

Memorandum

To Edwin E. Smith, Chair, UCC Article 9 Review Committee
Steven L. Harris, Reporter, UCC Article 9 Review Committee
Stephen L. Sepinuck, ABA Advisor
From Thomas E. Plank, Member, ALI Members Consultative Group
Re March 2009 Draft-Treatment of Chattel Paper.
Date September 14, 2009

In addition to my memo on the March 2009 Draft-Proposed Comment 5 for Section 9-318, I am submitting additional comments on the March 2009 proposed draft as they relate to control and possession of chattel paper and the classification of stripped rentals in chattel paper.

1. § 9-105 Definition of Control

I believe that the amendments proposed for § 9-105 will be very useful. However, having recently spent a good deal of time wrestling with the concept of “control” of electronic chattel paper, and especially in the context of converting from tangible to electronic and electronic to tangible, I have discovered statutory shortcomings and ambiguities for both tangible chattel paper and electronic chattel paper.

The changes in the comments regard “papering out electronic chattel paper” amplifies these shortcomings and ambiguities. The essential problem is (a) the potential simultaneous existence of original tangible chattel paper and an authoritative copy of electronic chattel paper and (b) upon papering out of an electronic contract, the non-existence of an “original” tangible chattel paper and the potential existence of multiple copies of the paper-out tangible chattel paper. I propose that the Committee resolve these shortcomings and ambiguities by further expanding § 9-105, and I provide a specific statutory provision to provide specific solutions to a variety of the issues caused by these problems. [I assume that abolishing the concept of “control” of electronic chattel paper and providing for a simple superpriority for buyer of chattel paper over inventory financiers is out of the question.]

The basic statutory shortcoming is that the rules for possessory perfection under § 9-313 and possessory superpriority under § 9-330 contemplate that there is only a single “original” tangible chattel paper. Although the existence of a single “original” tangible chattel paper seems to be implicit in the rules for possessory interests in chattel paper, the definition of tangible chattel paper is not so constrained. [This is in contrast to the definition of a promissory note under article 3, which requires a signed, original written document.] The proposed amendment to the comment highlights this statutory shortcoming, and to resolve it I propose that an expanded § 9-105 include a definition of “possession” of tangible chattel paper.

First, I set forth the separate subsections of the expanded definition, and after each subsection I provide an explanation for the particular provisions.

§ 9-105 Control and Possession of Electronic Chattel Paper

[New subsections:

(c) Except as otherwise provided in this section, a person has “possession” of tangible chattel paper under this Part only if the person has possession of the tangible medium evidencing the monetary obligation of the debtor and creating the security interest, license or lease (1) that is signed by the debtor or (2) in the case of tangible chattel paper converted from electronic chattel paper, that contains a certification of the conversion signed by the secured party that had control of the electronic chattel paper.

[Comment: This provision does several things: 1) it make explicit what is implicit for chattel paper that originally began as tangible chattel paper—the secured party must have possession of the original; 2) it provides a means for creating a single authoritative copy of tangible chattel paper that has been converted from electronic chattel paper; and it solves the problem of how to deal with the “possession” of a participation interest in chattel paper that is deemed to be chattel paper. This provision does not attempt to address the problem of multiple original tangible chattel paper.]

(d) A person that otherwise satisfies all of the elements for control of electronic chattel paper shall be deemed to have control notwithstanding possession of the same chattel paper in the form of tangible chattel paper.

[Comment: this provision ensures that upon conversion of chattel paper from one form to another, the simultaneous existence of the same chattel paper in both forms does not destroy either possession or, more importantly, control.

(e) To the extent that different persons have possession of tangible chattel paper and control of electronic chattel paper representing the same chattel paper, each person shall be deemed to have a pro rata property interest in the chattel paper.

[Comment: Because there can exist chattel paper in two forms, each of which can be “controlled” or “possessed”, we need rules to determine primacy between the two forms of chattel paper. We could give primacy always to those with control of electronic paper, those with possession of tangible paper, those who hold the latest creation, or those who are the first receive either control or possession from the common controlling/possession person. I propose a pro rata interest, because I cannot think of any way to provide notice to the world on who should win if the two forms are separated. This subsection would also address the problem of more than one signed original tangible chattel paper. Note that this rule is similar to that adopted for security entitlements in financial assets.

(f) To the extent that a person has priority in chattel paper pursuant to section 9-330 of this Article at any time, that person retains such priority against any existing or future secured party perfected other than by control or possession even if the person no longer has possession or control of the chattel paper so long as the debtor does not acquire possession or control.

[This provision is designed to deal with the problem of a person that acquires priority under § 9-330 and then transfers or loses possession or control. For example, a buyer of chattel paper may acquire tangible chattel paper free of an earlier filing inventory financier and then

convert the tangible to electronic form. If in the conversion process the person fails to maintain control, does the conversion retroactively destroy the buyer's superpriority? It should not. But that is a debatable point. Similarly, if a buyer acquires control of electronic chattel paper, and then converts to tangible chattel paper, and it is not clear that there is any "authoritative copy" of the tangible chattel paper that can be possessed (or there are multiple copies of the reconverted tangible paper), the person should not lose the priority based on control.

2. § 9-102 Comment 5d—Classification of Stripped Rentals and Definition of Payment Intangibles

I am concerned that the addition to the comment is not consistent with important provisions of Article 9 and will introduce more confusion in this area. The treatment of participation interests in specific types of collateral—namely, accounts and chattel paper—under Article 9 is troublesome. As a policy matter, for some purposes, a participation interest in an account or chattel paper should be treated like the underlying account or chattel paper. This is especially true in the case of perfection and priority by filing. This seems to be the import of the additional comment. Unfortunately, the comment is inconsistent with the express definition of an account or chattel paper and, in the case of chattel paper, also appears to be inconsistent with the nature of chattel paper as a "specialty." A participation interest presumably would be evidenced by a written agreement. This written agreement would not satisfy the definition of chattel paper, and possession of this written agreement would not seem to qualify the purchaser for perfection rules of § 9-313 or the special priority rules of § 9-330. But the comment would seem to add additional grounds for uncertainty on these points.

Also, one must question the effectiveness of a comment that contradicts a decided case without any change in the statute.

I propose two alternative amendments. One alternative assumes the adoption of the modification to § 9-105 that I suggest above. The second assumes no such modification. The point of the amendment set forth below is to provide that, for purposes of perfection by filing and priority based on filing, but not for purposes of possession or a possessory security interest, a participation interest in an account or chattel paper be deemed to be an account or chattel paper, as applicable.

1: Assuming adoption of § 9-105(c) or comparable provision:

Amendment to § 9-102(a)(2) ("Account"):

At the end of the subsection, add the following: "**The term includes a participation interest in or a secured party's rights under a partial assignment of an account.**"

Amendment to § 9-102(a)(11) ("Chattel Paper"):

At the end of the subsection, add the following: "**The term includes a participation interest in or a secured party's rights under a partial assignment of chattel paper.**"

[Comment: This will make a participation interest an account or chattel paper for all purposes other than possession or control. It does not, however, answer the question of who the account debtor is with respect to the participation in the account or chattel paper.

2: Assuming non-adoption of § 9-105(c) or comparable provision:

Amendment to § 9-102(a)(2) (“Account”):

At the end of the subsection, add the following: “**Solely for purposes of perfection under § 9-310(a) and priority under § 9-322, the term includes a participation interest in or a secured party’s rights under a partial assignment of an account.**”

Amendment to § 9-102(a)(11) (“Chattel Paper”):

At the end of the subsection, add the following: “**Solely for purposes of perfection under Section 9-310(a) and Section 9-312(a) and priority under § 9-322, the term includes a participation interest in or a secured party’s rights under a partial assignment of chattel paper.**”