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Writing Your Own Rules: Contracting out of (and into) the Uniform Commercial Code; Intrastate Choice of Law

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WRITING YOUR OWN RULES: CONTRACTING OUT OF (AND INTO) THE UNIFORM COMMERCIAL CODE; INTRASTATE CHOICE OF LAW

Fred H. Miller[*]

I. INTRODUCTION

In August 1892, just prior to the annual meeting of the American Bar Association, twelve representatives from seven states met as "a conference" with the goal of achieving better uniformity of law,[1] which some held to be the "touch-stone out of which grew the Constitution of the United States. . . ."[2] Why was this task taken up by representatives from the states and not left to the federal government? James Madison had written in Number 45 of the Federalist Papers: "The powers delegated by the proposed Constitution to the federal government are few and defined. Those which are to remain in the State governments are numerous and indefinite."[3] Thus, while a certain amount of uniformity of law could be accomplished by the federal government, its power was, at least then, perceived as severely limited.[4]

Accordingly, the main burden of achieving necessary uniformity of law fell to the states.[5] But inherent in the reservation of powers reserved to the states was the possibility of diverse legislative

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1. WALTER P. ARMSTRONG, JR., A CENTURY OF SERVICE: A CENTENNIAL HISTORY OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS 11 (West 1991).

2. *Id.* The statement is attributed to Nathan MacChesney, an Illinois Commissioner to the National Conference.

3. THE FEDERALIST NO. 45 (James Madison).

4. ARMSTRONG, *supra* note 1, at 13.

5. *Id.*

enactments by different states upon the same subjects.[6] While this was acceptable for local matters, it was less tenable for matters that involved interstate transactions or the interstate movement of citizens.[7] Therefore, voluntary action by the legislative bodies of the states to adopt substantially identical laws appeared to be the most feasible method of preventing this undesirable diversity of law.[8]

This initial conference in 1892 was the beginning step in shouldering the task of promoting uniformity left to the states. Further conferences were held in 1893 and have been held in each year thereafter (except for 1945).[9] In 1915, the present name for these conferences was adopted: the National Conference of Commissioners on Uniform State Laws ("NCCUSL" or "National Conference").[10]

The desire to develop a unified body of commercial law was one of the primary reasons to organize the conference. This motivation was expressed by Justice Story in *Swift v. Tyson*[11] who stated that "the true interpretation and effect [of contracts and other instruments of a commercial nature] . . . are to be sought, not in the decisions of the local tribunals, but in the general principles and doctrines of commercial jurisprudence."[12] This articulation followed Lord Mansfield's holding that the law respecting negotiable instruments is "not the law of a single country only, but of the commercial world."[13] Justice Story's statement also followed the view of Chief Justice Lemuel Shaw of the Supreme Court of Massachusetts, who believed that:

> nothing is more important to a commercial community than to have all questions relative to the rights and duties of holders, and all other parties to negotiable bills and notes, definitely settled. And it is greatly desirable, that throughout all the States of the Union, which, to many purposes, constitute one extended commercial community,

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6. *Id.*
7. *See id.* at 14 (citing Swift v. Tyson, 41 U.S. 1, 18–19 (1842)).
8. *Id.* at 13.
9. *Id.* at 24, 65.
10. *Id.* at 30.
11. 41 U.S. 1 (1842).
12. *Id.* at 19.
13. ARMSTRONG, *supra* note 1, at 14.

the rules upon this subject should be uniform.[14]

It is, therefore, not surprising that a Commercial Law Committee was one of the earliest committees created by the National Conference, and in 1895 the conference requested the committee to procure as soon as practicable a bill relating to commercial paper.[15] In 1896, the National Conference adopted the Negotiable Instruments Law ("NIL")[16] which became the first project of NCCUSL to be adopted in every state, territory, and in the District of Columbia.[17] The NIL was followed by the Uniform Sales Act,[18] the Uniform Warehouse Receipts Act in 1906,[19] and then by acts on bills of lading,[20] stock transfers,[21] conditional sales[22] and trust receipts.[23] Ultimately, these acts were merged with drafts on other commercial subjects into the Uniform Commercial Code ("UCC") and enacted in every state;[24] that story need not be repeated here.

However, more was involved in these statutes than a desire for uniformity; the existing state law governing commercial transactions was not only non-uniform, but was also simply ill-suited to govern the way commerce actually operated. Two familiar examples suffice to make that point. At common law, contracts are formed by offer and acceptance and if one differs from the other, there may be no legally recognized contract even if the parties act as if they have an enforceable bargain.[25] Additionally, a contract might be unenforceable if the terms of the contract may result in surprise to one side due to "gamesmanship" or even pure coincidence.[26] Some UCC

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14. *Id.* at 25.

15. *Id.*

16. *Id.*

17. *Id.* at 26.

18. *Id.* at 30, 32.

19. *Id.* at 32.

20. *Id.*

21. *Id.*

22. *Id.* at 167.

23. *Id.* at 168.

24. *See* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 23–24 (5th ed. 2000). All references to the UCC are to the current official version of each UCC Article, even if not widely enacted, unless otherwise indicated.

25. *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS §§ 58, 59 (1981) (an acceptance must comply with requirements of offer, and a reply which adds qualifications is not an acceptance); E. A. FARNSWORTH, CONTRACTS § 3.13 (4th ed. 2004) (generally describing the common law requirements of acceptance).

26. *See, e.g.*, Poel v. Brunswick-Balke-Collender Co., 110 N.E. 619, 620 (N.Y. 1915)

Article 2 provisions on the formation of contracts for the sale of goods were intended to radically alter these aspects of sales law.[27] Thus, the provisions of Article 2 make contracts easier to form by allowing contracts to be formed through conduct rather than exclusively through the exchange of communications.[28] The Article 2 rules also abandon the requirement that an acceptance must coincide precisely with all terms of the offer,[29] and UCC section 2-207 attempted to bring fairness into the exchange of forms to eliminate "term surprise."[30] In short, the rigidity of the common law rules ignored the modern realities of commerce. Specifically, the provisions of Article 2 were designed to both keep the welsher in the deal and to deny unearned and unfair advantage to the contracting party who, by pure happenstance or design sent the first—or in some cases, the last—form and thus ended up with their terms when the exchanged forms did not agree.[31]

Another example of the common law's inability to effectively govern commerce involves the rules for assigning a contract. By the time of the UCC, the common law had advanced from its historic rule in England that a chose in action could not be assigned.[32] Rights could generally be assigned at this time, provided the substitution of a right of the assignee for the right of the assignor would not result in a material impact on the obligor[33] and was not forbidden by law or agreement.[34] Even so, the assignee took the assigned right subject to most defenses to it that the obligor could raise against the assignor.[35] Since much of the purpose behind the rules governing negotiable instruments—like checks and promissory notes,[36] which are a type of contract—was to promote their free transferability,[37] it is clear the

(finding no contract despite extensive correspondence).

27. WHITE & SUMMERS, *supra* note 24, § 1-2.

28. *Id.*

29. *Id.*

30. *Id.* § 1-3. *See also* U.C.C. § 2-207 (2003) (by focusing on terms parties agree on).

31. WHITE & SUMMERS, *supra* note 24, § 1-3.

32. RESTATEMENT (SECOND) OF CONTRACTS, § 317 cmt. c (1981).

33. *Id.* § 317(2)(a).

34. *Id.* § 317(2)(b); FARNSWORTH, *supra* note 25, §§ 11.2–11.4.

35. RESTATEMENT (SECOND) OF CONTRACTS, § 336(2).

36. The contract of the maker of a note is to pay when the note is due, and that of the drawer of a check is to pay if the bank on which the check is drawn dishonors the check. U.C.C. §§ 3-412, 3-414(b) (2003).

37. FREDERICK H. MILLER & ALVIN C. HARRELL, THE LAW OF MODERN PAYMENT

basic common law rules relating to assignments of contracts were not completely workable in many situations. For instance, a taker of an instrument could not part with value (or may have required a reserve) if the taker could be defeated in enforcing the instrument by defenses that were not known to the taker at the time the instrument was offered.

As a consequence, one may well wonder about the subject matter of this article. That is to say, if the UCC is made up of rules to govern transactions that were not well-governed by the separate laws of the several states prior to the advent of the UCC, why would transacting parties now governed by the UCC wish to have law outside the UCC applied to their transaction? Conversely, why would transacting parties not governed by the UCC desire their transaction to be governed by the rules of the UCC which, by definition, were not designed with that type of transaction in mind?

II. OPTING OUT OF THE UCC

This article explores why parties entering into certain transactions might decide to contract out of (or into) UCC governance and exposes some of the potentially adverse consequences that can arise as a result of opting out of (or into) a given regulatory scheme.

The first part of the above question is the easier one to discuss, as there assuredly are limited examples of when one or both parties will desire to escape rules specifically formulated for their type of transaction. Of course, because of the emphasis of the UCC on freedom of contract,[38] there is less incentive to opt out of UCC rules, at least as a general matter, because the effect of a rule can be varied by agreement, within limits.[39] Nonetheless, there are rational reasons

SYSTEMS AND NOTES 98, 116–17 (West Group 2002).

38. U.C.C. § 1-302 cmt. 1. *See also id.* § 1-302(b) (providing that the parties, by agreement, may determine the standards of performance if they are not manifestly unreasonable); *id.* § 1-302(a) (providing that, "[e]xcept as otherwise provided in subsection (b) [of section 1-302] or elsewhere in [the UCC], the effect of provisions of [the UCC] may be varied by agreement"); *id.* § 5-103 cmts. 2, 3 (parties may look outside the UCC to vary standards of performance dealing with letters of credit, but should avoid modifying Article 5 definitions).

39. *See, e.g.*, U.C.C. § 2A-503 (allowing a lease to include rights and remedies in addition to and in substitution for those in Article 2A and to limit or alter the measure of damages and exclude consequential damages); *id.* § 2A-504 cmt. 1 (recognizing the ability to agree on an appropriate amount or formula for damages). This freedom of contract allows the parties to select appropriate rules to govern their transaction and thus achieve one of the UCC's paramount

why one may wish to opt out.

One reason to opt out—which no longer exists—is the practice of crossing out the words "to the order of" in the line on checks beginning with "Pay to the order of." In the past, consumers were advised to do so because it precluded the holder of the check from establishing due-course status to take free of certain defenses the consumer might have to payment.[40] The consumer could raise these defenses in situations involving delivery of defective merchandise, fraud, or non-delivery if the consumer was able to stop payment on the check in time.[41] However, the depository bank could still sue on the consumer's drawer's contract and recover the funds because the bank allowed the payee to withdraw some or all of the uncollected funds.[42]

A number of other examples of methods to opt out related to payment system law do exist. They include:

- a promise or order, other than in a check, that includes a conspicuous statement to the effect that the promise or order is not negotiable or is not governed by UCC Article 3.[43] This method might be employed to avoid a state consumer law sanction for taking a negotiable instrument.[44]
- a promise or order that states an express condition to payment, is subject to or governed by another record, or that rights or obligations with respect to it are stated in another record.[45]
- a payment order that states a condition to payment to the

purposes "to permit the continued expansion of commercial practices through custom, usage, and agreement of the parties . . . ." *Id.* § 1-103(a)(2). Indeed, in 1999, the drafting committee revising UCC Article 1 deleted a proposed section that would have expressly allowed parties to opt into the UCC for a reason to be discussed, *infra*, and stated there was no reason to specifically opt out, as freedom of contract already allowed that. *See* Fred H. Miller, *Intrastate Choice of Applicable Law in the UCC*, 54 SMU L. REV. 525, 526 n.8 (2001) [hereinafter Miller, *Intrastate Choice*].

40. U.C.C. § 3-104 cmt. 2.

41. *See id.* § 3-302 cmt. 4.

42. *See id.* §§ 3-104(a), 3-109, 3-302, 3-305, 3-414, 4-211. The absence of the so-called "magic words of negotiability" remove the instrument from the coverage of UCC Article 3 as to holder in due course status. *See id.* § 3-104 cmt. 2. Today, in the case of a check, that is no longer true because checks are processed by automated means and seldom examined, so such "gamesmanship" could allow unfair surprise. *Id.* § 3-104(c) cmt. 2; *see id.* § 3-104(c).

43. U.C.C. § 3-104(d).

44. *See, e.g.*, OKLA. STAT. tit. 14A, § 2-403 (2006) (prohibiting seller from taking a negotiable instrument other than a check as evidence of the obligation of the buyer in a consumer credit sale).

45. U.C.C. § 3-106(a) & cmt. 1.

beneficiary, other than the time of payment.[46] The nature of this particular payment system is intolerant to a need to check outside information.[47]

- a letter of credit that contains a central and fundamental non-documentary condition to the issuer's obligation, such as a requirement that the issuer determine whether the beneficiary has performed the underlying contract or whether the applicant has defaulted.[48]

There are other instances, outside the context of payment system law where a party may want to opt out of governance by the UCC. One such example is a transaction that involves computer software. Computer software is intellectual property and since it can be copied easily once it is made available, it is usually provided subject to a license that precludes its use beyond sites licensed to use it and other designated uses. If the information is downloaded from the internet, it clearly is subject to law other than UCC Articles 2 or 2A as there are no goods involved.[49] Moreover, if the computer software is custom designed, a court likely will find the predominant purpose of the transaction was the design services even if goods were a part of the transaction and apply the law governing services rather than Article 2 of the UCC.[50] Conversely, if the computer software is embedded in goods being sold, such as a computer operated braking system in a car, and is not a motivating factor in their selection—even if important to the operation of the goods—the application of Article 2 or Article 2A makes sense. This result can be reached by using the traditional predominant purpose test for the applicability of these UCC Articles.[51]

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46. *Id.* § 4A-103(a)(1)(i).

47. *See id.* § 4A-207(b).

48. *Id.* § 5-108 & cmt. 9.

49. UCC Article 2 deals with transactions in goods. U.C.C. § 2-102 (2003). *But see id.* § 2-103(1)(k) (excluding information from goods). UCC Article 2A deals with leases of goods. *Id.* § 2A-102. *But see id.* § 2A-103(1)(p) (excluding information from leases of goods). The applicable law then would be the common law of contracts, except in Maryland or Virginia. These states have enacted the Uniform Computer Information Transactions Act ("UCITA"), which provides the clear rules that this significant area of commerce needs. *But see infra* note 54.

50. *See, e.g.*, Pearl Investments, LLC v. Standard I/O, Inc., 257 F. Supp. 2d 326, 329 (D. Me. 2003) (development of software system primarily constitutes a service and Article 2 is not applicable).

51. *See* U.C.C. § 2-103 cmt. 7 (providing courts discretion to determine whether and how far Article 2 applies to transactions including both the sale of goods and the transfer of rights in information).

It is where the computer software involves a material purpose in the purchase that the applicability of Article 2 may become problematic. These cases involve so-called "smart goods", and even include the acquisition of off-the-shelf boxed software because the information is on a disk. In such cases, some courts have applied UCC Article 2 on the basis it is a transaction in goods,[52] even if not a sale,[53] or have applied Article 2 rules on the basis that transaction was similar to a sale.[54]

The consequences of applying UCC Article 2 in this particular commercial setting can be quite disastrous to the owner of the software. For example, if Article 2 is applied, under the "first sale" doctrine the owner of the software may lose all control over it and thus the entire value the software represents.[55] In short, the information industries do not deal in tangible goods but rather in intangible information, and a body of law based on the sale of manufactured goods ill fits licenses and other transactions in computer information. Indeed, as when parties attempted to apply

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52. Softman Products Co. v. Adobe Sys., Inc., 171 F. Supp. 2d 1075, 1084 (C.D. Cal 2001).

53. *See, e.g.*, Sawyer v. Pioneer Leasing Co., 428 S.W.2d 46, 54 (Ark. 1968) (holding an equipment lease subject to Article 2 of the UCC).

54. There certainly is precedent for this approach as courts often used Article 2 rules to resolve lease issues before the advent of Article 2A. *See id.* Indeed, further illustrative of this approach, the Official Comment to UCC section 2A-102 invites a court to apply the rules of Article 2A by analogy to transactions that are leases of personal property other than goods. U.C.C. § 2A-102 cmt. 1. Representative cases applying Article 2 to software are, for example, *SoftMan Products Co.*, 171 F. Supp. 2d at 1075, and *Step-Saver Data Systems, Inc. v. Wyse Technology*, 939 F.2d 91 (3d Cir. 1991). At first glance, this may appear to be an excellent approach akin to the "policy approach" advocated by White and Summers and articulated by the Idaho Supreme Court:

> In order to determine which provisions are applicable, we will look to the commercial setting in which the problem arises and contrast the relevant common law with Article 2—we will use Article 2 as "a premise for reasoning only when the case involves the same considerations that gave rise to the Code provisions and an analogy is not rebutted by additional antithetical circumstances.

Glenn Dick Equip. Co. v. Galey Constr., Inc., 541 P.2d 1184, 1190 (Idaho 1975); *see also* WHITE & SUMMERS, *supra* note 24, at § 1-1. The key then to selecting the properly applicable law is the commercial setting. Compare *Adobe Systems, Inc. v. Stargate Software, Inc.*, 216 F. Supp. 2d 1051 (N.D. Cal. 2002), which has a far more sensitive and thoughtful analysis than in the *SoftMan* and *Step-Saver* cases and which recognizes the inappropriateness of using the provisions of Article 2 as a general matter in this context.

55. *See, e.g.*, Novell, Inc. v. Network Trade Ctr., Inc., 25 F. Supp. 2d 1218, 1229–30 (D. Utah 1997) (stating that under the first sale doctrine, the "owner/purchaser" of a copyrighted product can dispose of it without regard to the desires or policies of the copyright holder), *vacated in part*, 187 F.R.D. 657 (D. Utah 1999); *see also Adobe Sys., Inc.*, 216 F. Supp. at 1058 (noting that, under the first sale doctrine, a copyright owner is only entitled to the value of each particular copy).

earlier sales law to transactions in the industrial economy, applying inappropriate law to information transactions leads to widespread confusion and inapt judicial reasoning.[56]

The risk of applying UCC Article 2 to this type of transaction cannot be as easily removed as the holder-in-due-course rule of UCC Article 3, which could be avoided by simply removing words of negotiability in a consumer check. However, under the UCC the parties to a transaction governed by the UCC are free within limits to apply the law of a particular jurisdiction to their transaction.[57] Thus, one possible method to avoid the application of UCC Article 2 and invoke more appropriate law would be to select the law of Virginia or Maryland, which have enacted UCITA. That resolution may fail in a given state, however, if that state retains former UCC section 1-105,[58] since the transaction may have no "reasonable relation" to Virginia or Maryland.[59] The resolution may also fail if the state has enacted a so-called "bomb shelter" bill that precludes the choice of Virginia or Maryland law in this context and that law survives legal challenge.[60]

56. LORIN BRENNAN, HOLLY K. TOWLE & JOEL ROTHSTEIN WOLFSON, COMMERCIAL INFORMATION LAW 100-6 to -9 (Glasser Legal Works 2004).

57. U.C.C. § 1-301. The same is true under former UCC section 1-105(1) which has been retained in a number of jurisdictions, but with less ability to select the law of a jurisdiction since the jurisdiction selected must have a reasonable relationship to the transaction. U.C.C. § 1-105(1) (1995) (amended 2003). *See, e.g.*, Ward Transformer Co. v. Distrigas of Mass. Corp., 779 F. Supp. 823, 824 (E.D.N.C. 1991) (holding that as long as the transaction bears a reasonable relation to the state, the parties may elect the governing jurisdiction); Marine Midland Bank v. United Mo. Bank, 643 N.Y.S.2d 528, 530 (N.Y. App. Div. 1996) (same); Benedictine Coll., Inc. v. Century Office Products, Inc., 853 F. Supp. 1315, 1323 (D. Kan. 1994) (same).

58. *See, e.g.*, United Counties Trust Co. v. Mac Lum, Inc., 643 F.2d 1140, 1143 (5th Cir. May 1981) (holding that a lease which designated New York law was ineffective because there was "no reasonable relation" to the state).

59. *See supra* note 57 and accompanying text.

60. *See, e.g.*, IOWA CODE § 554D.125 (2000). Section 554D.125 provides that a choice-of-law provision in a computer information agreement (an agreement that would be governed by UCITA or a similar applicable state law specified in the choice-of-law provision) that is to be interpreted pursuant to the laws of a state that has enacted UCITA, or a substantially similar law, is voidable and must be interpreted pursuant to Iowa law instead, if the party against whom the provision will operate is a resident or business with its principal place of business in Iowa. This type of legislation stems from a belief that UCITA's licensee protections are too limited (even though the protections are at least as great as under whatever current law would provide) which overrides the value it confers by providing clear rules to govern transactions equally significant to, or greater in significance than, those actually governed by UCC Article 2. *See* Miller, *Intrastate Choice*, *supra* note 39, at 529. This concern led to the elimination of an explicit opt-out and opt-in provision that originally was in UCITA. *See id.* at 528–30. This was certainly counterproductive since the provision not only merely confirmed what can be done by contract, but placed some explicit protective limits on such contracts.

However, just as the parties maintain some freedom to select the law of a particular jurisdiction to apply to a transaction governed by the UCC,[61] they should also be able to choose from other "law" available (whether enacted or not) within the same jurisdiction which would apply to the transaction otherwise. In other words, they should be able to select applicable law intrastate rather than interstate. The UCC contemplates this possibility as a logical extension from several Official Comments to UCC Article 5. Specifically, an Official Comment to UCC section 5-103 states in pertinent part: "[p]arties who do not wish to be governed by the . . . provisions of Article 5 must normally either adopt the law of a jurisdiction other than a State of the United States [because Article 5 is enacted in all states] or state explicitly the rule that is to govern."[62]

UCC section 5-116(c) also provides that the liability of designated parties for an action or omission "is governed by any rules of custom or practice, such as the Uniform Customs and Practice for Documentary Credits [which is not a statute or a case law rule, but a set of agreed-upon rules by parties engaged in letter-of-credit practice], to which the letter of credit, confirmation, or other undertaking is expressly made subject."[63] An Official Comment further states in part: "practice adopted in a letter of credit will override the rules of Article 5 [except in certain cases—for example, the nonvariable terms of Article 5]. . . ."[64] Accordingly, a provision like the following should avoid the application of UCC Article 2 and supply the more applicable and appropriate rules:

> The parties agree that this transaction involves both goods and information and that the transaction has, as a material purpose, access to and use of the information involved.

61. U.C.C. § 1-301 (2003).

62. *Id.* § 5-103 cmt. 2.

63. *Id.* § 5-116(c).

64. *Id.* § 5-116 cmt. 3. See also UCC section 1-302, on variation by agreement, and Official Comment 2:

> [T]he parties may vary the effect of . . . [the UCC] by stating that their relationship will be governed by recognized bodies of rules or principles applicable to commercial transactions. Such bodies of rules or principles may include, for example, those that are promulgated by intergovernmental authorities such as UNCITRAL [which does not have the power to legislate itself] . . . , or non-legal codes such as trade codes.

Id. § 1-302 cmt. 2; *see also id.* § 1-301 cmt. 2 (parties have "broad autonomy" to select governing law).

> Accordingly, they agree that the application to the entire transaction of Article 2 of the Uniform Commercial Code, as enacted in the jurisdiction whose law is chosen by them to govern this transaction, is inappropriate, and further stipulate that their choice-of-law agreement shall be interpreted to the extent of the information included in this transaction to instead apply the Uniform Computer Information Transactions Act (as finally promulgated by the National Conference of Commissioners on Uniform State Laws) to determine their rights and duties, even though not enacted in the jurisdiction whose law is otherwise chosen.

The parties to the above-referenced transaction should not be precluded from opting out of UCC Article 2 because the UCITA contains mandatory rules essentially no different than UCC Article 2.[65] The parties should also not be precluded from opting out because there is a reasonable relation between the transaction and UCITA to the extent a provision like former UCC section 1-105 may be interpreted to apply.[66] Moreover, since no "bomb shelter" bill[67] could be interpreted to restrict the ability of the parties to vary the effect of any particular non-mandatory provision, and thus should not restrict their ability to vary the effect of non-mandatory provisions, there should be no limitations that would prevent contracting out of UCC Article 2.

However, the fact that the parties may opt out of what they consider to be inappropriate law contained in the UCC is not to suggest that the decision to do so is one to be made lightly; there are many considerations that need to be evaluated.

First, the focus of the parties normally will be on no more than one or two issues that are believed to make the UCC rule on those

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65. *See, e.g.*, U.C.I.T.A. § 111 (2001) (unconscionability); *id.* § 114(b) (good faith); *id.* § 406(b) (disclaimers); *id.* § 803(d) (consequential damage restrictions).

66. *See supra* note 57 and accompanying text. In this context any jurisdiction is absent and thus perhaps so is the relevance of former section 1-105.

67. *See* IOWA CODE § 554D.125 (2000). Taking the Iowa law as representative, it clearly contemplates the selection of an enacted law and not the selection of a set of "model" rules. *See supra* text accompanying note 60. Moreover, the agreement is for the rules to "govern," and not to merely furnish a basis for "interpretation" of the rights and duties under the computer software agreement. A court should not rewrite the statute to override the intent of parties who have chosen a method to reach a result not clearly precluded by the statute.

issues seemingly unwise in application. To illustrate, in the second example above involving both goods and computer software, the concern in a transfer of software may not be the possible characterization of the transaction as a sale, but whether applying the UCC Article 2 implied warranty of merchantability[68] to the software could extend to a possible inaccuracy in informational content. In UCITA there is no implied warranty of merchantability as to informational content.[69] However, to completely opt out of the possible application of Article 2 in this context[70] may be unnecessary, when all that need be done is to specifically disclaim the application of Article 2's implied warranty of merchantability as to informational content.[71]

It should be recognized though, that in some contexts opting out to avoid a particular UCC rule may result in opting into a legal regime that omits a beneficial rule or one with some rules that are equally or more inappropriate. For example, if a party to a contract opts out of UCC Article 3 by inserting a condition to payment—because of concern that a subsequent holder in due course may cut off the possible defense that the condition has not been performed[72]—the party may opt into less beneficial rules that do not contain the protection afforded an agent when improperly signing a check under UCC section 3-402(c).[73] The party may also opt out of the generous-discharge rule for fraudulent alteration designed to discourage such activity under UCC section 3-407(b).[74]

To illustrate this risk further, if a lessor recharacterizes a lease as a secured transaction—as permitted under UCC section 2A-504[75]—to avoid the limitation on recovery of the rent, which requires a

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68. U.C.C. § 2-314.

69. "Informational content" means information that is intended to be communicated to or perceived by an individual in the ordinary use of the information. U.C.I.T.A. § 102(a)(37). There is no warranty, as under UCITA section 403(c), because such content may involve questions of tastefulness, beauty or pleasing nature that are matters of personal taste. *Id.* § 403 cmt. 5. Rather, UCITA contains a particular warranty as to informational content under section 404. *Id.* § 404.

70. *See supra* cases cited in note 54.

71. U.C.C. §§ 2-314, 2-316. Opting out may be unnecessary for another reason; it is unlikely that there is liability risk for mere inaccuracy where the information is made available generally and is not personally tailored to a particular licensee. U.C.I.T.A. § 404 cmt. 3.

72. U.C.C. §§ 3-305(b), 3-105.

73. *Id.* § 3-402(c).

74. *Id.* § 3-407(b).

75. *Id.* § 2A-504(3) & cmt. 3.

discount to present value,[76] it could have disastrous consequences in the event of the lessee's bankruptcy.[77]

Another consideration is whether the opt out will be able to effect the rights of third parties.[78] If opt out is accomplished by eliminating one or more of the essential criteria for inclusion within the UCC,[79] then the UCC, except by analogy, cannot determine the rights and responsibilities of third parties. However, if a transaction, for example, would be governed by UCC Article 2 and that law would confer specific rights on a type of third party—such as the ability to take good title if goods are entrusted to a merchant who deals in goods of that kind and, in breach of trust, that merchant sells them in ordinary course to a purchaser[80]—it is doubtful any agreement between the entruster and the merchant can preclude the rights of the purchaser granted by the applicable UCC statute.[81] On the other hand, if the entruster and the merchant validly agreed for the law of a jurisdiction that for some reason had repealed UCC section 2-403(2) to govern, the purchaser presumably could not avail itself of UCC section 2-403(2).[82] Arguably, then, third party rights can be impacted in certain circumstances, especially if the third party were on notice of the agreement and yet proceeded.[83]

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76. *Id.* § 2A-529(1). No discounting may be required under law other than UCC Article 2A. *See, e.g.*, U.C. Leasing, Inc. v. State *ex rel.* State Bd. of Pub. Affairs, 737 P.2d 1191, 1194 (Okla. 1987) (holding that the terms of a lease permitted discounting).

77. Even if a financing statement is filed as a precaution, the remedies of a lessor and a secured party are quite different both in and out of bankruptcy. *See id.* §§ 2A-504 & cmt. 3, 9-505 & cmt. 2. *See also* 11 U.S.C. § 544 (2001).

78. Varying the effect of a UCC rule by agreement, *see supra* notes 38–39 and accompanying text, normally will only impact the parties themselves. *See* U.C.C. § 1-302 & cmt. 1. *See also* Carlson v. Tandy Computer Leasing, 803 F.2d 391, 393–94 (8th Cir. 1986); H.K. & Shanghai Banking Corp. v. HFH USA Corp., 805 F. Supp. 133, 140 (W.D.N.Y. 1992); *In re* Eagle Enter., Inc., 223 B.R. 290, 292–93 (Bankr. E.D. Pa. 1998).

79. *See supra* note 42 and accompanying text.

80. U.C.C. § 2-403(2).

81. *Id.* § 1-302 cmt. 1.

82. This assumes the UCC jurisdiction does not treat UCC section 2-403(2) as embodying a fundamental policy and that UCC section 1-301 is the law in the UCC jurisdiction, so that the parties have virtually complete autonomy to select the governing law. *See* U.C.C. § 1-301.

83. *See* U.C.C. §§ 5-103 cmt. 2, 3-104 cmt. 2, 1-302 cmt. 1 (referencing UCC section 1-103 and rules supplementary to the UCC, such as estoppel and ratification).

III. OPTING INTO THE UCC

What of the other side of the coin—opting in? The UCC always has presumed that the parties to a transaction not governed by the UCC may nonetheless want to have it apply.[84] For example, an Official Comment specifically invites the parties to a transaction creating a lease of personal property other than goods or a bailment of personal property to provide by agreement that UCC Article 2A applies.[85] Another Official Comment states that the immediate parties to an order or promise that is not an instrument may provide by agreement that one or more of the provisions of Article 3 determine their rights and obligations under the writing.[86] UCC Article 8 provides that an interest in a partnership or limited liability company is not a security unless it is dealt in or traded on securities exchanges or in securities markets, is an investment company security, or its terms expressly provide that it is a security governed

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84. *See id.* § 1-302.

85. *Id.* § 2A-102 cmt. "Purposes". One issue with opt in is whether the law being left behind is mandatory and cannot be avoided. Law outside the UCC is seldom expressed on this matter, while in the UCC to a large degree it is. *See id.* § 1-302(a)–(b). In the private law/commercial law area, most laws are not considered to be mandatory. *See* McClain v. Cont'l Supply Co., 168 P. 815, 818–19 (Okla. 1917) (holding an attorney's fee provision valid). Consumer protection laws, however, invariably are mandatory. *See* OKLA. STAT. tit. 14A, § 1-107 (2000). Occasionally, other laws are construed to be as well. *See, e.g.*, Reid v. Auxier, 690 P.2d 1057, 1061 (Okla. Civ. App. 1984), *superseded by statute*, OKLA. STAT. tit. 15, § 215(B) (2000), *as recognized in* 1414 P'ship v. Taveau, 815 P.2d 1228 (Okla. Civ. App. 1991) (holding a liquidated damages proviso void where damages were neither impracticable nor extremely difficult to determine as the statute required), *and* Forster-Davis Motor Corp. v. Abrams, 53 P.2d 569, 571 (Okla. 1936) (holding that the promise to pay another's debt must be in writing). But there seems little downside in trying. If the opt in is valid, the goal is achieved. If it is not, one is no worse off than if the opt in had not been tried, as there is no sanction for trying. If there is a sanction, that is a proxy for a mandatory provision and trying would be foolish.

86. U.C.C. § 3-104 cmt. 2 (2003). Illustrations would include drafts used to pay for oil and gas leases that are payable only on the clearance of title but which are generally treated as if they were negotiable instruments. The same is true for "complex" promissory notes which, due to "excessive" luggage, may not otherwise qualify as a promissory note under UCC section 3-104(a)(3). *See id.* § 3-104(a)(3). It also includes writings that evidence a right to payment of a monetary obligation that in ordinary course of business are transferred by delivery with any necessary endorsement or assignment; and which are included in UCC Article 9 as "instruments," but which are not negotiable instruments under UCC Article 3. *See id.* § 9-102(a)(47). The same would perhaps be true for variable rate promissory notes that may not qualify as negotiable instruments under former UCC Article 3 (still the law in New York and South Carolina), even though treated as such in commerce; an opt in in this case would seem beneficial. *Compare* Taylor v. Roeder, 360 S.E.2d 191, 193–94 (Va. 1987) (declining to create an exception to the UCC in favor of instruments providing for a variable rate of interest not ascertainable from the instrument itself), *with* Amberboy v. Societe de Banque Privee, 831 S.W.2d 793, 795 (Tex. 1992) (finding the negotiable instrument subject to Article 3).

by UCC Article 8.[87]

There can be a variety of reasons why some parties may want to opt into the UCC. In may cases, they may perceive that the law that would otherwise govern their transaction is outdated. Recall this was one of the reasons UCC Article 2 was promulgated in the first place, even though in many respects general contract law has now caught up with or been influenced by the more useable rules of Article 2.[88] In other situations, it may be that the law that would otherwise govern the transaction is incomplete or unclear.[89] Certainly, for

87. U.C.C. § 8-103(c).

88. Another illustration may be a party drafting a guaranty for a modern transaction that wishes to avoid an out-of-date codification of older guaranty law, *see* OKLA. STAT. tit. 15, §§ 321–344, 371–385 (2000), in favor of the more modern rules codified in UCC Article 3, particularly section 3-605, that mirror the Restatement (Third) of the Law of Suretyship. U.C.C. § 3-605 cmt. 1. Indeed, it would seemingly be possible to opt into the Restatement as the more complete law, under the same analysis set forth in this article. *See supra* text accompanying note 64.

89. Several examples come to mind. First, the drafting committee of NCCUSL and the ALI that produced the 2002 amendments to UCC Articles 3 and 4 was approached by the Electronic Check Clearinghouse Organization to amend the statute so as to apply those Articles to electronic checks by redefining the definition of "order" in UCC section 3-103(a)(8) to include other than a written instruction. U.C.C. § 1-303 cmts. 1–2 (2002) (amended 2003). The organization at that time believed it was operating under the rules of UCC Articles 3 and 4 by reason of agreements opting into that law, but realized the possible limits to that approach. *See, e.g.*, American Nat. Bank & Trust Co. v. Central Bank, 132 B.R. 171 (Bankr. D. Colo. 1991) (clearinghouse rule treated electronic debits as items under UCC Article 4); Security First Network Bank v. C.A.P.S., Inc., 47 UCC Rep. Serv. 2d 670, 676 (N.D. Ill. 2002) (NACHA Operating Rule section 13.1.20 applied UCC Article 4 to debit entries as a gap filler). The drafting committee declined on the basis that to do so would perhaps conflict with applicable federal law. *See* Regulation E, 12 C.F.R. pt. 205 (2006). Also, doing so might invoke provisions that would not work well in an electronic environment. *But see* CLARKS' BANK DEPOSIT & PAYMENTS MONTHLY (A.S. Pratt & Sons Group, Arlington, Va.), May 2006, at 3.

A second example was the reaction of some statutory lien interests when faced with the inclusion of various rules for different kinds of statutory liens under UCC Article 9. *See* U.C.C. §§ 9-102(a)(5), 9-109(a)(2) (2003). In many instances the statutes creating those liens did little else, leaving uncertainty as to priority and means of enforcement. *See id.* § 1-109 cmts. 2–3. Consequently, the clear rules of Article 9 were not unwelcome.

A third example might involve the exclusions from federal law on electronic fund transfers and thus the protections of Regulation E for electronic fund transfers from consumer accounts. One of the exclusions is for a telephone initiated transfer that does not take place under a telephone bill payment or other written plan in which periodic or recurring transfers are contemplated. *See* Regulation E, 12 C.F.R. § 205.3(c)(6) (2006). This exclusion was involved in two cases, *Abyaneh v. Merchants Bank, North*, 670 F. Supp. 1298 (M.D. Pa. 1987), and *Kashanchi v. Texas Commerce Med. Bank*, 703 F.2d 936 (5th Cir. 1983), where without the protection of Regulation E section 205.6 limiting the liability of a consumer for an unauthorized transfer, the loss for an unauthorized transfer out of the consumer's account was placed on the consumer by agreement. In such circumstances, the consumers might well have wished to apply UCC Article 4A by agreement if they had the bargaining power (even though it was drafted for commercial transfers and, because of potential conflict in section 4A-108, excludes a funds transfer if any part is governed by Regulation E) because at least UCC Article 4A has

example, some people thought it was more important to codify and clarify the law governing service transactions than it was to update UCC Article 2 itself.[90]

While the incentive to opt into the UCC may be strong in a variety of circumstances, the decision to do so, like the decision to opt out, should not be made lightly. As in the case of opting out, a critical consideration is what might come along with the rule perceived to be more appropriate to govern the situation. To illustrate, suppose the decision is made to opt into UCC Article 8 for a partnership interest that would not otherwise constitute a security.[91] Let us also suppose that the partnership agreement contains restrictions on who can be a partner, and that a partner subsequently grants a security interest in his or her partnership interest, such as the right to distributions. If that security interest goes into default, giving the secured party the right to enforce it by disposing of the collateral,[92] will the rights of the secured party override the restriction on transfer in the partnership agreement designed to protect the other partners? Presumably not, under UCC section 8-204,[93] if the secured party has knowledge of the restriction,[94] as it presumably would after having examined the partnership agreement. This result would occur despite UCC section 9-406(d), which normally overrides a term in an agreement that prohibits, restricts, or

requirements that could reduce the risk of loss in this type of case. *See* U.C.C. §§ 4A-201 to -204.

90. PEB Study Group, *PEB Study Group: Uniform Commercial Code, Article 2 Executive Summary*, 46 BUS. LAW. 1869, 1875, 1878 (1991). This was not done due to the perceived complexity of codifying the rules for different types of service contracts. Of course, a statute need not cover all possible rules for many diverse types of contracts. A statute covering basic issues common to all types of service contracts involving such matters as formation, interpretation, performance and remedies would still be of considerable value. Absent such a statute, opting into UCC Article 2 might be desirable on such issues, perhaps with selective adjustments. For example, a seller installing a product where the transaction involves a sale of goods and a sale of services might wish Article 2 to cover both the sale and service aspects. Rather than relying on a court to discern the predominant purpose, a provision opting into Article 2 for the service aspect might provide more flexibility, for example, to liquidate damages. *Compare* OKLA. STAT. tit. 15, §§ 214, 215 (2000) (three-prong inquiry distinguishing liquidated damages from a voidable penalty) *with* U.C.C. § 2-718 (2003) (respecting parties right to contract in light of standard of reasonableness). But the seller also would probably want to disclaim warranty liability for the quality of the service under UCC sections 2-314 and 2-316 in favor of a standard of due care. U.C.C. §§ 2-314, 2-316.

91. U.C.C. § 8-103(c).

92. *Id.* §§ 9-601(a)(1), 9-610.

93. *Id.* § 8-204.

94. *Id.*

requires consent to the transfer, creation, attachment, perfection, or enforcement of the security interest,[95] because the collateral is a security and thus cannot be an account, chattel paper, payment intangible or promissory note to which section 9-406(d) applies.[96] The point is nonetheless made that opting in requires careful analysis.[97]

Another illustration might be the decision to opt in for oil and gas lease drafts that are payable only if the condition of good title is satisfied.[98] If a holder-in-due-course agrees to a contract of opt in,[99] then that person might be able to enforce the draft even if the failure to deliver good title would provide a good defense in the hands of a mere assignee of the draft as an ordinary contract.[100]

IV. CONCLUSION

The ability of the parties to a transaction to select the law that will govern that transaction is a valuable tool to effectuate their intent and goals, although it has both legal and practical considerations that require careful evaluation. However, on the whole, it has been a little used tool, as opposed to use of the commonly recognized ability to vary the effect of non-mandatory provisions by agreement, or via choice-of-law provisions.

Of course, while selecting a whole body of rules may be a more efficient way of designing appropriate rules for a transaction than doing so one rule at a time, that very efficiency can involve the risk of importing inappropriate rules along with the desired ones. That

95. *Id.* § 9-406(d).

96. *Id.* § 9-102(a)(2) (account); *id.* § 9-102(a)(49) (investment property); *id.* § 9-102(a)(11) (chattel paper); *id.* § 9-102(a)(61) (payment intangible); *id.* § 9-102(a)(42) (general intangible); *id.* § 9-102(a)(65) (promissory note). *See also* Steven O. Weise & Edwin E. Smith, PEB Draft Commentary on Impact of UCC Section 9-406 and 9-408 on Anti-Assignment Provisions Relating to Interests in Unincorporated Business Organizations (Nov. 11, 2006) (unpublished comment, on file with author).

97. One concern that arose when the UCC Article 1 drafting committee was considering an explicit articulation of the right to opt out found in UCC section 1-302 on variation by agreement was that such an express permission could lead to malpractice liability if opt out was not used, and an unfortunate consequence that could have been prevented by opting out occurred. *See* Miller, *Intrastate Choice*, *supra* note 39, at 528. To the extent such a concern is valid, it would be similar in the case of opting in.

98. *See supra* text accompanying note 86.

99. It would seem so if a so-called waiver of defenses clause is enforceable, as it generally is outside of the consumer context. *See* U.C.C. § 9-403(b).

100. *Id.* §§ 3-105(b), 3-305, 9-404.

risk is normally assumed in selecting the law of another jurisdiction, however, and indeed the risk there may be greater because at least one usually is more familiar with the laws of one's own state, set of rules, or trade code with which one customarily works.[101] Thus, with care, "intrastate choice of law" can be as valuable a tool as interstate choice of law or varying the effect of particular rules by private agreement.

101. Given that NCCUSL's process involves the participation of all interested parties and not just that of the Commissioners themselves, the same is likely to be true for a uniform or model law such as UCITA and any article of the UCC.