessee who buys or leases from the lessor in good faith for value as a result of a disposition under this section takes the goods free of the original lease contract and any rights of the original lessee even though the lessor fails to comply with one or more of the requirements of this Article.

(5) The lessor is not accountable to the lessee for any profit made on any disposition. A lessee who has rightfully rejected or justifiably revoked acceptance shall account to the lessor for any excess over the amount of the lessee's security interest (Section 2A-508(5)).

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-706(1), (5) and (6).

Changes: Substantially revised.

Purposes: Subsection (1), a revised version of the first sentence of subsection 2-706(1), allows the lessor the

right to dispose of goods after default by the lessee (even if the goods remain in the lessee's possession - Section 2A-525(2)) or after the lessor refuses to deliver or takes possession of the goods. The lessor's decision to exercise this right is a function of a commercial judgment, not a statutory mandate replete with sanctions for failure to comply. Cf. Section 9-507. As the owner of the goods, in the case of a lessor, or as the prime lessee of the goods, in the case of a sublessor, compulsory disposition of the goods is inconsistent with the nature of the interest held by the lessor or the sublessor and is not necessary because the interest held by the lessee or the sublessee is not protected by a right of redemption under the common law or this Article. Subsection 2A-527(5).

The rule for determining the measure of damages recoverable by the lessor against the lessee is a function of several variables. If the lessor has elected to effect disposition under subsection (1) and such disposition is by lease that qualifies under subsection (2), the measure of damages set forth in subsection (2) will apply, absent agreement to the contrary. Sections 2A-504, 2A-103(4) and 1-102(3).

The lessor's damages will be established using the new lease agreement as a measure if the following three criteria are satisfied: (i) the lessor disposed of the goods by lease, (ii) the lease agreement is substantially similar to the original lease agreement, and (iii) such disposition was in good faith, and in a commercially reasonable manner. Thus, the lessor will be entitled to recover from the lessee the accrued and unpaid rent as of the date of default, and the present value, as of the date of default, of the difference between the rent reserved under the new lease and the original lease, together with incidental damages less expenses saved in consequence of the lessee's default. If the lessor's disposition does not satisfy the criteria of subsection (2), the lessor may calculate its claim against the lessee pursuant to Section 2A-528. Section 2A-523(1)(e). Note that the reference in Section 2A-527(2)(a) and (b) is to the date of default not to the date of an event of default. An event of default under a lease agreement becomes a default under a lease agreement only after the expiration of any relevant period of grace and compliance with any notice requirements under this Article and the lease agreement. American Bar Foundation, Commentaries on Indentures, § 5-1, at 216-217 (1971). Section 2A-501(1). This conclusion is also a function of whether, as a matter of fact or law, the event of default has

been waived, suspended or cured. Sections 2A-103(4) and 1-103.

Two of the three criteria to be met by the lessor are familiar, but the concept of the new lease agreement that is substantially similar to the original lease agreement is not. Given the many variables facing a party who intends to lease goods and the rapidity of change in the market place, the policy decision was made not to draft with specificity. It was thought unwise to seek to establish certainty at the cost of fairness. The decision of whether the new lease agreement is substantially similar to the original will be determined case by case.

While the section does not draw a bright line, it is possible to describe some of the factors that should be considered in a finding that a new lease agreement is substantially similar to the original. The various elements of the new lease agreement should be examined. Those elements include the term of the new lease (because the damages are calculated under subsection (2) as the difference between the total rent payable for the entire term of the new lease agreement and the remaining lease term of the original lease); the options to purchase or release; the lessor's representations, warranties and covenants to the lessee as well as those to be provided by the lessee to the lessor; and the services, if any, to be provided by the lessor or by the lessee. All of these factors allocate cost and risk between the lessor and the lessee and thus affect the amount of rent to be paid. These findings should not be made with scientific precision, as they are a function of economics, nor should they be made independently, as it is important that a sense of commercial judgment pervade the finding. See Section 2A-507(2). To establish the new lease as a proper measure of damage under subsection (2), these various factors, taken as a whole, must result in a finding that the new lease agreement is substantially similar to the original.

The following hypothetical illustrates the difficulty of providing a bright line. Assume that A buys a jumbo tractor for $1 million and then leases the tractor to B for a term of 36 months. The tractor is delivered to and is accepted by B on May 1. On June 1 B fails to pay the monthly rent to A. B returns the tractor to A, who immediately releases the tractor to C for a term identical to the term remaining under the lease between A and B. All terms and conditions under the lease between A and C are identical to those under the original lease between A and B, except that C does not provide any property damage or other insurance

coverage, and B agreed to provide complete coverage. Coverage is expensive and difficult to obtain. The new lease should be viewed as not substantially similar to the original. However, if the lessor seeks a recovery under Section 2A-528 the new lease can be introduced into evidence to establish market rent (Section 2A-507), with a proper allowance for the lessor's cost of replacing the lost insurance coverage.

Subsection (3), which is new, provides that if the lessor's disposition is by lease that does not qualify under subsection (2), or is by sale or otherwise, Section 2A-528 governs.

Subsection (4), a revised version of subsection 2-706(5), applies to protect a subsequent buyer or lessee who buys or leases from the lessor in good faith and for value, pursuant to a disposition under this section. Note that by its terms, the rule in subsection 2A-304(1), which provides that the subsequent lessee takes subject to the original lease contract, is controlled by the rule stated in this subsection.

Subsection (5), a revised version of subsection 2-706(6), provides that the lessor is not accountable to the lessee for any profit made by the lessor on a disposition. This rule follows from the fundamental premise of the bailment for hire that the lessee under a lease of goods has no equity of redemption to protect.

Cross References:

Sections 1-102(3), 2-706(1), 2-706(5), 2-706(6), 2A-103(4), 2A-304(1), 2A-504, 2A-507(2), 2A-523(1)(e), 2A-525(2), 2A-527(5), 2A-528 and 9-507.

Definitional Cross References:

"Buyer" and "Buying". Section 2-103(1)(a).
"Delivery". Section 1-201(14).
"Good faith". Sections 1-201(19) and 2-103(1)(b).
"Goods". Section 2A-103(1)(h).
"Lease". Section 2A-103(1)(j).
"Lease contract". Section 2A-103(1)(l).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Present value". Section 2A-103(1)(u).

"Rights". Section 1-201(36).
"Sale". Section 2-106(1).
"Security interest". Section 1-201(37).
"Value". Section 1-201(44).

§ 2A-528. LESSOR'S DAMAGES FOR NON-ACCEPTANCE OR REPUDIATION.

(1) Except as otherwise provided with respect to damages liquidated in the lease agreement (Section 2A-504) or determined by agreement of the parties (Section 1-102(3)), if a lessor elects to retain the goods or a lessor elects to dispose of the goods and disposition is by lease agreement that for any reason does not qualify for treatment under Section 2A-527(2), or is by sale or otherwise, the lessor may recover from the lessee as damages for non-acceptance or repudiation by the lessee (a) accrued and unpaid rent as of the date of default, (b) the present value as of the date of default of the difference between the total rent for the remaining lease term of the original lease agreement and the market rent at the time and place for tender computed for the same lease term, and (c) any incidental damages allowed under Section 2A-530, less expenses saved in consequence of the lessee's default.

(2) If the measure of damages provided in subsection (1) is inadequate to put a lessor in as good a position as performance would have, the measure of damages is the profit, including reasonable overhead, the lessor would

have made from full performance by the lessee, together with any incidental damages allowed under Section 2A-530, due allowance for costs reasonably incurred and due credit for payments or proceeds of disposition.

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-708.

Changes: Substantially revised.

Purposes: Subsection (1), a substantially revised version of Section 2-708(1), states the basic rule governing the measure of lessor's damages for non-acceptance or repudiation by the lessee; repudiation is defined (Section 2A-402) to include the lessee's post acceptance default for failure to pay rent and the like. Section 2A-523(1). This measure will apply if the lessor elects to retain the goods (whether undelivered, returned by the lessee, or repossessed by the lessor after acceptance and default by the lessee) or if the lessor's disposition does not qualify under subsection 2A-527(2). Section 2A-527(3). Note that under some of these conditions, the lessor may recover damages from the lessee pursuant to the rule set forth in Section 2A-529. There is no sanction for disposition that does not qualify under subsection 2A-527(2). Application of the rule set forth in this section is subject to agreement to the contrary. Sections 2A-504, 2A-103(4) and 1-102(3).

The measure of damage is the accrued and unpaid rent as of the date of default together with the present value, as of the date of default, of the difference between market rent and the original rent for the remaining term of the lease, and incidental damages, less expenses saved in consequence of the default. Note that the reference in Section 2A-528(1)(a) and (b) is to the date of default not to the date of an event of default. An event of default under a lease agreement becomes a default under a lease agreement only after the expiration of any relevant period of grace and compliance with any notice requirements under this Article and the lease agreement. American Bar Foundation, Commentaries on Indentures, § 5-1, at 216-217 (1971). Section 2A-501(1). This conclusion is also a function of whether, as a matter of fact or law, the event of default has been waived, suspended or cured. Sections 2A-103(4) and 1-103. Market rent will be

computed pursuant to Section 2A-507. In the case of a default by the lessee, the time for tender should be interpreted as the date of the default. If, as of the date of default, the lessor has attempted and failed to obtain possession of the goods, the lessor has, among various additional rights and remedies, a cause of action against the lessee for damages due to loss of use of possession of the goods between the date of default and the date the lessor obtains possession of the goods. Sections 2A-525(3), 2A-103(4), 1-201(1). See also Section 2A-530. This conclusion is [illegible] an important policy decision to protect the lessor's residual interest in the goods. Section 2A-103(1)(g).

Subsection (2), a somewhat revised version of the provisions of [illegible]-708(2), states a measure of damages which applies in each case that subsection (1) applies but the measure of damages in subsection (1) is inadequate to put the lessor in as good a position as performance would have. The measure of damage is the lessor's profit, including overhead, together with incidental damages with allowance for costs reasonably incurred and credit for payments or proceeds of disposition. In determining the amount of due credit with respect to proceeds of disposition, a proper value should be attributed to the lessor's [illegible] interest in the goods. Sections 2A-103(1)(r) and 2A-530(4).

[illegible] profit, a court should include any expected appreciation in the goods, e.g., the foal of a leased brood mare. Also, in this subsection is intended to give the lessor the benefits of the bargain, a court should consider any reasonably expected benefit or profit expected by the lessor from the performance of the lease agreement. See Honeywell, Inc. v. [illegible] Inc., 317 F. Supp. 406, 413 (N.D. Ga. 1970); [illegible] Co., 36 N.J. Super. 128, 131, 114 A.2d 875, 877 (Ch. Div. 1955). Further, in calculating profit, the present value should be given effect. Taylor v. Commercial Credit Equip. Corp., 170 Ga. App. 322, 316 S.E.2d 788 (Ct. App. 1984). See generally Section 2A-103(1)(u).

Cross References

Sections [illegible]-708, 2A-103(1)(u), 2A-402, 2A-504, 2A-507, 2A-[illegible], and 2A-529.

Definitional Cross References:

"Agreement". Section 1-201(3).
"Goods". Section 2A-103(1)(h).
"Lease". Section 2A-103(1)(j).
"Lease agreement". Section 2A-103(1)(k).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Party". Section 1-201(29).
"Present value". Section 2A-103(1)(u).
"Sale". Section 2-106(1).

§ 2A-529. LESSOR'S ACTION FOR THE RENT.

(1) After default by the lessee under the lease contract (Section 2A-523(1)), if the lessor complies with subsection (2), the lessor may recover from the lessee as damages:

(a) for goods accepted by the lessee and for conforming goods lost or damaged within a commercially reasonable time after risk of loss passes to the lessee (Section 2A-219), (i) accrued and unpaid rent as of the date of default, (ii) the present value as of the date of default of the rent for the remaining lease term of the lease agreement, and (iii) any incidental damages allowed under Section 2A-530, less expenses saved in consequence of the lessee's default; and

(b) for goods identified to the lease contract if the lessor is unable after reasonable effort to dispose of them at a reasonable price or the circumstances reasonably indicate that effort will be unavailing, (i)

accrued and unpaid rent as of the date of default, (ii) the present value as of the date of default of the rent for the remaining lease term of the lease agreement, and (iii) any incidental damages allowed under Section 2A-530, less expenses saved in consequence of the lessee's default.

(2) Except as provided in subsection (3), the lessor shall hold for the lessee for the remaining lease term of the lease agreement any goods that have been identified to the lease contract and are in the lessor's control.

(3) The lessor may dispose of the goods at any time before collection of the judgment for damages obtained pursuant to subsection (1). If the disposition is before the end of the remaining lease term of the lease agreement, the lessor's recovery against the lessee for damages will be governed by Section 2A-527 or Section 2A-528.

(4) Payment of the judgment for damages obtained pursuant to subsection (1) entitles the lessee to use and possession of the goods not then disposed of for the remaining lease term of the lease agreement.

(5) After a lessee has wrongfully rejected or revoked acceptance of goods, has failed to pay rent then due, or has repudiated (Section 2A-402), a lessor who is held not entitled to rent under this section must nevertheless be

awarded damages for non-acceptance under Sections 2A-527 and 2A-528.

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-709.

Changes: Substantially revised.

Purposes: Subsection (1) provides another method of determining the measure of lessor's damages after default by the lessee. Absent agreement to the contrary (Section 2A-504), this Article provides the lessor, in this section and the two preceding sections, three alternate methods of computing damages recoverable from the defaulting lessee (Section 2A-523(1)(e)). This section, as well as the two preceding sections, applies to goods subject to the lease, even if such goods have been repossessed from the lessee or otherwise (Section 2A-525(2)). This is a departure from Section 2-709, the statutory analogue. The departure is not surprising given the essential difference between a sale and a lease.

Absent the right to repossess the goods, the recovery stated in subsection (1)(a) would not compensate the lessor for his or her loss. Consider a lease of a carpet cleaner by A to B, for a term of two days. A purchased the carpet cleaner for $500.00. The rent for the two day term is $75.00. If B defaulted by not paying the rent and refusing to return the carpet cleaner and A was not allowed to repossess the carpet cleaner, the measure of damage stated in this section would allow a recovery of not more than $75.00, together with incidental damages. The rule stated in this Article, which allows the lessor the right to repossess the goods from the lessee and to recover damages, is consistent with the lessor's ownership of the goods. DeKoven, Proceedings After Default by the Lessee Under a True Lease of Equipment, in 1C P. Coogan, W. Hogan, D. Vagts, Secured Transactions Under the Uniform Commercial Code, § 29B.06[4] (1986). The statutory analogue, Section 2-709, only provides an action for the price of the goods sold, which is consistent with the seller's agreement to dispose of all of his or her right, title and interest in the goods to the buyer. That measure of damage would not have been appropriate here as the lessor's agreement is to dispose of possession and use of the goods for a term; the bargain includes the return of the goods at the end of the term. It

would be anomalous to allow the lessee to improve on the bargain, i.e. retain the goods, solely by virtue of his or her default, even if that had been balanced by allowing the lessor to sue to recover the price or value of the goods.

The measure of the lessor's damages under this section is a function of a two-part rule. First, subparagraph (1)(a) establishes a rule of recovery with respect to goods accepted by the lessee (even if repossessed by the lessor) and with respect to conforming goods lost or damaged within a commercially reasonable time after risk of loss passed to the lessee. Thus, reading subsections (1), (2) and (3) together, if accepted goods are repossessed by the lessor and the lessor holds the goods for the lessee for the balance of the term, lessor's damages will be calculated pursuant to subsection (1)(a); if the lessor leases, sells or otherwise disposes of the goods, subsection (1)(a) is inapplicable and the lessor's damages will be calculated pursuant to Section 2A-528, unless the lessor's disposition was by a substantially similar lease, in which case Section 2A-527(2) applies. Second, subparagraph (1)(b) establishes a rule of recovery with respect to goods identified to the lease contract (but not accepted by the lessee - see subparagraph (1)(a)) only if the lessor is unable, after reasonable effort, to dispose of them at a reasonable price, or if circumstances indicate the effort would be unavailing.

As a condition to the lessor's election to employ the method to measure the lessor's claim against the lessee set forth in subsection (1), the lessor must comply with subsection (2), which provides that, with one exception, goods identified to the lease contract and in the lessor's control (whether as a result of repossession or otherwise) must be held for the lessee for the balance of the lease term. This eliminates the possibility of a double recovery by the lessor and preserves the value of the leasehold estate to the lessee.

Subsection (3) creates an exception to the requirement set forth as a condition to subsection (1), that goods identified to the contract and in the lessor's control be held by the lessor. (Section 2A-529(2)). If the lessor disposes of those goods prior to collection of the judgment (whether as a matter of law or agreement), the lessor's recovery is governed by the measure of damages in Section 2A-527 if the disposition is by lease that is substantially similar to the original lease, or otherwise by the measure of damages in Section 2A-528. Section 2A-523 official comment Number 11.

The relationship between subsections (2) and (3) is best stated by examining a hypothetical. Assume the lease is for a term of two years and after default by the lessee the lessor recovers the goods from the lessee and obtains judgment against the lessee for damages pursuant to subsection (1). If the lessor holds the goods so recovered until the end of the two year term, any subsequent disposition will have no effect on the lessor's judgment. If, however, the lessor determines that the lessee is judgment proof, the lessor might be wise to dispose of the goods before the end of the remaining lease term, even though the amount that the lessor then will be allowed to recover from the lessee, as determined by the provisions of Section 2A-527 or 2A-528, is less than the judgment. Subsection (3) allows the lessor to make this election at any time before collection of the judgment.

Subsection (4), which is new, further reinforces the requisites of Subsection (2). In the event the judgment for damages obtained by the lessor against the lessee pursuant to subsection (1) is satisfied, the lessee regains the right to use and possession of the remaining goods for the balance of the original lease term; a partial satisfaction of the judgment creates no right in the lessee to use and possession of the goods.

The relationship between subsections (2) and (4) is important to understand. Subsection (2) requires the lessor to hold for the lessee identified goods in the lessor's possession. Absent agreement to the contrary, whether in the lease or otherwise, under most circumstances the requirement that the lessor hold the goods for the lessee for the term will mean that the lessor is not allowed to use them. Sections 2A-103(4) and 1-203. Further, the lessor's use of the goods could be viewed as a disposition of the goods that would bar the lessor from recovery under this section, remitting the lessor to the two preceding sections for a determination of the lessor's claim for damages against the lessee.

Subsection (5), the analogue of subsection 2-709(3), further reinforces the thrust of subsection (3) by stating that a lessor who is held not entitled to rent under this section has not elected a remedy; the lessor must be awarded damages under Sections 2A-527 and 2A-528. This is a function of two significant policies of this Article - that resort to a remedy is optional, unless expressly agreed to be exclusive (Section 2A-503(2)) and that rights and remedies provided in this Article are cumulative. (Section 2A-501(2) and (4)).

Cross References:

Sections 1-203, 2-709, 2-709(3), 2A-103(4), 2A-501(2), 2A-501(4), 2A-503(2), 2A-504, 2A-523(1)(e), 2A-525(2), 2A-527, 2A-528 and 2A-529(2).

Definitional Cross References:

"Action". Section 1-201(1).
"Conforming". Section 2A-103(1)(d).
"Goods". Section 2A-103(1)(h).
"Lease". Section 2A-103(1)(j).
"Lease agreement". Section 2A-103(1)(k).
"Lease contract". Section 2A-103(1)(l).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Present value". Section 2A-103(1)(u).
"Reasonable time". Section 1-204(1) and (2).

§ 2A-530. LESSOR'S INCIDENTAL DAMAGES.

Incidental damages to an aggrieved lessor include any commercially reasonable charges, expenses, or commissions incurred in stopping delivery, in the transportation, care and custody of goods after the lessee's default, in connection with return or disposition of the goods, or otherwise resulting from the default.

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-710.

Changes: Revised to reflect leasing practices and terminology.

Definitional Cross References:

"Aggrieved party". Section 1-201(2).
"Delivery". Section 1-201(14).

"Goods". Section 2A-103(1)(h).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).

§ 2A-531. STANDING TO SUE THIRD PARTIES FOR INJURY TO GOODS.

(1) If a third party so deals with goods that have been identified to a lease contract as to cause actionable injury to a party to the lease contract (a) the lessor has a right of action against the third party, and (b) the lessee also has a right of action against the third party if the lessee:

(i) has a security interest in the goods;

(ii) has an insurable interest in the goods; or

(iii) bears the risk of loss under the lease contract or has since the injury assumed that risk as against the lessor and the goods have been converted or destroyed.

(2) If at the time of the injury the party plaintiff did not bear the risk of loss as against the other party to the lease contract and there is no arrangement between them for disposition of the recovery, his [or her] suit or settlement, subject to his [or her] own interest, is as a fiduciary for the other party to the lease contract.

(3) Either party with the consent of the other may sue for the benefit of whom it may concern.

OFFICIAL COMMENT

Uniform Statutory Source: Section 2-722.

Changes: Revised to reflect leasing practices and terminology.

Definitional Cross References:

"Action". Section 1-201(1).
"Goods". Section 2A-103(1)(h).
"Lease contract". Section 2A-103(1)(1).
"Lessee". Section 2A-103(1)(n).
"Lessor". Section 2A-103(1)(p).
"Party". Section 1-201(29).
"Rights". Section 1-201(36).
"Security interest". Section 1-201(37).

ARTICLE 1 AND ARTICLE 9: CONFORMING AMENDMENTS

§ 1-105. TERRITORIAL APPLICATION OF THE ACT; PARTIES' POWER TO CHOOSE APPLICABLE LAW

(1) Except as provided hereafter in this section, when a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties. Failing such agreement this Act applies to transactions bearing an appropriate relation to this state.

(2) Where one of the following provisions of this Act specifies the applicable law, that provision governs and a contrary agreement is effective only to the extent permitted by the law (including the conflict of laws rules) so specified:

Rights of creditors against sold goods. Section 2-402.

Applicability of the Article on Leases. Sections 2A-105 and 2A-106.

Applicability of the Article on Bank Deposits and Collections. Section 4-102.

Bulk transfers subject to the Article on Bulk Transfers. Section 6-102.

Applicability of the Article on Investment Securities. Section 8-106.

Perfection provisions of the Article on Secured Transactions. Section 9-103.

OFFICIAL COMMENT

Uniform Statutory Source: Section 1-105, 1978 Official Text of the Act.

Changes: Subsection (2) is amended to reference two sections of the Article on Leases (Article 2A), which is being promulgated at the same time as this amendment.

§ 1-201(37). GENERAL DEFINITIONS: "SECURITY INTEREST"

(37) "Security interest" means an interest in personal property or fixtures which secures payment or performance of an obligation. The retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer (Section 2-401) is limited in effect to a reservation of a "security interest". The term also

includes any interest of a buyer of accounts or chattel paper which is subject to Article 9. The special property interest of a buyer of goods on identification of those goods to a contract for sale under Section 2-401 is not a "security interest", but a buyer may also acquire a "security interest" by complying with Article 9. Unless a consignment is intended as security, reservation of title thereunder is not a "security interest", but a consignment in any event is subject to the provisions on consignment sales (Section 2-326).

Whether a transaction creates a lease or security interest is determined by the facts of each case; however, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, and

(a) the original term of the lease is equal to or greater than the remaining economic life of the goods,

(b) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods,

(c) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement, or

(d) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

A transaction does not create a security interest merely because it provides that

(a) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than the fair market value of the goods at the time the lease is entered into,

(b) the lessee assumes risk of loss of the goods, or agrees to pay taxes, insurance, filing, recording, or registration fees, or service or maintenance costs with respect to the goods,

(c) the lessee has an option to renew the lease or to become the owner of the goods,

(d) the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed, or

(e) the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.

For purposes of this subsection (37):

(x) Additional consideration is not nominal if (i) when the option to renew the lease is granted to the lessee the rent is stated to be the fair market rent for the use of the goods for the term of the renewal determined at the time the option is to be performed, or (ii) when the option to become the owner of the goods is granted to the lessee the price is stated to be the fair market value of the goods determined at the time the option is to be performed. Additional consideration is nominal if it is less than the lessee's reasonably predictable cost of performing under the lease agreement if the option is not exercised;

(y) "Reasonably predictable" and "remaining economic life of the goods" are to be determined with reference to the facts and circumstances at the time the transaction is entered into; and

(z) "Present value" means the amount as of a date certain of one or more sums payable in the future, discounted to the date certain. The discount is determined by the interest rate specified by the parties if the rate is not manifestly unreasonable at the time the transaction is entered into; otherwise, the discount is determined by a commercially reasonable rate that takes into account the facts and circumstances of each case at the time the transaction was entered into.

OFFICIAL COMMENT

Uniform Statutory Source: Section 1-201(37), 1978 Official Text of the Act.

Changes: Substantially revised.

Purpose: This amendment to Section 1-201(37) is being promulgated at the same time that the Article on Leases (Article 2A) is being promulgated as an amendment to this Act.

One of the reasons it was decided to codify the law with respect to leases was to resolve an issue that has created considerable confusion in the courts: what is a lease? The confusion exists, in part, due to the last two sentences of the definition of security interest in the 1978 Official Text of the Act. Section 1-201(37). The confusion is compounded by the rather considerable change in the federal, state and local tax laws and accounting rules as they relate to leases of goods. The answer is important because the definition of lease determines not only the rights and remedies of the parties to the lease but also those of third parties. If a transaction creates a lease and not a security interest, the lessee's interest in the goods is limited to its leasehold estate; the residual interest in the goods belongs to the lessor. This has significant implications to the lessee's creditors. "On common law theory, the lessor, since he has not parted with title, is entitled to full protection against the lessee's creditors and trustee in bankruptcy...." 1 G. Gilmore, Security Interests in Personal Property § 3.6, at 76 (1965).

Under pre-Act chattel security law there was generally no requirement that the lessor file the lease, a financing statement, or the like, to enforce the lease agreement against the lessee or any third party; the Article on Secured Transactions (Article 9) did not change the common law in that respect. Coogan, Leasing and the Uniform Commercial Code, in Equipment Leasing - Leveraged Leasing 681, 700 n.25, 729 n.80 (2d ed. 1980). The Article on Leases (Article 2A) has not changed the law in that respect, except for leases of fixtures. Section 2A-309. An examination of the common law will not provide an adequate answer to the question of what is a lease. The definition of security interest in Section 1-201(37) of the 1978 Official Text of the Act provides that the Article on Secured Transactions (Article 9) governs security interests disguised as leases, i.e., leases intended as security; however, the definition is vague and outmoded.

Lease is defined in Article 2A as a transfer of the right to possession and use of goods for a term, in return for consideration. Section 2A-103(1)(j). The definition continues by stating that the retention or creation of a security interest is not a lease. Thus, the task of sharpening the line between true leases and security interests disguised as leases continues to be a function of this section.

The first paragraph of this definition is a revised version of the first five sentences of the 1978 Official Text of Section 1-201(37). The changes are modest in that they make a style change in the fourth sentence and delete the reference to lease in the fifth sentence. The balance of this definition is new, although it preserves elements of the last two sentences of the prior definition. The focus of the changes was to draw a sharper line between leases and security interests disguised as leases to create greater certainty in commercial transactions.

Prior to this amendment, Section 1-201(37) provided that whether a lease was intended as security (i.e., a security interest disguised as a lease) was to be determined from the facts of each case; however, (a) the inclusion of an option to purchase did not itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee would become, or had the option to become, the owner of the property for no additional consideration, or for a nominal consideration, did make the lease one intended for security.

Reference to the intent of the parties to create a lease or security interest has led to unfortunate results. In discovering intent, courts have relied upon factors that were thought to be more consistent with sales or loans than leases. Most of these criteria, however, are as applicable to true leases as to security interests. Examples include the typical net lease provisions, a purported lessor's lack of storage facilities or its character as a financing party rather than a dealer in goods. Accordingly, amended Section 1-201(37) deletes all reference to the parties' intent.

The second paragraph of the new definition is taken from Section 1(2) of the Uniform Conditional Sales Act (act withdrawn 1943), modified to reflect current leasing practice. Thus, reference to the case law prior to this Act will provide a useful source of precedent. Gilmore, Security Law, Formalism and Article 9, 47 Neb. L. Rev. 659, 671 (1968). Whether a transaction creates a lease or a security

interest continues to be determined by the facts of each case. The second paragraph further provides that a transaction creates a security interest if the lessee has an obligation to continue paying consideration for the term of the lease, if the obligation is not terminable by the lessee (thus correcting early statutory gloss, e.g. In re Royer's Bakery, Inc., 1 U.C.C. Rep. Serv. (Callaghan) 342 (Bankr. E.D. Pa. 1953)) and if one of four additional tests is met. The first of these four tests, subparagraph (a), is that the original lease term is equal to or greater than the remaining economic life of the goods. The second of these tests, subparagraph (b), is that the lessee is either bound to renew the lease for the remaining economic life of the goods or to become the owner of the goods. In re Gehrke Enters., 1 Bankr. 647, 651-52 (Bankr. W.D. Wis. 1979). The third of these tests, subparagraph (c), is whether the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or for nominal additional consideration, which is defined later in this section. In re Celeryvale Transp., 44 Bankr. 1007, 1014-15 (Bankr. E.D. Tenn. 1984). The fourth of these tests, subparagraph (d), is whether the lessee has an option to become the owner of the goods for no additional consideration or for nominal additional consideration. All of these tests focus on economics, not the intent of the parties. In re Berge, 32 Bankr. 370, 371-73 (Bankr. W.D. Wis. 1983).

The focus on economics is reinforced by the next paragraph, which is new. It states that a transaction does not create a security interest merely because the transaction has certain characteristics listed therein. Subparagraph (a) has no statutory derivative; it states that a full payout lease does not per se create a security interest. Rushton v. Shea, 419 F. Supp. 1349, 1365 (D. Del. 1976). Subparagraph (b) provides the same regarding the provisions of the typical net lease. Compare All-States Leasing Co. v. Ochs, 42 Or. App. 319, 600 P.2d 899 (Ct. App. 1979) with In re Tillery, 571 F.2d 1361 (5th Cir. 1978). Subparagraph (c) restates and expands the provisions of former Section 1-201(37) to make clear that the option can be to buy or renew. Subparagraphs (d) and (e) treat fixed price options and provide that fair market value must be determined at the time the transaction is entered into. Compare Arnold Mach. Co. v. Balls, 624 P.2d 678 (Utah 1981) with Aoki v. Shepherd Mach. Co., 665 F.2d 941 (9th Cir. 1982).

The relationship of the second paragraph of this subsection to the third paragraph of this subsection deserves to be explored. The fixed price purchase option provides a

useful example. A fixed price purchase option in a lease does not of itself create a security interest. This is particularly true if the fixed price is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed. A security interest is created only if the option price is nominal and the conditions stated in the introduction to the second paragraph of this subsection are met. There is a set of purchase options whose fixed price is less than fair market value but greater than nominal that must be determined on the facts of each case to ascertain whether the transaction in which the option is included creates a lease or a security interest.

It was possible to provide for various other permutations and combinations with respect to options to purchase and renew. For example, this section could have stated a rule to govern the facts of In re Marhoefer Packing Co., 674 F.2d 1139 (7th Cir. 1982). This was not done because it would unnecessarily complicate the definition. Further development of this rule is left to the courts.

The fourth paragraph provides definitions and rules of construction.

§ 9-113. SECURITY INTERESTS ARISING UNDER ARTICLE ON SALES OR UNDER ARTICLE ON LEASES

A security interest arising solely under the Article on Sales (Article 2) or the Article on Leases (Article 2A) is subject to the provisions of this Article except that to the extent that and so long as the debtor does not have or does not lawfully obtain possession of the goods

(a) no security agreement is necessary to make the security interest enforceable; and

(b) no filing is required to perfect the security interest; and

(c) the rights of the secured party on default by the debtor are governed (i) by the Article on Sales (Article 2) in the case of a security interest arising solely under such Article or (ii) by the Article on Leases (Article 2A) in the case of a security interest arising solely under such Article.

OFFICIAL COMMENT

Uniform Statutory Source: Section 9-113, 1978 Official Text of the Act.

Changes: This section is amended to include security interests arising under the Article on Leases (Article 2A), which is being promulgated at the same time as this amendment. Section 2A-508(5). After the effective date of the amendment to this section all references in the Act to Section 9-113 will be deemed to refer to this section, as amended. E.g., Sections 9-203(1) and 9-302(1)(f).

Cross Reference:

Article 2A, esp. Section 2A-508(5).

Definitional Cross References:

"Agreement". Section 1-201(3).
"Goods". Section 2A-103(1)(h).
"Lease". Section 2A-103(1)(j).
"Party". Section 1-201(29).
"Rights". Section 1-201(36).
"Sale". Section 2-106(1).
"Security interest". Section 1-201(37).

UNIFORM STATE LAWS

What are they?

Uniform State Laws are the products of a unique organization that has been working for the improvement of state laws since 1892. The National Conference of Commissioners on Uniform State Laws, representing both state government and the legal profession, is a genuine confederation of state interests.

Today there are more than 300 practicing lawyers, judges, law professors and government officials serving as Uniform Law Commissioners (ULC). These state-appointed commissioners, selected for their wide range of legal expertise and experience, provide an immeasurable resource for drafting "uniform" and "model" state laws.

ULC Uniform Acts, Codes and Court Rules – needed where differences in state laws create specific interstate and national problems – have ranged from eliminating jurisdictional child custody disputes to addressing the legalities of electronic transfer of stock ownership.

When uniformity is neither practical nor necessary, ULC Model Acts have provided states with a concisely-structured legislative framework adaptable to their particular needs and problems – in areas such as sentencing and correction reform, and state administrative procedures.

Differences in state laws can deter the free flow of goods, credit and services; restrain full economic growth; and invite federal intervention to compel uniformity. Constitutionally, states have wide latitude for cooperating to solve these problems. ULC is their own cooperative institution for doing so, as well as for contributing to the continuing process of law reform and progress.

Back in 1892

The "Gay Nineties" rolled in on the railroad tracks that were tying the nation together. And Americans were beginning to swap horses for bicycles and motor cars. This new mobility was the prime factor from which ULC sprang.

The Alabama State Bar Association recognized, as early as 1881, the legal tangles created by wide variations in state laws. But it was not until August, 1889, that the American Bar Association decided at its 12th annual meeting to work for "uniformity of the laws" in the 44 states.

Within a year, the New York legislature authorized the governor to appoint three commissioners to explore the best way to effect uniformity of law to ease problems developing between increasingly interdependent states. The ABA endorsed New York's action. The result was the first meeting of the "Conference of State Boards of Commissioners on Promoting Uniformity of Law in the U.S."

Seven states sent commissioners to that 1892 meeting. By 1900, 32 states and two territories had law commissioners. By 1905, only Nevada and Alaska were holdouts, and they joined the parade in 1911.

National Conference
of Commissioners
on Uniform State Laws
676 North St. Clair Street
Chicago, Illinois 60611
(312) 915-0195

Uniform Law Commissioners

UNIFORM STATE LAWS

Cost and Value

States provide nearly all of the funds for ULC by means of a system of assessments based on population. Most of the money is used to support the work of the drafting committees, and to explain Uniform and Model Acts to legislators, other government officials and specialized and general audiences.

ULC gets maximum results from minimum budgets because its major asset – drafting expertise – is donated. The only compensation received by Uniform Law Commissioners is that of knowing they have provided states with solutions to their legal problems. They receive no salaries or fees for their work as commissioners.

This means that lawyers devote hundreds and even thousands of hours–amounting in some cases to millions of dollars worth of time–to the development of ULC proposals. No state could afford the bills for the legal expertise that goes into the drafting of each ULC Uniform or Model Act.

In appraising ULC's value to the states, it is also important to look at its impact on their treasuries. Most ULC proposals rely on "private law," or law governing individual relationships without intervention or regulation by any state agency – except where redress is sought in state courts for breach of a legal obligation. By contrast, "public law" provides for regulation, generally by an executive agency. ULC helps states avoid the costs of creating new regulatory agencies.

The Hard Job

When drafting is completed on an act, a Uniform Law Commissioner's work has only begun. Commissioners then work for adoption of the proposal by the states. Normal resistance to anything "new" makes this the hardest part of a commissioner's job. But the result can be workable modern state law that helps keep the federal system alive.

GENESIS of a Law

Anyone can ask ULC to draft a law. But not all requests are pressing enough to claim its time and resources. Determining the need for and feasibility of a proposed new law, then, is an important first step. The decision to draft is preceded by a thorough screening process:

- Initial screening of requests for new drafting projects is done by the Scope and Program Committee. This group evaluates the need, urgency, current state of law in the affected area, and feasibility of enactment before making a recommendation to the Executive Committee to further review the request.
- Executive Committee members look at a request in terms of ULC's financial and member resources as well as the availability of additional expertise and funding to insure success of the draft. If these appear favorable to the project, they appoint a special Drafting Committee.
- Foundation and government grants support some of ULC's drafting efforts, making it possible to expand advisory committee participation, and to retain expert reporter-draftsmen – usually lawyers experienced in the field – for maximum input and assistance to the Drafting Committee.

Drafting proceeds at meetings of this special committee held thoughout the year. After basic premises and philosophy are decided, a "first tentative draft" is developed for circulation to experts both within and outside the legal profession, to draw criticism and suggestions that will shape succeeding drafts.

Uniform and Model Acts are a minimum of two years in preparation, since they must be considered at no less than two annual meetings by all commissioners sitting as a Committee of the Whole.

Before any annual meeting presentation, a Review Committee for each act determines: 1) whether the draft conforms to the assignment; 2) what policy decisions were made by drafters; and 3) whether the draft is ready for scrutiny "line by line" by the entire Conference.

Once ULC as a whole approves an act, its final test is by a vote by states – one vote per state. A majority of states present, and no less than 20 states, must vote approval of an act before it can be officially adopted as a Uniform or a Model Act, Code or Court Rule.

This unique and lengthy process of screening, drafting, revising and polishing is responsible for the fine edge of excellence that marks ULC "products." After receiving the ULC stamp of approval, a Uniform or Model Act is officially promulgated for consideration by the states.

Legislatures are urged to adopt *Uniform Acts* exactly as written, to "promote uniformity in law among the several states."

Model Acts, on the other hand, are designed to serve as guideline legislation, which states can borrow from or adapt to suit their individual needs and conditions.

Commissioners

Each of the 50 states, the District of Columbia and Puerto Rico select lawyers to serve on their uniform state law commissions. Since ULC is a confederation of state commissions, each state sets its own rules for selection. Most have at least three, and the governor usually selects them.

Considered non-partisan, many commissioners receive their first appointment from a governor of one party, then continue under another party, thus serving for decades.

Famous commissioners include President Woodrow Wilson; Supreme Court Justices Louis D. Brandeis and William F. Rehnquist, and the Harvard Law legend, Roscoe Pound.

Updating Acts

Exemplifying a Uniform Act, the Uniform Commercial Code (UCC) structures nearly all commercial transactions in every state in the U.S. Another ULC proposal having wide influence is the Model State Administrative Procedure Act (MSAPA). Most states have adopted it, and look to its provisions to guide their state agencies.

Both UCC and MSAPA are successes that states have benefited from. But even the best of laws is outdated by technological and social change. Thus, one of the duties of the ULC leadership is to constantly review past successes, checking their relevance for today.

Several methods insure that needed updating goes on. For the Commercial Code, the problem is solved by a "Permanent Editorial Board" charged with keeping abreast of developments that require changes in the law.

The Model State Administrative Procedure Act, however, requires appointment of a new committee to revise quarter-century-old rules developed before state governments "boomed" in the 60s and 70s.

Whether a ULC proposal is brand new, a revision, or an amendment, state government can be sure that it's in step with the times.

A Tradition of Excellence

A Brief History of ULC & How It Works

It was a century ago that lawyers first recognized how wide variations in state laws could tangle interstate problems. The Alabama State Bar Association is credited with taking the first formal action to encourage development of "uniform" laws to deal with the problem. That came in an 1881 resolution.

But it was not until August, 1889, when the American Bar Association was holding its 12th annual meeting, that there was a formal move to work for "uniformity in the laws" of the then 44 states.

Within a year, the New York Legislature authorized that state's governor to appoint three commissioners "to examine the subjects of marriage and divorce, insolvency, the form of notarial certificates and other subjects; to ascertain the best means to effect an assimilation and uniformity of the laws of the states; and especially to consider whether it would be wise and practicable for the state of New York to invite other states of the Union to send representatives to a convention to draft uniform laws to be submitted for the approval and adoption of the several states. . ."

A few months later, the ABA endorsed the New York action and urged every other state, the District of Columbia and territorial legislatures to follow the example.

In the Beginning – Seven States

Other states heeded the call. When the first meeting of the "Conference of State Boards of Commissioners on Promoting Uniformity of Law in the U.S." was held in Saratoga, N.Y., Aug. 24, 1892, seven states sent commissioners. They were Delaware, Georgia, Massachusetts, Michigan, New York, New Jersey and Pennsylvania.

The new commissioners didn't waste time. They immediately completed and urged states and territories to adopt three acts – Act Relating to Acknowledgments on Written Instruments; Act Validating Wills Lawfully Executed Without the State; and Act Recognizing as Valid, Wills Probated in Another State.

These first commissioners on uniform laws also recommended that states enact laws governing payment of notes; validating contracts; divorce; and marriage. The latter included raising the marrying age to 18 for males and 16 for females.

They also adopted a table of weights and measures after noting "it will probably be a surprise to most people to learn that legal weights of a bushel . . . with the exception of wheat alone, vary in all states."

After this first burst of activity, the Conference produced no other proposals until 1896 when the Negotiable Instruments Act was completed. This was to become the only act adopted by every state and the District of Columbia.

Then There Were 32

By the turn of the 20th Century, 32 states and two territories had appointed commissioners on uniform laws. During their second decade, Uniform Law Commissioners (ULC) concentrated on legislation that made interstate commerce easier. The resulting laws dealt with sales, warehousing and transportation. A majority of states adopted all of them before these pioneer acts – along with the Negotiable Instruments Act – were superseded by the Uniform Commercial Code (UCC).

In 1905, only Nevada and the Territory of Alaska still had not appointed commissioners. But they joined the club in 1911.

In its third decade, the Conference considered and adopted legislative proposals on a number of issues and problems ranging from partnerships to child labor. And in 1915, the organization officially became the National Conference of Commissioners on Uniform State Laws.

The "Roaring 20s" drummed up new problems and ULC responded with proposals in such areas as aviation and public utilities. In the 1930s, commissioners wrestled with machine gun laws as well as torts and trusts.

Fifty-Year Assessment

As the Conference approached its Golden Anniversary year, its leadership began to reassess its role and to try to determine how ULC could better serve the federal system. Though the past had been productive, commissioners decided they could be even more useful in the future if they attacked major problems with comprehensive solutions rather than trying to cope with them a piece at a time.

The result was the launching of the project that produced the Uniform Commercial Code (UCC). In 1940, ULC officially took on the task of drafting a comprehensive code to provide guidelines for all commercial transactions. Work on some of its components already had begun. In 1947, ULC and the American Law Institute joined in a partnership that put all of the components together into a UCC that was offered to the states for their consideration in 1951. Then came the tedious battles for adoption in every state legislature. By 1967, Louisiana was the lone holdout and it still has not adopted all of UCC.

The breadth and depth of UCC is difficult to grasp. It guarantees that "commercial" transactions in California are subject to the same law as those in Maine. A child purchasing penny candy in a neighborhood shop and a manufacturer buying robot welders for his assembly lines both complete their transactions within the framework of UCC. In UCC states, the code encompasses every sale of goods from crude oil to autos; every bank check written; and all commercial paper, stock and bond transactions.

Success of UCC inspired commissioners to produce and work for adoption of a wide variety of comprehensive legislative solutions to basic state problems. These include: the Uniform Probate Code; Uniform Consumer Credit Code; Uniform Marriage and Divorce Act; Uniform Alcoholism and Intoxication Treatment Act; and a package of proposals designed to do for land transactions what UCC did for commercial transactions – provide modern law to deal with modern problems.

While it was forging its major projects over the past two decades, ULC also managed to commence and complete legislation needed by states to deal with more specific problems. These include such proposals as the Uniform Child Custody Jurisdiction Act; Uniform Anatomical Gift Act; Uniform Class Actions Act; and Uniform Determination of Death Act.

Uniform and Model Acts

In addition to "Uniform Acts," which every state is urged to adopt, ULC also drafts "Model Acts" to guide legislatures dealing with issues that need not be treated uniformly by all states. Some models – such as the Model State Administrative Procedure Act – have been adapted for use by most states.

It's important to state treasuries that most ULC proposals fall into the category of "private law" – the body of law based on English common law that governs the basic legal relationships between people. No governmental body intervenes in "private law" relationships. People conduct their affairs without interference. When a breach of a legally enforceable, private obligation occurs, the courts are available to sort out the facts and grant remedies which range from monetary payments to injunctive relief. For example, the Uniform Residential Landlord and Tenant Act governs the contractual relationship between landlord and tenant. This relationship proceeds unfettered unless a party breaches an obligation – such as a landlord's obligation to maintain fit and safe premises. If such a breach occurs, then the wronged party can seek damages and reparations for losses sustained.

This contrasts with "public law" which usually involves using an executive agency, or bureau, as a regulatory body. In that case, legislatures enact laws vesting authority in an administrative agency which then carries out the duties of investigator, rulemaker, regulator and enforcer. Because new agencies must be created to enforce public law, it usually costs more money.

Why the Conference Works

Dedicated commissioners make the Conference work. They include about 250 practicing lawyers, law professors and judges. It is the effort contributed by these people – commissioners receive no salaries or fees for their work with the Conference – that earned NCCUSL the media label of "prestigious." In this century, President Woodrow Wilson and U.S. Supreme Court Justices Louis D. Brandeis and William F. Rehnquist served as commissioners. So did such law school legends as Roscoe Pound of Harvard.

Commissioners are appointed by each of the 50 states, the District of Columbia and Puerto Rico. The number of commissioners appointed (most states have at least three) and the method of appointment varies from state to state. In most states, the governor is responsible for appointments. But commissioners usually are considered non-partisan. This leads to many commissioners being appointed by the governor of one party and reappointed by the governor of another party. In this way, some commissioners serve ULC for decades.

A Two-Part Job

Such dedicated commissioners usually relish both parts of their unpaid service. This includes drafting and then working for enactment of modern legislation designed to solve problems common to all states.

ULC's reputation was built on the high quality of its drafts. That quality is the result of a procedure structured to bring a unique blend of legal minds to bear on a problem. It begins with the choice of a drafting committee whose members are selected to insure that as much expertise and as many viewpoints as possible will be represented at the drafting table.

For example, there were a number of real estate law experts appointed to the committee responsible for preparing preliminary drafts of the land transactions package which includes the Uniform Land Transactions Act (ULTA), Uniform Simplification of Land Transfers Act (USOLTA), Uniform Condominium Act (UCA), Uniform Planned Community Act (UPCA) and Model Real Estate Cooperative Act (MRECA). These included commissioners who were law school professors as well as practicing lawyers specializing in

real estate law. Then lawyer and non-lawyer experts were invited to provide specialized knowlege to the committee. These advisers represented associations of lenders, builders, sellers, lawyers and consumers. But all decisions were made by commissioners who represent only the people of their states.

The Drafting Ordeal

Preliminary drafts of the proposals were prepared and circulated to advisers and others interested in the committee's deliberations. That included every commissioner. Eventually, the committee was ready to present its work at an annual meeting of ULC for "initial consideration" by every commissioner.

During the annual meeting, commissioners assemble for a week or more to spend every day and some nights studying each "tentative draft" prepared by the committees. The drafts are read "line-by-line" and then discussed, debated and changed. With more than 200 pairs of trained eyes probing every concept and word, it's a rare draft that leaves an annual meeting in the same form as it goes in. Because ULC is a confederation of state commissions on uniform laws, close issues are decided by polling state delegations. Regardless of the number of representatives from each state, each state has only one vote.

Shortly after the annual meeting ends, committees with uncompleted drafts begin incorporating changes made during the meeting and dealing with new problems raised by commissioners and non-commissioners.

Proposals are subjected to this rigorous procedure for at least two annual meetings before they become eligible for designation as ULC products. The final decision on whether a proposal is ready for "promulgation" to the states is made near the close of an annual meeting – again on a one-state, one-vote basis. But the procedure can take much longer. Because of the complexities of ULTA, USOLTA, UCA, UPCA and MRECA, a decade elapsed before the proposals were adopted by ULC.

Conference Proposes – State Disposes

When drafting is completed, a commissioner's job has only begun. Each now is obligated to go back to his state and work for adoption of the completed proposals.

Normal resistance to anything "new" makes this the most difficult part of a commissioner's responsibility. Remember, it took 14 years before UCC was adopted by 49 states.

But the result can be workable, modern state law that helps keep the federal system alive. The work of ULC simplifies the legal life of businesses and individuals by providing rules and procedures that are consistent from state to state. And it insures that problems can be solved close to home in state courts and agencies rather than being lost in overworked federal courts and U.S. departments and agencies.

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Introduced: 1/9/89
Referred: Labor and Commerce and
Judiciary

go00629s

IN THE SENATE

BY THE RULES COMMITTEE BY REQUEST OF THE GOVERNOR

SENATE BILL NO. 88

IN THE LEGISLATURE OF THE STATE OF ALASKA

SIXTEENTH LEGISLATURE - FIRST SESSION

A BILL

For an Act entitled: "An Act relating to investment securities under the Uniform Commercial Code."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

* Section 1. AS 45.01.201(5) is amended to read:

(5) "bearer" means the person in possession of an instrument, document of title, or certificated security payable to bearer or endorsed in blank;

* Sec. 2. AS 45.01.201(14) is amended to read:

(14) "delivery" with respect to instruments, documents of title, chattel paper, or certificated securities means voluntary transfer of possession;

* Sec. 3. AS 45.01.201(20) is amended to read:

(20) "holder" means a person who is in possession of a document of title or an instrument or a certificated [AN] investment security drawn, issued, or endorsed to the person or to the order of the person or to bearer or in blank;

* Sec. 4. AS 45.05.114(b) is amended to read:

(b) Unless otherwise agreed, if documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (AS 45.07.507) or of a certificated security (AS 45.08.306) or is forged or fraudulent or there is fraud in the transaction.

(1) the issuer must honor the draft or demand for payment

if honor is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course (AS 45.03.302) and in an appropriate case would make it a person to whom a document of title has been duly negotiated (AS 45.07.502) or a bona fide purchaser of a certificated security (AS 45.08.302); and

(2) in all other cases as against its customer, an issuer acting in good faith may honor the draft or demand for payment despite notification from the customer of fraud, forgery, or other defect not apparent on the face of the documents, but a court of appropriate jurisdiction may enjoin this honor.

* Sec. 5. AS 45.08.102 is repealed and reenacted to read:

Sec. 45.08.102. DEFINITIONS AND INDEX OF DEFINITIONS. (a) In this chapter, unless the context otherwise requires,

(1) a "certificated security" is a share, participation, or other interest in property of or an enterprise of the issuer or an obligation of the issuer which is

(A) represented by an instrument issued in bearer or registered form;

(B) of a type commonly dealt in on securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment; and

(C) either one of a class or series or by its terms divisible into a class or series of shares, participations, interests, or obligations;

(2) an "uncertificated security" is a share, participation, or other interest in property or an enterprise of the issuer or an obligation of the issuer which is

(A) not represented by an instrument and the transfer

SB 87 cont'd

Section 2 of the bill adds a new section, AS 44.47.525. to authorize DCRA to make certain loan modifications on mortgages that it has financed under AS 44.47.370 -- 44.47.-560. In making the loan modifications, the department must find that the modification(s) will be advantageous to both the borrower and the state and would be considered prudent by private lending standards. The types of loan modifications that the department may make are (1) rescheduling principal payments; or (2) reducing interest rates within specified guidelines; or (3) both. The department is required to adopt regulations prescribing the terms and conditions of, and the procedures for, the loan modifications authorized in this bill.

The provisions and guidelines specified in sec. 2 will provide DCRA with the needed flexibility to address the needs of borrowers with mortgages that exceed their present ability to make the required payments, while assuring that a loan modification is also made in the best interests of the state.

Section 3 provides a definition of "limited commercial use."

Finally, sec. 4 provides for an effective date of July 1, 1989.

I urge your support of this bill.

Sincerely,

/s/
Steve Cowper
Governor

SB 88

SENATE BILL NO. 88 by the Rules Committee by request of the Governor, entitled:

"An Act relating to investment securities under the Uniform Commercial Code."

was read the first time and referred to the Labor and Commerce Committee and the Judiciary Committee.

Zero fiscal notes published today from Department of Law, Department of Revenue and Department of Natural Resources.

Governor's transmittal letter dated January 9:

SB 88 cont'd

Dear Senator Kelly:

Under the authority of art. III, sec. 18, of the Alaska Constitution, I am transmitting a bill to enact the 1977 amendments to Article 8 of the Uniform Commercial Code, on investment securities. These amendments were developed by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in cooperation with the American Law Institute and the American Bar Association. These amendments, already enacted in 35 states, are essential to update Alaska's version of the Uniform Commercial Code (UCC) and recognize modern methods and necessities of financial transactions.

In trading securities, electronic transfers have become quite common and may, ultimately, make paper certificates obsolete. This bill proposes to keep up with these changes in the securities industry by introducing the concept of uncertificated securities. In the new Article 8 (AS 45.08 in Alaska's version of the UCC), the term "instrument" will no longer imply the existence of specific pieces of paper that act as evidence of obligations between people. These amendments have been endorsed by the Securities Industry Committee of the American Society of Corporate Secretaries.

This bill proposes to maintain Alaska's version of the Uniform Commercial Code as up-to-date as possible.

Sincerely,

/s/
Steve Cowper
Governor

SB 89

SENATE BILL NO. 89 by Senator Faiks, entitled:

"An Act relating to civil liability of zoos and zoo operators."

was read the first time and referred to the Judiciary Committee.

SB 90

SENATE BILL NO. 90 by Senator Faiks, entitled:

"An Act repealing the Railbelt energy fund' and providing for an effective date.

AMENDMENTS TO ARTICLE 8
OF THE UNIFORM COMMERCIAL CODE (UCC)

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* "Why every state needs the Article 8 Amendments - Now"

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* "A Certificateless Article 8 ? We Can Have It Both Ways," by Martin J. Aronstein, from The Business Lawyer, January 1976

* Endorsement of Article 8 Amendments by the Securities Industry Committee of the American Society of Corporate Secretaries

* Endorsement of Article 8 Amendments by the Securities Industry Association

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A Certificateless Article 8? We Can Have It Both Ways

By MARTIN J. ARONSTEIN*

IN THE aftermath of the "Paperwork Crunch" which seriously impaired the operation of the securities markets during the late 1960s, the air was filled with proposals for reform. Not surprisingly, many of these proposals focused on the elimination of the most visible manifestation of paperwork problems—the negotiable stock certificate. But it was correctly perceived that "The Certificateless Society" was incompatible with an existing legal regime firmly based on the assumption that shares of corporate stock must inevitably be represented by indispensable instruments. In an effort to resolve this incompatibility, the American Bar Association's Section of Corporation, Banking and Business Law organized a Committee on Stock Certificates. The Committee was charged with the duties of determining what legislation, if any, would be needed to facilitate the elimination of negotiable stock certificates and of drafting such legislation. The Committee issued its Report on September 15, 1975.[1] The author served as the Committee's Reporter.

This article is intended to be neither a summary of nor a substitute for the Committee's Report. Rather, its primary objective is to call the Bar's attention to the Committee's project and to enlist the cooperation of the Bar in the implementation of the Committee's recommendations. Its secondary, and somewhat selfish, objective is to permit the Reporter to express some personal views which are outside the scope of the Report and which are not necessarily shared by the Committee or its other individual members.

At the risk of sacrificing the element of surprise, it should be stated at the outset that the Committee's principal recommendations are two. The first is the relatively minor amendment of state corporation statutes to validate the issuance of stock not represented by certificates.[2] The second is a major and comprehensive revision of Article 8 and related sections in other Articles of the Uniform Commercial Code intended to govern the attributes of uncertificated shares.[3] The Committee does not recommend the adoption of general federal legislation at this time but recognizes that such legislation may be required in the future. One of the circumstances that would seem almost certain to lead to federal intervention would be the failure of the state legislatures

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not stood still. Out in the marketplace, where stock is actually dealt with, the development of certificateless transfer has proceeded—apace, in the view of some, and with too deliberate speed, in the opinion of others. As the Report describes in some detail, significant strides toward "The Certificateless Society" have already been made without the benefit of any substantial statutory change. Existing certificateless systems, which may be broadly defined as methods to transfer stock without the physical movement of indispensable prices of paper, masquerade under a variety of appellations. The common legal basis of each of these systems, however, is that somewhere a certificate exists and that someone is holding it as the shareholder's agent-bailee.

The most rudimentary form of certificatelessness is the street name brokerage account.[6] In this arrangement, the broker acts as the agent of the customer, a single undisclosed principal, and holds the certificate as the customer's bailee. Certificate movement is eliminated between customer and broker when the customer buys or sells through his broker-agent. Certificates continue to be used for transactions with the issuer, like presentment for registration of transfer, redemption or exchange, and for transfers for value to or from third party buyers, sellers and pledgees. There is, however, one common transfer for value, the customer's pledge to secure a margin loan from the broker, which, by virtue of the broker's prior possession, can be effected without certificate movement. There is also the comparatively rare transfer for value between two customers of the same broker, when, at the same time, one buys and the other sells the same security. This transfer is effected simply by the entries on the broker's books.[7] By and large, common law principles of agency, reinforced by safeguards imposed by the federal securities law and the self-regulatory organizations, have proved adequate to govern the relationship between the customer and his broker. Article 8's certificate-based law continues to govern the relationships with issuers and other third parties.

The independent securities depository is, in legal effect, an extension of the brokerage account model, but with one important exception. Like the broker, the depository holds certificates in its name and deals with the issuer and other outsiders as the agent of an undisclosed principal. The principal is the aggregate of the depository's customers, usually referred to as participants. Unlike the typical brokerage situation, however, transactions between participants are neither rare nor fortuitous but, rather, are commonplace and by design. Indeed, the primary objective of the depository is to permit transfers between the principals of a common agent without certificate movement.

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argue, of course, that a security interest in uncertificated mutual fund shares could be perfected under section 9-305 by simply giving notice to the transfer agent in his imagined capacity as the bailee of the debtor's certificate. It is highly doubtful, however, that a prudent lender or his counsel could be persuaded to advance the loan under those circumstances. Furthermore, few, if any, transfer agents would have any institutionalized procedure for dealing with such a notice even if one were received. In the pledge situation, therefore, both the lender and the issuer take refuge in the only procedure now expressly validated by statute—the issuance of a certificate to the shareholder and the delivery of that certificate to the lender. Reliance on the agency-bailment rationale is just not commercially acceptable under the present law.

The dividend reinvestment plans, in which the typical transaction is the purchase of small numbers of shares for participating shareholders,[11] operate without certificates for essentially the same reasons that have led to certificatelessness in the mutual funds. When, however, the participant wishes to deal with his shares in another transaction, issuers respond, in almost every case, by issuing certificates.[12] Unlike mutual fund shares, however, the shares accumulated in the dividend reinvestment plan accounts are the very same intangible interests that are commonly traded in normal market transactions and used as collateral for secured loans. Officials of American Telephone & Telegraph Co., which operates the largest of such plans, are confident that they could develop adequate procedures to deal with both the outright transfer and the pledge of uncertificated shares by book-entry if only a satisfactory legal framework could be provided. The potential demand for such procedures is foreshadowed by the fact that, after only slightly more than two years of operation, AT&T was "holding," as the nominal agent-bailee for some 541,000 shareholders, more than 9 million uncertificated shares.

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the depository, in effect, represents to the transferee that the subject matter of the transfer exists and has been transferred to him. Thus, the transferee receives the same assurance that the receipt of a clean, duly indorsed certificate would afford him. It is in reliance on the depository's representation that the transferee parts with his consideration with confidence that he has received the benefit of his bargain.

The depository concept was a logical outgrowth of the clearing facilities maintained by the various stock exchanges. For years these facilities were utilized to monitor and expedite the transfer of funds and the delivery of securities between exchange members. Although these simultanous exchanges were nominally between individual members, they were made through the clearinghouse which became a de facto intermediary in the exchange. Viewing the clearinghouse as an independent party, dealing with all members, was a transition more in form than substance. The clearinghouse's function as a depository of both funds and securities followed quite naturally from its function as a mere record-keeper.

The statutory validation of book-entry transfer was initially limited, by the terms of section 8-102(3), to entities wholly-owned by a securities exchange or association. The growth of the depository concept in the United States has, therefore, taken place almost exclusively in conjunction with the exchanges. There is general agreement that the Depository Trust Co., the New York depository which now controls over 2 billion shares of stock, has served its broker participants well. It should be remembered, however, that these brokers were already participating in a system which settled the money side of transactions with essentially the same mechanism by which the securities side is now settled.

The exchange-related depository has also provided a mechanism to facilitate another kind of transfer for value—the broker's loan. In these transactions, lending banks, participating as "pledgees," are satisfied to advance funds to borrowing brokers on the strength of the depository's representation that the broker's stock, by virtue of the depository's book-entry, has been as effectively pledged as would be the case if certificates had been delivered to them by the brokers. The demonstrable saving that can be achieved by eliminating certificate delivery upon pledge and re-delivery upon release has resulted in the substantial use of this procedure by the banks.[15]

The expansion of the exchange-related depositories to include significant participation by banks (other than as pledgees), insurance companies, pension funds and other institutional investors is far from foreordained. These investors are not, as are the brokers, under a constant obligation to make daily settlements with their counterparts through an institutionalized clearing facility. They have typically made independent arrangements for C.O.D. settlements directly or through bank agents. For them, the use of a depository

15. The procedure has also made it feasible for banks located in areas remote from the financial centers to compete with the local banks for the brokers' loan business.

What the foregoing discussion suggests is that the concept of certificate immobilization in independent depositories is far from certain to result in a satisfactory reduction in the paperwork problems of the securities industry. The elimination of stock certificates, or, in the current fictionalized parlance, the use of the issuer or its transfer agent as a "depository," may prove to be at least a significant part of the ultimate solution. If that be the case, the burden of developing the mechanisms that will be commercially acceptable alternatives to the simultaneous certificate-for-money exchange rests upon the industry. It is our function, as lawyers, to make sure that the governing law will provide an environment in which industry-developed systems can be implemented with confidence in their legal consequences. Our proposed revision of Article 8 is an attempt to create that environment.

Drafting the Statute

Professor Jolls has suggested that a statute governing the attributes of uncertificated shares need not be nearly so complex as Article 8 and might take the form of an additional article of the Uniform Commercial Code, perhaps denominated Article 8A.[18] Our initial attempts to draft such a separate statute convinced us, for several reasons, that an integration of the rules for certificated and uncertificated shares and, necessarily, a complete revision of present Article 8 would be the more fruitful approach.

The process of putting pencil to paper for the first time exposed a number of problems that would have to be dealt with in a separate article. Parties dealing with uncertificated shares should be able to find, in the governing statute, the answers to all questions answered by present Article 8 except where the question, by its nature, has no application in the absence of a certificate. Could an issuer's lien exist? What is the effect of an issuer's restriction on transfer? Who, if anyone, could be a bona fide purchaser? Were there exceptions to the statute of frauds? Was there a statute of frauds? The dozen or so basic sections that Professor Jolls suggested might constitute an adequate statute grew quickly and substantially in number.

Even more important, our observation of what was taking place in the industry convinced us that the total elimination of stock certificates, even if ultimately realized, was a very long way off. What we saw was a system in which both certificated and uncertificated shares would continue to co-exist, in many cases, within the same issue of securities. Under those circumstances, the rules for each form of stock would, in many instances, require exceptions in the corresponding rules for the other form. For example, the seller's duty to perform, stated in section 8-314, might be satisfied not only by the delivery of a certificate but also by the transfer of an equivalent uncertificated security. Even assuming the ultimate elimination of certificates for a particular issue,

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18 Jolls, *The Uniform Commercial Code and the Certificateless Society*, 26 Bus. Law. 627 (1971).

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A Certificateless Article 8? We Can Have It Both Ways

By MARTIN J. ARONSTEIN*

IN THE aftermath of the "Paperwork Crunch" which seriously impaired the operation of the securities markets during the late 1960s, the air was filled with proposals for reform. Not surprisingly, many of these proposals focused on the elimination of the most visible manifestation of paperwork problems—the negotiable stock certificate. But it was correctly perceived that "The Certificateless Society" was incompatible with an existing legal regime firmly based on the assumption that shares of corporate stock must inevitably be represented by indispensable instruments. In an effort to resolve this incompatibility, the American Bar Association's Section of Corporation, Banking and Business Law organized a Committee on Stock Certificates. The Committee was charged with the duties of determining what legislation, if any, would be needed to facilitate the elimination of negotiable stock certificates and of drafting such legislation. The Committee issued its Report on September 15, 1975.[1] The author served as the Committee's Reporter.

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At the risk of sacrificing the element of surprise, it should be stated at the outset that the Committee's principal recommendations are two. The first is the relatively minor amendment of state corporation statutes to validate the issuance of stock not represented by certificates.[2] The second is a major and comprehensive revision of Article 8 and related sections in other Articles of the Uniform Commercial Code intended to govern the attributes of uncertificated shares.[3] The Committee does not recommend the adoption of general federal legislation at this time but recognizes that such legislation may be required in the future. One of the circumstances that would seem almost certain to lead to federal intervention would be the failure of the state legislatures

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to act within a reasonable time. The role that the Bar can play in expediting necessary state adoption is apparent.

The Committee's Objective

The Committee's first order of business was to define the scope of its mission. Amid urgent pleas to legislate the stock certificate out of existence, it was tempting to envision the Committee as identifying or, perhaps, even inventing the ideal certificateless system and then proceeding to draft legislation that would both compel that system's universal adoption and regulate its operation. That vision was soon abandoned in favor of a more limited goal.

Initially it was recognized that any viable system had to be (1) technologically feasible, (2) legally permissible and (3) commercially acceptable. Further analysis revealed, however, that the first two of these elements did not really constitute limitations. We quickly came to the view that, given adequate time and resources, the technology was up to achieving whatever results the industry demanded. The important question was not whether a particular system could be devised but, rather, whether it could be implemented at a cost its users would be willing to pay—in short, whether it was commercially acceptable. Similarly, the drafting of legislation to permit the institution of certificateless systems was a relatively simple task requiring, in the main, amendments of a minor nature to the typical corporation statutes. At least two states have already adopted such amendments.[4] The real burden on the legislative draftsman, as we saw it, was to provide a legal environment within which parties could deal with uncertificated stock with that same high degree of confidence that the present certificate-based law now affords. Or, to phrase it somewhat differently, we attempted to create a legal framework that would not merely permit the issuance of uncertificated stock but would make its use commercially acceptable.

Thus, despite some early notions that we might re-invent the wheel, the Committee wisely decided that the industry and its related technologists were the most logical source of system development. The appropriate task for us lawyers was to assure that the law could accommodate whatever systems the industry devised. The statutory changes recommended by the Committee and set forth in the Appendices to its Report neither compel the adoption of certificateless systems nor prescribe the form such systems should take. Rather, we attempted to construct a law, as did the draftsmen of Article 9, designed to "make it possible for new [systems] . . . as they develop, to fit comfortably under its provisions."[5]

The Legal Basis of Certificatelessness

In the years before and since the Committee's organization, the world has

4 *Michigan Business Corporation Act* § 335, 15 Mich. Stat. Ann. § 21.200(335) (1974), *California Corporations Code* § 416(b).

5. *Uniform Commercial Code* § 9-101, Comment.

not stood still. Out in the marketplace, where stock is actually dealt with, the development of certificateless transfer has proceeded—apace, in the view of some, and with too deliberate speed, in the opinion of others. As the Report describes in some detail, significant strides toward "The Certificateless Society" have already been made without the benefit of any substantial statutory change. Existing certificateless systems, which may be broadly defined as methods to transfer stock without the physical movement of indispensable pieces of paper, masquerade under a variety of appellations. The common legal basis of each of these systems, however, is that somewhere a certificate exists and that someone is holding it as the shareholder's agent-bailee.

The most rudimentary form of certificatelessness is the street name brokerage account.[6] In this arrangement, the broker acts as the agent of the customer, a single undisclosed principal, and holds the certificate as the customer's bailee. Certificate movement is eliminated between customer and broker when the customer buys or sells through his broker-agent. Certificates continue to be used for transactions with the issuer, like presentment for registration of transfer, redemption or exchange, and for transfers for value to or from third party buyers, sellers and pledgees. There is, however, one common transfer for value, the customer's pledge to secure a margin loan from the broker, which, by virtue of the broker's prior possession, can be effected without certificate movement. There is also the comparatively rare transfer for value between two customers of the same broker, when, at the same time, one buys and the other sells the same security. This transfer is effected simply by the entries on the broker's books.[7] By and large, common law principles of agency, reinforced by safeguards imposed by the federal securities law and the self-regulatory organizations, have proved adequate to govern the relationship between the customer and his broker. Article 8's certificate-based law continues to govern the relationships with issuers and other third parties.

The independent securities depository is, in legal effect, an extension of the brokerage account model, but with one important exception. Like the broker, the depository holds certificates in its name and deals with the issuer and other outsiders as the agent of an undisclosed principal. The principal is the aggregate of the depository's customers, usually referred to as participants. Unlike the typical brokerage situation, however, transactions between participants are neither rare nor fortuitous but, rather, are commonplace and by design. Indeed, the primary objective of the depository is to permit transfers between the principals of a common agent without certificate movement.

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7. *Uniform Commercial Code* § 8-313(1)(c). By its terms this section would appear to apply only when there is "a specific security in the broker's possession." It would in no event apply to a bank custodian.

As early as 1962, it was thought desirable to define expressly the legal consequences of intra-depository transfer. This was accomplished by adding section 8-320 to the official text of the Uniform Commercial Code. That section equates "the making of appropriate entries on the books"[8] of the depository to "a delivery of a security"[9] and thereby establishes the rights and duties of the respective participants between themselves and with others with whom they might deal. The developing depository system, with several depositories each maintaining accounts with the others, may be comfortably viewed as an aggregate of agents and sub-agents representing the aggregate of participants in all of them and holding the participants' certificates as bailees or sub-bailees. For the purpose of governing transactions with issuers and non-participants, which are normally effected by certificate delivery, the rest of present Article 8 continues to provide an acceptable legal framework.

The agency rationale is pushed still further, and, we believe, too far, in those systems which conceptualize the issuer or its transfer agent as the agent-bailee of all the shareholders. Existing systems premised on that rationale include the mutual funds, the increasingly popular dividend reinvestment plans and an almost wholly certificateless system which parades under the anomalous description of Transfer Agent Depository.[10] When the issuer is viewed as the bailee of its shareholders' certificates, the situation is functionally identical to that where no certificates exist. It is, so to speak, "The Certificateless Society" built on a legal foundation which was never intended to accommodate it.

The substantial disappearance of certificates from the mutual fund universe is a consequence of the commercial needs of the issuers and shareholders. In open-end mutual funds, the model transactions, the purchase of shares from the issuer and the redemption of shares by the issuer, do not involve third parties. In these two-party transactions which typically involve small numbers of shares and do not require simultaneous exchanges of money, the certificate's utility is reduced to no more than that of a simple statement from the issuer or letter of instructions from the shareholder. The commercial requirements of both parties are better and more economically satisfied without certificates than with them. Outright transfers for value between shareholders are rare, particularly in the no-load funds where the issuer stands always ready to sell or redeem shares at their net asset value.

In pledge transactions of mutual fund shares, however, the certificate continues to be demanded because it performs a necessary function. One could

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8. *Uniform Commercial Code* § 8-320(1).

9. *Id.* § 8-320(3).

10. The "Transfer Agent Custodian" concept should also be included in this group. That relationship arises when, by agreement between a particular shareholder and the issuer, certificates are not delivered to the shareholder but are held in the transfer office subject to the shareholder's instructions for further registration of transfer. It is commonly used by some brokers who have a continuing need for both customer name certificates and certificates of specific denominations to be used in making settlements.

argue, of course, that a security interest in uncertificated mutual fund shares could be perfected under section 9-305 by simply giving notice to the transfer agent in his imagined capacity as the bailee of the debtor's certificate. It is highly doubtful, however, that a prudent lender or his counsel could be persuaded to advance the loan under those circumstances. Furthermore, few, if any, transfer agents would have any institutionalized procedure for dealing with such a notice even if one were received. In the pledge situation, therefore, both the lender and the issuer take refuge in the only procedure now expressly validated by statute—the issuance of a certificate to the shareholder and the delivery of that certificate to the lender. Reliance on the agency-bailment rationale is just not commercially acceptable under the present law.

The dividend reinvestment plans, in which the typical transaction is the purchase of small numbers of shares for participating shareholders,[11] operate without certificates for essentially the same reasons that have led to certificatelessness in the mutual funds. When, however, the participant wishes to deal with his shares in another transaction, issuers respond, in almost every case, by issuing certificates.[12] Unlike mutual fund shares, however, the shares accumulated in the dividend reinvestment plan accounts are the very same intangible interests that are commonly traded in normal market transactions and used as collateral for secured loans. Officials of American Telephone & Telegraph Co., which operates the largest of such plans, are confident that they could develop adequate procedures to deal with both the outright transfer and the pledge of uncertificated shares by book-entry if only a satisfactory legal framework could be provided. The potential demand for such procedures is foreshadowed by the fact that, after only slightly more than two years of operation, AT&T was "holding," as the nominal agent-bailee for some 541,000 shareholders, more than 9 million uncertificated shares.

The Transfer Agent Depository concept differs from the dividend reinvestment plans in two important respects. First, it envisages a system where certificates are issued to a shareholder only when they are expressly requested.[13] Secondly, it contemplates that shares will not only be held in uncertificated form but may be transferred or pledged to third parties by the making of appropriate entries on the issuer's books.[14] The name, "depository," and the

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contrived rationale imply that the issuer or its transfer agent is holding a certificate as the agent-bailee of the several shareholders. That certificate is either a useless formality or a patent fiction. We are told, for example, that somewhere in the AT&T transfer office there reposes a certificate representing the 9 million shares beneficially owned by those 541,000 dividend reinvestment plan participants. It seems almost ludicrous to imagine that important legal consequences would turn on whether or not that certificate is really there.

While the agency-bailment rationale lends an aura of validity to uncertificated shares that may satisfy a law professor or even a judge, it does not respond to the questions which the prudent businessman or his counsel needs to have answered before he can proceed with confidence. By what means and with what frequency must the issuer evidence the ownership of shares? What must a shareholder do, and what may an issuer require, to effect the registration of transfer? When does a purchaser become the owner of the shares he has bought? By what means can a secured lender perfect a security interest in his debtor's shares? How may an unsecured creditor reach his debtor's shares?

In short, the uncertificated share needs a governing statute to provide clear answers to those dozens of questions that existing law now provides with respect to the certificate. Without such answers, it is unreasonable to expect the expansion of wholly certificateless transfer to the kinds of transactions which account for the bulk of the industry's paperwork problems. The Committee concluded that the requisite degree of confidence, and, hence, commercial acceptability, is unlikely to be reached in the present legal framework that does not even acknowledge the existence of uncertificated shares and, therefore, utterly fails to deal with them.

The Future of System Development

It has been frequently stated that a major roadblock to the elimination of certificates would be the unsophisticated individual investor. Such an assumption is not in accordance with the facts. Holders of mutual fund shares and participants in dividend reinvestment plans have, in preponderant numbers, cheerfully foregone the possession of certificates that were unnecessary to satisfy their commercial requirements. Under existing rules of law, however, certificates are and will continue to be demanded for those transactions which they were originally developed to facilitate—the simultaneous exchange of stock for money between unrelated parties neither of which is prepared to extend unsecured credit to the other. Any system that can successfully displace stock certificates in the typical transfer for value must provide a commercially acceptable alternative to precisely that kind of exchange.

The securities depository is one such alternative. By holding its participants' stock in the depository's name, the depository assures itself that a purported transferor is the owner of the stock to be transferred and has entrusted the transfer power to the depository. By crediting the transferee's account,

the depository, in effect, represents to the transferee that the subject matter of the transfer exists and has been transferred to him. Thus, the transferee receives the same assurance that the receipt of a clean, duly indorsed certificate would afford him. It is in reliance on the depository's representation that the transferee parts with his consideration with confidence that he has received the benefit of his bargain.

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constitutes a departure from their traditional settlement procedures rather than an extension of an already established *modus operandi*.

Thus far, despite the intensive use of depositories by brokers, participation by non-broker eligible entities has been quite limited. There are a number of factors that have militated against bank participation and some of them have been only recently corrected. Nevertheless, there is currently very little hard evidence that the exchange-related depositories are destined to expand into a national comprehensive depository system that will obviate the need for continuing efforts to eliminate the stock certificate and its attendant problems. It should also be observed that the impact of the exchange-related depositories, even in the context of broker-to-broker settlements, is itself a function of the part to be played in the securities markets of the future by the exchanges themselves. To the extent that the exchanges become less significant in the total picture—a distinct possibility in the light of recent events—the ameliorating effect of their depository facilities will be correspondingly reduced.

As a step to encourage the use of depository facilities by non-brokers, the Banking & Securities Industry Committee sponsored an amendment to section 8-102(3) which has already been adopted by more than forty states.[16] The effect of this amendment is to permit the distribution of the capital stock of depositories among their users. This is intended to create a cooperate rather than a proprietary form of ownership and control. Depository Trust Co. has already announced plans to distribute its stock to its users during 1975. Whether this will achieve the objective of increased non-broker participation remains to be seen.

Another effect of the 8-102(3) amendment, however, is to permit the organization of depositories which are not related to a securities exchange. One such depository was organized in 1974 under the sponsorship of a group of bank transfer agents and has already achieved substantial growth.[17] Unlike the exchange-related entities, this depository sees itself only as a communications network which will permit rapid transmittal of transfer instructions to issuers and rapid acknowledgment of registration to prospective buyers and pledgees. Facilities for clearing the money side of transactions are not encompassed within the system and will have to be provided independently. Thus, for non-broker participants, the use of this system will be much less of a departure from their current practices than would be participation in an exchange-related depository. It is much too early for even its own managers to predict the extent to which such a depository will be commercially acceptable.

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16. The text of this amendment does not appear in the Official Text of the Uniform Commercial Code. It is set forth in Appendix B of the Report of the Committee on Stock Certificates.

17. By June 1975, the TAD Depository Corp. had on deposit over 12 million shares in more than 1600 different issues.

What the foregoing discussion suggests is that the concept of certificate immobilization in independent depositories is far from certain to result in a satisfactory reduction in the paperwork problems of the securities industry. The elimination of stock certificates, or, in the current fictionalized parlance, the use of the issuer or its transfer agent as a "depository," may prove to be at least a significant part of the ultimate solution. If that be the case, the burden of developing the mechanisms that will be commercially acceptable alternatives to the simultaneous certificate-for-money exchange rests upon the industry. It is our function, as lawyers, to make sure that the governing law will provide an environment in which industry-developed systems can be implemented with confidence in their legal consequences. Our proposed revision of Article 8 is an attempt to create that environment.

Drafting the Statute

Professor Jolls has suggested that a statute governing the attributes of uncertificated shares need not be nearly so complex as Article 8 and might take the form of an additional article of the Uniform Commercial Code, perhaps denominated Article 8A.[18] Our initial attempts to draft such a separate statute convinced us, for several reasons, that an integration of the rules for certificated and uncertificated shares and, necessarily, a complete revision of present Article 8 would be the more fruitful approach.

The process of putting pencil to paper for the first time exposed a number of problems that would have to be dealt with in a separate article. Parties dealing with uncertificated shares should be able to find, in the governing statute, the answers to all questions answered by present Article 8 except where the question, by its nature, has no application in the absence of a certificate. Could an issuer's lien exist? What is the effect of an issuer's restriction on transfer? Who, if anyone, could be a bona fide purchaser? Were there exceptions to the statute of frauds? Was there a statute of frauds? The dozen or so basic sections that Professor Jolls suggested might constitute an adequate statute grew quickly and substantially in number.

Even more important, our observation of what was taking place in the industry convinced us that the total elimination of stock certificates, even if ultimately realized, was a very long way off. What we saw was a system in which both certificated and uncertificated shares would continue to co-exist, in many cases, within the same issue of securities. Under those circumstances, the rules for each form of stock would, in many instances, require exceptions in the corresponding rules for the other form. For example, the seller's duty to perform, stated in section 8-314, might be satisfied not only by the delivery of a certificate but also by the transfer of an equivalent uncertificated security. Even assuming the ultimate elimination of certificates for a particular issue,

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18 Jolls, *The Uniform Commercial Code and the Certificateless Society*, 26 Bus. Law 627 (1971).