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The Application of Arizona's Uniform Commercial Code in Construction Contexts

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This article addresses the application and operation of Arizona's Uniform Commercial Code in Title 47, specifically Chapter 2 (Sales) and Chapter 9 (Secured Transactions) ("UCC") in construction contexts. Most commonly, payment claims in construction are driven by terms in prime contracts, subcontracts, invoices and related terms and conditions, credit agreements, and the like. Parties may also seek to enforce verbal agreements not reduced to writing. In certain contexts affecting contracts for the sale of "goods," the UCC will govern a contractor's or supplier's payment claim exclusively, adding a layer of complexity to payment enforcement among the parties and likely excluding verbal agreements.

The following provides guidance on the main components of UCC Chapters 2 and 9, particularly concerning the determination of the nature of the contract subject to the UCC, how doctrines like the Statute of Frauds ("SOF") apply in contracts for the sale of goods and services, security interests bolstering collection efforts, and the Arizona Court of Appeals' application of the UCC in the seminal case of *Double AA Builders, Ltd. v. Grand State Constr. LLC*, 210 Ariz. 503, 114 P.3d 835 (App. 2005).

I. Definitions

a. Contracts for the Sale of Goods

The definition of "goods" guides the manner in which the UCC will apply as a sale and payment recovery mechanism. Under A.R.S. §47-2105, "goods" are defined to mean "all things (including specially manufactured goods) which are movable at the time of identification to the contract for the sale other than the money in which the price is to be paid, [investment securities] and things in action."[1] Section § 47-2105 requires that goods be both existing and identified before any interest in them can pass.[2] Otherwise, the goods that are not both existing and identified in a contract are considered "future goods."[3] A purported present sale of future goods or of any interest therein operates as a contract to sell.[4] Furthermore, "goods" includes things may be attached to, but can be severed from, realty as described in A.R.S § 47-2107.[5]

Section 47-2107 identifies certain goods that are to be severed from realty. For example, a contract for the sale of a structure or its materials to be removed from realty is a contract for the

[1] A.R.S. § 47-2105(A).
[2] A.R.S. § 47-2105(B).
[3] *Id.*
[4] *Id.* A.R.S. 47-2106 defines "contract for sale" as including both a present sale of goods and a contract to sell goods at a future time. A "sale" consists in the passing of title from the seller to buyer for a price and a "present sale" means a sale which is accomplished by the making of a contract. *Id.*
[5] *Id.* See A.R.S. § 47-2107 (goods that can be severed from realty).

sale of goods within Chapter 2 *if they are to be severed by the seller*.[6] However, until severance, a purported present sale thereof which is not effective as a transfer of an interest in land is effective only as a contract to sell.[7]

Though murky, this definition distinguishing "things" that are attached and severable from realty is critical in construction contexts - things such as materials and equipment that are already incorporated into a real property improvement are not subject to the UCC because they have been converted from personal property to real property, in which case the UCC no longer applies. The following discussion therefore simplifies matters and only applies to construction materials and equipment before they have been incorporated into a project and thus are subject to a real property interest such as a mechanic's and materialmen's lien.

II. Scope and Formation

Chapter 2 of the UCC only applies to transactions in goods.[8] It does not apply to any transaction which, although in the form of an unconditional contract to sell or present sale, is intended to operate only as a security transaction.[9] Further, Chapter 2 does not impair nor repeal any statute that regulates sales to consumers, farmers, or other specified classes of buyers. Essentially, this Chapter applies to the sale of goods and not to contracts primarily for services. If the contract is one for the sale of goods and services, this Chapter may still apply.

The UCC in Section 47-2204 provides a simple framework for first determining the existence of a contract for sale, before determining if the contract should have been in writing and is one for goods or services. While this framework comports mostly with common law principles, these guidelines to find a contract for sale may override a common law understanding, such as the level of definiteness required to find material terms to a contract.

1. A contract for the sale of goods may be made in any manner sufficient to show agreement by the parties, including conduct by both parties recognizing the contract exists.[10]

2. A contract may be formed even when the moment of making it is undetermined (provided there is an agreement sufficient to constitute a binding contract).[11]

3. A contract may be formed even though one or more terms are left open, so long as the parties have intended to make a contract and there exists a reasonably certain basis for giving an appropriate remedy.[12]

[6] A.R.S. § 47-2107(A).
[7] *Id.*
[8] A.R.S. § 47-2102.
[9] *Id.*
[10] A.R.S. § 47-2204(A).
[11] A.R.S. § 47-2204(B).
[12] A.R.S. § 47-2204(C).

III. Statute of Frauds

The SOF is set forth in A.R.S. § 47-2201. Under the statute, a contract for the sale of goods for the price of five hundred dollars ($500.00) or more is not enforceable by way of action or defense *unless* there is "some writing sufficient to indicate that a contract for sale has been made between the parties."[13] Further, when one party seeks to enforce the written contract against the other party, the contract must be signed by the party against whom enforcement is sought.[14] This is what is known as the writing requirement of the SOF.

Though a writing is required under this section for all contracts for the sale of goods exceeding $500.00, the SOF is considered satisfied, and a writing will not be deemed deficient, merely because it omits or incorrectly states a term.[15] However, the SOF will not be satisfied and the contract enforceable *if the writing fails to specify the quantity of the goods being sold*.[16]

a. Merchants

The rules and requirements of the SOF differ slightly when the contract is between merchants. A merchant is defined as "a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill."[17] The SOF provides an exception to the written requirement for contracts between merchants. Specifically, if the contract for the sale of goods over $500.00 is made orally, the SOF will still be satisfied so long as if within a reasonable time: (1) one merchant sends a written confirmation of the contract, (2) the party receiving it has reason to know of the contents of the contract, and (3) the receiving party does not object within ten (10) days of having received the confirmation.[18] The key here is that the contract must be between merchants and there must have been no objection to the written confirmation.

b. Contracts That Do Not Satisfy the SOF.

A contract that does not satisfy the written requirement of the SOF may still be valid in other respects and, thus, enforceable. Section 47-2201(C) provides that the following types of contracts for goods will still be enforceable:

1. If the goods are to be specifically manufactured for the buyer and are not suitable for sale to others in the ordinary course of the seller's business and the seller, before notice of repudiation is received and under circumstances which reasonably indicate that the

[13] A.R.S. § 47-2201(A).
[14] *Id.* It is sufficient for the signature to be by an authorized agent or broker of the party against whom enforcement is sought. *Id.*
[15] *Id.*
[16] *Id.*
[17] A.R.S. § 47-2104(A).
[18] A.R.S. § 47-2201.

goods are for the buyer, has made either a substantial beginning of their manufacture or commitments for their procurement; or

2. If the party against whom enforcement is sought admits in his pleading, testimony, or otherwise in court that a contract for sale was made, but the contract is not enforceable under this provision beyond the quantity of goods admitted; or

3. With respect to goods for which payment has been made and accepted, or which have been received and accepted.[19]

IV. Case Law

The definitions and rules of UCC Chapter 2 bring to light contracts between contractors, subcontractors, and suppliers on construction projects, including contracts and credit agreements to furnish materials to a specific project or over time on various projects. The UCC is a must-read if a contract for goods is sought to be enforced. Parties typically have contracts in writing valued more than $500.00 and sufficient to satisfy the SOF, but other agreements may not be written and/or signed by the party to be charged to meet the SOF. Arizona case law emphasizes the importance of satisfying the SOF and heeding the application of the UCC when a party alleges that payment for materials are due.

Double AA Builders, Ltd. v. Grand State Constr. L.L.C.[20] discusses the doctrine of promissory estoppel and its application in contracts between general contractors and subcontractors. Additionally, the case discusses Arizona's approach to determining whether the UCC applies to mixed contracts involving both goods and services.

a. The Application of Promissory Estoppel in Bid Scenario

In *Double AA*, Double AA Builders, Ltd. ("General Contractor") solicited bids from subcontractors for a construction project to build a Home Depot Store in Mesa, Arizona.[21] Grand State Construction, L.L.C. ("Subcontractor") faxed a written but unsigned bid to General Contractor stating that the price was good for thirty days.[22] General Contractor relied upon Subcontractor's bid in preparing its price for the project and advised Subcontractor that it was the successful bidder for the scope of work - when General Contractor sent the subcontract to the Subcontractor, however, Subcontractor refused to sign explaining that it could not undertake the work.[23] General Contractor claimed damages to recover the difference paid to a replacement contractor at a higher price than Subcontractor's bid and filed suit under the doctrine of promissory

[19] A.R.S. § 47-2201(C).
[20] 210 Ariz. 503, 114 P.3d 835 (App. 2005).
[21] *Id.* at 505.
[22] *Id.*
[23] *Id.*

estoppel.[24] The Subcontractor argued that the doctrine of promissory estoppel should not be applied in the context of subcontractors submitting bids to general contractors.[25]

On this issue, the Court explained that Arizona has long recognized and applied the promissory estoppel doctrine and it may be used in the context of subcontractors if the doctrine's required elements are proven.[26] The Court reasoned from an industry perspective first, that a subcontractor's refusal to honor its bid can be financially disastrous for the general contractor who uses the bid in its pricing and is then bound by the bid price submitted to the owner.[27] Factually, the Court found substantial evidence warranting the application of promissory estoppel because (1) the Subcontractor submitted a bid "good for 30 days" constituting a promise to perform at the bid price (and likewise realized General Contractor would rely on the bid if it was the lowest), and (2) General Contractor did rely on Subcontractor's bid by incorporating it in its own proposal to the owner.[28]

b. Predominant Purpose Test to Find Application of Statute of Frauds

The Subcontractor in *Double AA* also argued that the SOF barred General Contractor's claim to enforce the subject subcontract, because the subcontract involved the sale of goods in excess of $500.00 and the faxed bid was not signed by the party to be charged.[29] The Court thus examined the nature of the alleged subcontract under the general SOF statute, A.R.S. § 44-101(4), which applies to contracts to sell or a sale of goods of $500.00 or more (and essentially mirrors the UCC's SOF requirements for contracts for the sale of goods cited above).

The General Contractor argued that the subject contract was predominantly for the sale of services (installation of EIFS insulation) instead of the sale of goods and, therefore, the contract was not barred by the SOF.[30] As an issue of first impression in Arizona, the Court addressed the issue of "whether the statute of frauds applies to a subcontract that contemplates the supplying of both goods and services."[31]

The Court recognized that if the transaction at issue includes both goods and services, most courts seek to determine whether the predominant purpose of the contract is the sale of goods or the provision of services.[32] Making this determination presents a question of fact.[33] Here, the Court held that, although the subcontract included both labor and materials, the predominant purpose was the installation to install the materials rather than a materials supply agreement.[34] The Court

[24] *Id.*
[25] *Id.* at 506.
[26] *Id.* at 507.
[27] *Id.* at 506.
[28] *Id.* at 508.
[29] *Id.* at 509.
[30] *Id.*
[31] *Id.*
[32] *Id.* at 509-510
[33] *Id.* at 510.
[34] *Id.*

came to this conclusion after considering (1) the Subcontractor was required to be licensed by the Arizona Registrar of Contractors in order to perform the work, and (2) the Subcontractor's reason for refusing to perform the obligation was that it could not adequately staff the job.[35] As predominantly a services contract, the Court held that the trial court correctly decided the SOF did not apply as defense to General Contractor's claim for damages.[36]

V. Notes on Collection in Secured Transactions

Chapter 9 of the UCC applies to Secured Transactions and is noteworthy to construction suppliers and others with secured interests *outside* of a mechanic's and materialmen's context. Chapter 9 governs all transactions, regardless of their form, which create a security interest in personal property or fixtures by contract, as well as the sale of accounts, chattel paper, payment intangibles or promissory notes.[37] The following is a brief summary of the scope of Chapter 9 and addresses one particular collection tool under A.R.S. § 47-9607.

Under A.R.S. § 47-9102, a "secured party" is defined as "(a) [a] person in whose favor a security interest is created or provided for under a security agreement, whether or not any obligation to be secured is outstanding; (b) [a] person that holds an agricultural lien; (c) [a] consignor; (d) [a] person to which accounts, chattel paper, payment intangibles or promissory notes have been sold; (e) [a] trustee, indenture trustee, agent, collateral agent or other representative in whose favor a security interest or agricultural lien is created or provided for; or (f) [a] person that holds a security interest" arising under certain enumerated statutes.[38]

A "debtor" is defined as "(a) [a] person having an interest, other than a security interest or other lien, in the collateral, whether or not the person is an obligor; (b) [a] seller of accounts, chattel paper, payment intangibles or promissory notes; or (c) [a] consignee."[39]

VI. Elements and Requirements of A.R.S. § 47-9607

Pursuant to A.R.S. § 47-9607, a secured party can enforce its rights only if one of two elements are met: (1) there is a security agreement that expressly authorizes the action; or (2) the debtor is in default.[40] If there is a security agreement authorizing the secured party to collect, the security interest must be enforceable against the debtor for this section to be applicable and the agreement must not waive the nonwaivable rights and duties provided under A.R.S. § 47-9602.[41]

Once one of the two elements are met, the secured party then has five options to obtain the collateral. First, the secured party may notify an account debtor or any other person who is

[35] *Id.*
[36] *Id.* at 511.
[37] U.C.C. § 9-109.
[38] A.R.S. § 47-9102(A)(72).
[39] *Id.* at § (A)(28).
[40] A.R.S. § 47-9607(A).
[41] *See* A.R.S. § 47-9203 (outlining the enforceability requirements). *See also* A.R.S. § 47-9602 (a secured party may not waive the commercially reasonable standard).

obligated to make payment for the collateral or render performance to or for the benefit of the secured party.[42] Second, the secured party may take proceeds to which they are entitled under section 47-9315.[43] Third, the secured party may enforce the account debtor or obligated party's obligations regarding the collateral or exercise the obligatory rights of the debtor to make payment or render performance, including if property is involved.[44] Fourth, if the security interest is in a deposit account perfected by the bank who maintains the account, the bank may apply the balance of the account to the obligations.[45] Fifth, if the security interest is in a deposit account, and the debtor, the secured party, and the bank have all agreed for the secured party to directly deposit the funds without the debtor's consent, or the secured party becomes the bank's customer, then the bank is allowed to pay the balance of the account to or for the benefit of the secured party.[46]

VII. Applicability of A.R.S. § 47-9607

a. Commercial Reasonableness Standard

When undertaking to collect from or enforce an obligation of an account debtor or other person obligated on collateral, the secured party must proceed in a commercially reasonable manner, including notifying the underlying obligors of impending collections.[47] In *Phoenix Corvette Sales, Ltd. v. Brooks*,[48] the court noted that under Arizona law, when a debtor defaults on a security agreement, the creditor may sell or dispose of the collateral and sue the debtor for the remaining deficiency.[49] However, "[e]very aspect of a disposition of collateral, including the method, manner, time, place and other terms, must be commercially reasonable."[50]

The standard of commercial reasonableness also applies when the secured party is entitled to charge back uncollected collateral or to full or limited recourse against the debtor.[51] In determining whether a secured party has acted in a commercially reasonable manner, courts have recognized that there is no statutory definition of the specific requirement necessary for an action

[42] A.R.S. § 47-9607 (A)(1).
[43] *Id.* at § (A)(2). *See* A.R.S. § 47-9315 (discussing a secured party's rights on disposition of collateral and in proceeds).
[44] A.R.S. § 47-9607(A)(3).
[45] *Id.* at § (A)(4).
[46] *Id.* at § (A)(5).
[47] *Id.* at § (C). *See Remedies Outside the Box: Enforcing Security Interests Under Article 9 of the Uniform Commercial Code*, AM. BAR ASS'N., https://www.americanbar.org/groups/business_law/resources/business-law-today/2012-august/remedies-outside-the-box/.
[48] App. Dec. 5, 2017, No. 1 CA-CV 17-0118, (2017) Ariz. App. Unpub. LEXIS 1818. Note, this is an unpublished decision, but it is being introduced as persuasive authority due to the limited case law on this statute.
[49] *Id.* at *3.
[50] *Id.* at *4.
[51] *Id.* at § (C)(2).

to be commercially reasonable.[52] Instead, the determination depends upon the circumstances, and the decision is considered one of fact rather than law.[53]

Additionally, A.R.S. § 47-9627 provides guidance as to what methods of disposition, collection, enforcement, or acceptance have been considered commercially reasonable. Pursuant to section 47-9627(B): "A disposition of collateral is made in a commercially reasonable manner if the disposition is made:

> (1) In the usual manner on any recognized market;
>
> (2) At the price current in any recognized market at the time of the disposition; or
>
> (3) Otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition."[54]

Additionally, under subsection (C), a collection, enforcement, disposition or acceptance is considered commercially reasonable if it has been approved:

> "(1) In a judicial proceeding;
>
> (2) By a bona fide creditors' committee;
>
> (3) By a representative of creditors; or
>
> (4) By an assignee for the benefit of creditors."[55]

It should be noted, however, that approval under subsection (C) need not be obtained for the conduct to be deemed commercially reasonable, as the standard can be met in other ways.[56] The burden will be on the secured party to prove that the required standard of reasonableness has been met.[57]

a. <u>Attorneys' Fees and Application of Proceeds</u>

Under A.R.S § 47-9607, if the secured party incurs legal expenses or attorneys' fees when collecting collateral, the secured party may deduct those expenses as reimbursement. Section 47-9608 sets out the order in which a secured party must pay or apply the cash proceeds of collection or enforcement.[58] First, the proceeds must be applied to the reasonable expenses of collection and

[52] *See Gulf Homes v. Goubeaux* (1979) 124 Ariz. 142, 144, 146 ("The decision of reasonableness is usually one of fact to be resolved by the trier of fact.").
[53] *Id.*
[54] A.R.S. § 47-9627(B).
[55] *Id.* at § (C).
[56] *Id.* at § (D).
[57] *See Gulf Homes*, (1979) 124 Ariz. at 145 ("When suing for a deficiency, the burden of proof is upon the secured party, who must prove that disposition of the collateral was conducted in a commercially reasonable manner.").
[58] A.R.S. § 47-9608(A)(1).

enforcement and, to the extent provided for by agreement and not prohibited by law, reasonable attorney fees and legal expenses incurred by the secured party.[59] Second, the remaining cash proceeds must be paid or applied to satisfy the obligations secured by the collateral.[60] Finally, any remaining proceeds will go towards satisfying any subordinate security interest or lien on the collateral, provided the secured party receives an authenticated demand for those proceeds before the end of distribution.[61]

If after distribution there is any surplus, the secured party must pay the surplus to the debtor.[62] If there is any deficiency, the obligor will be liable.[63] Note, however, that if the underlying transaction is a sale of accounts, chattel paper, payment intangibles, or promissory notes, the right to surplus and liability for deficiency is different.[64] In such case, the debtor is not entitled to any surplus and, similarly, the obligator will not be liable for any deficiency.[65]

VIII. Taking Possession After Default

Once a default has been entered, A.R.S. § 47-9609 provides a secured party the right to take possession of the collateral and, without removal, allows the secured party to render equipment unusable and to dispose of collateral on a debtor's premises.[66] When taking possession of the collateral, the secured party may do so pursuant to judicial process or without judicial process, only if it proceeds without breach of the peace.

IX. Court Interpretation

Very few cases discuss or interpret A.R.S. § 47-9607. In *ARA Inc. v. City of Glendale*,[67] the court declined to rule on whether the statute creates an independent cause of action, stating that the court saw no reason at that stage of litigation to rule on that issue. However, the Court did note that courts nationwide are split on this issue[68] and referenced a Fourth Circuit unpublished decision which concluded the UCC provision corresponding to A.R.S. § 47-9607 does not create an independent cause of action.[69]

In *Forest Capital, LLC v. Blackrock, Inc.*, the Fourth Circuit noted that when determining "whether a statute creates a private right of action, the central inquiry is whether the legislative

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[59] *Id.*
[60] *Id.*
[61] *Id.* See also A.R.S. § 47-9608(A)(3), providing that a secured party need not apply or pay the non-cash proceeds of the collection and enforcement under A.R.S § 47-9607 unless the failure to do so would be commercially unreasonable.
[62] A.R.S. § 47-9608(A)(4).
[63] *Id.*
[64] A.R.S. § 47-608(B).
[65] *Id.*
[66] A.R.S. § 47-9609.
[67] *ARA Inc. v. City of Glendale* (D. Ariz. 2019) 360 F. Supp. 3d 957.
[68] *Id.* at 970-71.
[69] *See Forest Capital, LLC v. BlackRock, Inc.*, (4th Cir. 2016) 658 Fed. App'x 675, 682.

body intended to create one, either expressly or by implication."[70] Because subsection (e) of UCC § 47-9607 provides that the section does not determine whether an account debtor, bank, or other person obligated on collateral owes a duty to a secured party, the Fourth Circuit held that the statute neither creates a right of action nor imposes any obligations on an account debtor.[71] Some Courts, however, have decline to adopt the Fourth Circuit court's reasoning and have held that the statute does create a private cause of action.[72]

[70] *Id.* at 678.
[71] *Id.*
[72] *See ARA Inc.* (D. Ariz. 2019) 360 F. Supp. 3d at 971.