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SECURED TRANSACTIONS

# The UCC Emerging Technologies Committee: Part II (Chattel Paper)

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In August of last year, this column reviewed certain proposed revisions to the Uniform Commercial Code being considered by the Uniform Commercial Code and Emerging Technologies Committee, a joint collaborative effort sponsored by the Uniform Law Commission and American Law Institute. See *Virtual Currencies (and Other Digital Assets) Under the UCC*, 25 N.Y.L.J. 266 (Aug. 5, 2021).

As a quick recap, the Committee was created in 2019 to study whether changes were needed to modernize the UCC. It quickly turned into a drafting committee whose objective it was to propose UCC amendments to accommodate emerging technologies, including distributed ledger technology, and virtual currency and other digital assets. Those proposed revisions now include a new Article 12 (Controllable Electronic Records), which will provide for negotiable digital records, as well as conforming revisions to such other parts of the UCC as Articles 1 (General Provisions) and 9 (Secured Transactions). The Committee has set its sights on completing this project and gaining approval of its sponsors by July 2022.

While that effort remains ongoing, it has also expanded into other areas, some related to technological developments and some not. Certain related areas include those dealing with the use of electronic signatures and electronic communications (in lieu of physical writings), and the definition of "conspicuous" in Article 1 (General Provisions). But it now also includes various amendments unrelated to technology, such as under Article 9 to clarify the treatment of commercial tort claims as proceeds of other collateral, and the usage and meaning of the terms "assignor" and "assignee," as well as to add to the Article 1 definition of "person" a protected series of an entity if that series is established under non-UCC law.

One of these other sets of significant revisions relate to chattel paper and leasing, and involves amendments relating not only to the increased reliance on electronic documents, but also the growing prevalence of hybrid (or "bundled") transactions (i.e., combining the sale or lease of specific goods with the provision of other property, such as software, services or other goods. It is this last category of proposed amendments that the column will focus on today.

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## Chattel Paper Redefined

Not surprisingly, in reviewing the amendments addressing the growth of electronic and hybrid lease and sale transactions, we first need to turn to the Article 9 definition of "chattel paper."

The term "chattel paper" is certainly one of Article 9's more complex definitions. "Chattel paper," as

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currently defined in UCC §9-102(a)(11), means a record or records that evidence both a monetary obligation and a security interest in specific goods, in specific goods and software used in the goods, in specific goods and license of software used in the goods, a lease of specific goods, or a lease of specific goods and license of software used in the goods. "Monetary obligation" is defined for this definition as a monetary obligation secured by the goods or owed under a lease of the goods, and includes a monetary obligation with respect to software used in the goods.

There are two important themes in the proposed revisions to the definition of "chattel paper." First, in what the drafters refer to as "semantic" or clean-up rather than substantive changes, the revised definition will make it clear that chattel paper is intended to capture the right to payment secured by or with respect to the lease of specific goods, and not the record evidencing that right (e.g., the secured note, lease or conditional sales agreement). It accomplishes this by describing the asset in the definition as "a right to payment of a monetary obligation" instead of a "record or records evidencing a monetary obligation." (Note that there is a proposed conforming change to the definition of "account" in 9-102(a)(2) to exclude "chattel paper" from that definition, rather than any "rights to payment evidenced by chattel paper or an instrument" and to the definition of "instrument" to exclude a record that evidences chattel paper.) The proposed commentary to 9-102(a)(11) then emphasizes that it is the right of the creditor to enforce against *specific* goods to realize payment that distinguishes chattel paper from other rights to payment, and notes that specific goods would *exclude* a security interest in "rotating collateral."

Second, it is often unclear to financiers if and when a lease that involves both the provision of goods and something else, such as services or other property, will still constitute chattel paper for Article 9 purposes. The draft amendments to the definition of "chattel paper" address this issue by stating that a lease will fit within that definition if the "predominant purpose" of the transaction giving rise to such lease is "to give the lessee the right to possession and use of the goods."

> The revisions to the Uniform Commercial Code proposed by the Emerging Technologies Committee are substantial in scope and nature, the most significant since the "revised Article 9" amendments effective in 2001.

The term "predominant purpose" is not defined in Article 9 nor in Article 2 (Sales) or 2A (Leases), where it is also proposed to be used. The proposed commentary to revised Articles 2 and 2A notes that while this test is an accepted (and perhaps majority) judicial approach to the issue of a "bundled transaction," courts have grappled with it for many years with often conflicting results. While it notes factors looked at by courts (i.e., nature of the overall transaction, language of the relevant agreement, whether there is (in the context of a sale) an allocation of purchase price (or cost) in respect of the goods and nature of the seller's or lessor's business (i.e., whether the it is in the business of selling or leasing goods of that kind)), more importantly and perhaps helpfully, the proposed commentary to §9-102 provides examples of when a transaction would or would not constitute chattel paper based on the predominant purpose test.

### Chattel Paper: Electronic vs. Tangible/Choice of Law

There are two other notable sets of proposed amendments relating to chattel paper under Article 9, one dealing with perfection and the other with choice of law.

The first set of changes is in response to the movement in the finance sector away from paper documents and towards the use of electronic chattel paper. This development has added confusion and complexity to the process of perfecting a security interest in chattel paper by possession (in the case of tangible chattel paper) or control (in the case of electronic chattel paper), either of which can give the secured

party priority over competing liens perfected only by filing.

A sale of or security interest in "tangible chattel paper" (as defined in 9-102(a)(79)) can be perfected by possession under 9-313(a) of the "original" copy. Given there is often more than one original signed copy, the finance industry has generally followed the path of designating by contract the counterpart signed copy that will constitute the "original" for purposes of perfection by possession. The current safe harbor for "electronic chattel paper" (as defined in 9-102(a)(31)), on the other hand, is set forth in §9-105, and provides for perfection by "control" of a single "authoritative copy."

One result of the growing use of electronic chattel paper is that the same chattel paper may now often exist in both tangible and electronic forms, or may exist in one type and then be converted to the other. In recognition of this trend, the drafters propose to transition to a single rule under a new §9-314A pursuant to which a lien can be perfected on tangible chattel paper by taking possession of *any and all* "authoritative" copies and in respect of electronic chattel paper by taking control of *any and all* "authoritative" copies. Note that as part of this transition, the drafters propose to eliminate the defined terms in §9-102 of "tangible chattel paper" and "electronic chattel paper" and refer instead these terms generically, such as a "tangible copy of the record evidencing the chattel paper" and the "electronic copy of the electronic record evidencing chattel paper." Also noteworthy is that the drafters have changed the requirements for control of electronic chattel paper to mostly track the requirements for a "controllable electronic record" under Article 12 (see the column first referenced above), but to provide assurances with respect to existing control arrangements, have essentially grandfathered in the existing rule defining control over electronic chattel paper under 9-105(b).

The term "authoritative copy" is not currently defined, nor is it proposed to be defined under the amendments. Instead, the commentary to §9-314A explains that the law would allow "considerable flexibility in determining the method to establish whether a particular copy is authoritative."

The last notable proposed change in regard to chattel paper relates to choice of law. A new §9-306A establishes a complex new set of rules for determining the law governing perfection, the effect of perfection or nonperfection, and the priority of a security interest in electronic and tangible chattel paper. For perfection by filing, the rule remains the same—the jurisdiction where the debtor is "located" applies to perfection (but it may not apply to priority, as noted below). For tangible copies, similar to existing law, the jurisdiction of location of the tangible copy of the chattel paper governs perfection by possession and (regardless of how perfected) priority of a security interest, *provided* no authoritative electronic copies exist. Where an authoritative electronic copy exists, a waterfall of five rules applies to determine both perfection and priority, starting with the jurisdiction specified as the "electronic chattel paper's jurisdiction" in the related record, provided that record is readily available for review, and ending with the jurisdiction where the debtor is located.

## Conclusion

The revisions to the Uniform Commercial Code proposed by the Emerging Technologies Committee are substantial in scope and nature, the most significant since the "revised Article 9" amendments effective in 2001. As they have continuously noted, all of the UCC Articles other than Article 6 (which was repealed in 2001) will be revised in some respect.

Keep in mind that this remains a work-in-process, although it is now close to completion. The final product must still be agreed upon by the drafters, and then approved by the two sponsor organizations, following which it will be promoted for adoption by the states and U.S. territories. Based on this, and the proposed transition rules, the actual implementation of these amendments is still a considerable distance away.