

MEMORANDUM

TO: Committee on the Uniform Commercial Code and Emerging Technologies

FROM: Steven Harris, Reporter

RE: Chattel Paper (to be discussed on May 3, 11 a.m. CT)

DATE: April 23, 2021

This Memorandum contains draft amendments to Uniform Commercial Code Article 9 that address issues that have arisen with respect to chattel paper, both electronic and tangible.

Background.

“Chattel paper” is one of several types of collateral that relate to rights to payment (receivables). Others include “accounts,” “instruments,” and “payment intangibles.”

Until Article 9 was revised in the 1990s, chattel paper was deserving of its name. It was a writing (*paper*), that was connected with a security interest in or lease of specific goods (*chattels*). A common example is an installment sale contract, under which a buyer of goods on credit promises to pay the sale price and secures that promise with a security interest in the goods. Another common example is an equipment lease, where the lessee promises to pay rent and the lessor retains a leasehold interest in the leased goods.

The 1999 official text expanded the definition of chattel paper to allow for an electronic record instead of a writing. Traditional, written chattel paper was denominated “tangible chattel paper,” whereas chattel paper that included an electronic chattel paper was denominated (despite the oxymoron) “electronic chattel paper.” The principal difference between tangible chattel paper and electronic chattel paper is that a security interest in the former can be perfected by taking possession (which, of course, is impossible to do with respect to an electronic record), whereas a security interest in the latter can be perfected by having control, a concept that subsequently appeared in UETA and E-SIGN.

Shortcomings in the current Article 9 provisions.

Tangible chattel paper. In a typical transaction, many writings evidence an installment contract or lease of goods. For example, in a lease transaction for which the lessor receives financing, the lessor, the lessee, and the financier each would receive a copy of the lease. Even before the 1999 revision of Article 9, “everyone” understood that the copy of the writing that constituted *the* chattel paper, *i.e.* the writing with respect to which possession was necessary and sufficient for perfection of a security interest, was the signed original.

Nevertheless, when there was more than one original, litigation required judges to determine whether possession of all signed originals was necessary to perfect by taking

possession of the chattel paper or whether possession of one of several originals would suffice. The comments to the 1999 revision addressed this issue.

In addition, different aspects of a single transaction may be evidenced by separate writings. For example, a transaction in which several items of equipment are leased often includes a master lease, which includes the terms applicable to all the goods, and specific schedules, which apply to specific leased goods. This issue, too, arose in litigation before the 1999 revision was promulgated and was addressed in the official comments.

Electronic chattel paper. As for electronic chattel paper, *control* was designed to function to the extent possible like *possession*. Just as Article 9 contemplated that only one person at a time can have possession of tangible chattel paper, so Article 9 defined control of electronic chattel paper by reference to a “single authoritative copy.”

As secured parties tried to take advantage of the electronic-chattel-paper provisions, they confronted some difficulties.

- *First*, the rule that a secured party cannot obtain control of electronic chattel paper unless there is a “single authoritative copy” impeded system design.
- *Second*, in some cases it has proven to be commercially desirable to “convert” tangible chattel paper into electronic chattel paper or to “paper out” electronic chattel paper into tangible chattel paper. The legal consequences of doing so are thought to be uncertain.
- *Third*, existing law does not deal satisfactorily with the situation where the records referred to in the current definition comprise one or more tangible authoritative copies of the records that evidence the right to payment and rights in related property and one or more electronic authoritative copies of those records.¹ This situation might arise when, *e.g.*, electronic chattel paper is subsequently amended by a writing, such that some terms of the chattel paper are contained in a tangible authoritative copy and some are contained in an electronic authoritative copy.

The 2010 amendments to Article 9 addressed the first issue by adding a general standard for control (borrowed from UETA and E-SIGN) and turning the 1999 conditions for control into a safe harbor. Under the general standard, a person would have control if “a system employed for evidencing the transfer of interests in the chattel paper reliably establishes the secured party as the person to which the chattel paper was assigned.” The amendments addressed the second and third issues in official comments.

Lawyers proved uncomfortable issuing a legal opinion to the effect that a particular system satisfied the general standard for control. As a result, their clients had strong incentives to use systems that allow for a “single authoritative copy,” rather than, for example, utilizing distributed ledger technology, which always involves multiple authoritative copies. Thus, the technology for maintaining electronic chattel paper remains frozen in time.

¹ The only copies that are relevant under the draft are those that are “authoritative.” Regarding the meaning of the term, see the Reporter’s Notes to draft § 9-314A.

Lawyers remain uncertain as to how a court would resolve the second and third issues described above.

Controllable electronic records v. chattel paper.

A fundamental principle underlying draft Article 12, dealing with controllable electronic records, is the distinction between a tangible or electronic record that evidences a right (*e.g.*, a right to payment) and the right itself.

The current definitions of “chattel paper,” “tangible chattel paper,” and “electronic chattel paper” muddle that distinction and so would be in tension with draft Article 12. Article 9 defines “chattel paper” as a “record or records” that evidence a monetary obligation and a security interest in or lease of specific goods. A record of this kind, *e.g.*, the paper on which an installment sale contract or equipment lease is written, typically is of no value, other than as evidence of the right to payment and interest in goods.² For the most part, this has not presented a problem, as those who deal with chattel paper understand that even though Article 9 defines “chattel paper” as a record or records, a security interest in chattel paper is in fact a security interest in the right to payment of the monetary obligation and in the interest in related property that are evidenced by the chattel paper.

Approach taken in the draft.

The draft would provide a single rule, under which a security interest in chattel paper could be perfected by taking possession of the tangible authoritative copies, if any, and obtaining control of the electronic authoritative copies, if any. This single rule would address cases where some records evidencing chattel paper are electronic and some are tangible or where a record in one medium is replaced by a record in another.

The draft also would redefine chattel paper more accurately, as the right to payment of a monetary obligation that is secured by a security interest in specific goods or owed under a lease of specific goods, if the right to payment and interest in the goods are evidenced by a record or records.

Section 1-201. General Definitions.

* * *

(b) Subject to definitions contained in other articles of the Uniform Commercial Code that apply to particular articles or parts thereof:

² Where a record evidencing the monetary obligation is a negotiable instrument, the paper itself is likely to have considerable value. See the Concluding Note below for a discussion of chattel paper evidenced by a negotiable instrument.

* * *

(11) “Chattel paper” means a ~~record or records that evidence both a right to~~ payment of a monetary obligation and a security interest in specific goods, a security interest in specific goods and software used in the goods, a security interest 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, if the right to payment and interest in related property are evidenced by a record or records. In this paragraph, “monetary obligation” means 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. The term does not include (i) charters or other contracts involving the use or hire of a vessel or (ii) records that evidence a right to payment arising out of the use of a credit or charge card or information contained on or for use with the card. If a transaction is evidenced by records that include an instrument or series of instruments, the group of records taken together constitutes chattel paper.

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~~(31) “Electronic chattel paper” means chattel paper evidenced by a record or records consisting of information stored in an electronic medium.~~

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~~(79) “Tangible chattel paper” means chattel paper evidenced by a record or records consisting of information that is inscribed on a tangible medium.~~

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Reporter’s Note

1. *Reconceptualization of “chattel paper.”* The amendments to this section would reflect the reality that the asset relied upon as collateral is a right to payment and not the record or records that evidence the right to payment and interest in related property. The records would remain relevant to perfection and priority of such a security interest.

Section 9-105. Control of Electronic Record Evidencing Chattel Paper.

(a) [When secured party has control.] A secured party has control of an electronic copy of a record evidencing the [right to payment that is the] chattel paper if the following conditions are met:

(1) the electronic copy, a record attached to or logically associated with the electronic copy, or the system in which the electronic copy is recorded, if any:

(A) enables the secured party to readily identify each electronic copy of the record as an authoritative copy or nonauthoritative copy of the record;

(B) enables the secured party to readily identify itself as the assignee of each authoritative electronic copy of the record;

(C) gives the secured party, subject to subsection (b), the exclusive power to prevent others from adding or changing an identified assignee of each authoritative electronic copy of the record;

(D) gives the secured party, subject to subsection (b), the exclusive power to transfer control of the authoritative copy of the record; or

(2) another person obtains control of the electronic copy of a record evidencing chattel paper on behalf of the secured party or, having previously obtained control of the electronic copy, acknowledges in an authenticated record that it has control on behalf of the secured party.

(b) [Meaning of “exclusive”.] A power specified in paragraph (a)(1) may be “exclusive,” even if:

(1) the electronic copy or the system in which it is recorded, if any, limits the use to which the electronic record may be put or has protocols that are programmed to result in a transfer of control; and

(2) the secured party has agreed to share the power with another person.

(c) [Identification of secured party.] For the purposes of clause (a)(1)(B), a secured party may be identified in any way, including by name, identifying number, cryptographic key, office, or account number.

Reporter's Note

1. “*Control.*” The amended definition of “control” is meant to reflect the functions that possession serves with respect to writings in a more accurate and technologically flexible way than does the current definition.

2. “*Authoritative copy.*” See the Reporter’s Note to draft § 9-314A.

3. *Use of singular.* The definition refers to “record” and “copy.” In any given case, there may be more than one relevant record and more than one copy. Under Section 1-106, unless the statutory context otherwise requires, words in the singular number include the plural.

Section 9-203. Attachment and Enforceability of Security Interest; Proceeds;

Supporting Obligations; Formal Requisites.

* * *

(b) **[Enforceability.]** Except as otherwise provided in subsections (c) through (i), a security interest is enforceable against the debtor and third parties with respect to the collateral only if:

(1) value has been given;

(2) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and

(3) one of the following conditions is met:

(A) the debtor has authenticated a security agreement that provides a description of the collateral and, if the security interest covers timber to be cut, a description of the land concerned;

(B) the collateral is not a certificated security and is in the possession of the secured party under Section 9-313 pursuant to the debtor's security agreement;

(C) the collateral is a certificated security in registered form and the security certificate has been delivered to the secured party under Section 8-301 pursuant to the debtor's security agreement; ~~or~~

(D) the collateral is deposit accounts, ~~electronic chattel paper~~, investment property, or letter-of-credit rights, and the secured party has control under Section 9-104, 9-105, 9-106, or 9-107 pursuant to the debtor's security agreement; or

(E) the collateral is chattel paper and the secured party has possession and control under Section 9-314A pursuant to the debtor's security agreement.

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Reporter's Note

1. *Substitute for authenticated security agreement.* Under subparagraphs (b)(3)(B) through (b)(3)(D), possession of tangible collateral and control of intangible collateral may substitute for an authenticated security agreement that provides a description of the collateral. With respect to chattel paper, some of the authoritative records that evidence the right to payment may be tangible and some electronic. Accordingly, new subparagraph (b)(3)(E) would provide that possession of the tangible authoritative records, if any, and control of the electronic records, if any, may substitute for an authenticated security agreement.

Section 9-207. Rights and Duties of Secured Party Having Possession or Control of Collateral.

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Section 9-208. Additional Duties of Secured Party Having Control of Collateral.

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Reporter's Note

These two sections will need to be reviewed.

Section 9-301. Law Governing Perfection and Priority of Security Interests. Except as otherwise provided in Sections 9-303 through 9-306, the following rules determine the law governing perfection, the effect of perfection or nonperfection, and the priority of a security interest in collateral:

(1) Except as otherwise provided in this section, while a debtor is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in collateral.

(2) ~~While~~ Except as otherwise provided in paragraph (5), while collateral is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a possessory security interest in that collateral.

(3) Except as otherwise provided in paragraph (4), while negotiable documents, goods, instruments, or money, ~~or tangible chattel paper~~ is located in a jurisdiction, the local law of that jurisdiction governs:

(A) perfection of a security interest in the goods by filing a fixture filing;

(B) perfection of a security interest in timber to be cut; and

(C) the effect of perfection or nonperfection and the priority of a nonpossessory security interest in the collateral.

(4) * * *

(5) While an authoritative tangible copy of a record evidencing chattel paper is located in a jurisdiction, the local law of that jurisdiction governs:

(A) perfection of a security interest in the chattel paper by possession and control under Section 9-314A; and

(B) the effect of perfection or nonperfection and the priority of a security interest in the chattel paper.

Reporter's Note

1. *Choice of governing law.* Under the amended definition of chattel paper, a right to payment and rights in related property may be evidenced by one or more tangible authoritative copies and one or more electronic authoritative copies.

Draft paragraph (5) would address these cases by tying the choice-of-law rules to the authoritative tangible copy. As a consequence, the local law of the jurisdiction where the authoritative tangible copy is physically located would govern perfection of a security interest in the chattel paper by possession and control under Section 9-314A. The location of the debtor would govern perfection by filing. See paragraph (1). However, under paragraph (5), if there is a tangible authoritative copy, the location of that copy would govern the effect of perfection or nonperfection and the priority of a security interest in the chattel paper.

Example 1: *D* is located (for choice-of-law purposes) in Iowa. An item of *D*'s chattel paper is evidenced by a single authoritative tangible copy that is located in Missouri. *SP-1* holds a perfected-by-filing security interest in the chattel paper. *SP-2* holds a security interest in the chattel paper and has possession of the tangible authoritative copy.

Under paragraph (1), the jurisdiction in which *SP-1* must file to perfect would be *D*'s location, *i.e.*, Iowa. Under paragraph (5), the law governing *SP-2*'s security interest would be the law of Missouri. The law of Missouri would also govern the effect of *SP-1*'s filing and *SP-2*'s possession as well as the relative priority of the conflicting security interests. Paragraph (2) would not apply.

Example 2: The facts are as in Example 1, except that the chattel paper is evidenced by an authoritative tangible copy and an authoritative electronic copy, and *SP-2* has perfected by taking possession of the tangible copy and obtaining control of the electronic copy.

The result is the same as in Example 1. Under paragraph (1), the place for *SP-1* to file to perfect would be *D*'s location, *i.e.*, Iowa. Under paragraph (5), the law governing *SP-2*'s security interest would be the law of Missouri. The law of Missouri would also govern the effect of *SP-1*'s filing and *SP-2*'s possession/control as well as the relative priority of the conflicting security interests. Paragraph (2) would not apply.

Example 3: The facts are as in Example 1, except that the chattel paper is evidenced by a single authoritative electronic copy with respect to which *SP-2* has obtained control.

The result is the same as in Example 1. Under paragraph (1), the place for *SP-1* to file to perfect would be *D*'s location, *i.e.*, Iowa. Under paragraph (5), the law governing *SP-2*'s security interest would be the law of Missouri. The law of Missouri would also govern the effect of *SP-1*'s filing and *SP-2*'s control as well as the relative priority of the conflicting security interests. Paragraph (2) would not apply.

Example 4: The facts are as in Example 1, except that *SP-2*'s security interest is perfected by filing and not by possession and control.

Paragraph (1) applies. The local law of the jurisdiction where *D* is located, *i.e.*, Iowa, would govern perfection, the effect of perfection or nonperfection, and the priority of the security interests. Paragraph (2) would not apply.

2. *Multiple authoritative tangible records.* Like existing law, paragraph (5) assumes that all the authoritative tangible records are located in the same jurisdiction.

Section 9-310. When Filing Required to Perfect Security Interest or Agricultural Lien; Security Interests and Agricultural Liens to Which Filing Provisions Do Not Apply.

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(b) **[Exceptions: filing not necessary.]** The filing of a financing statement is not necessary to perfect a security interest:

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(8) in deposit accounts, ~~electronic chattel paper~~, investment property, or letter-of-credit rights which is perfected by control under Section 9-314;

(9) in proceeds which is perfected under Section 9-315; ~~or~~

(10) that is perfected under Section 9-316; or

(11) in chattel paper which is perfected by possession and control under Section 9-314A.

* * *

Section 9-313. When Possession by or Delivery to Secured Party Perfects Security Interest Without Filing.

(a) **[Perfection by possession or delivery.]** Except as otherwise provided in subsection (b), a secured party may perfect a security interest in negotiable documents, goods, instruments, or money, or tangible chattel paper by taking possession of the collateral. A secured party may perfect a security interest in certificated securities by taking delivery of the certificated securities under Section 8-301.

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Reporter's Note

1. Perfection by possession of tangible chattel paper has been deleted from this section. Instead, perfection by possession and control would be governed by new Section 9-314A.

Section 9-314. Perfection by Control.

(a) **[Perfection by control.]** A security interest in investment property, deposit accounts, or letter-of-credit rights, or electronic chattel paper may be perfected by control of the collateral under Section 9-104, ~~9-105~~, 9-106, or 9-107.

(b) **[Specified collateral: time of perfection by control; continuation of perfection.]** A security interest in deposit accounts, ~~electronic chattel paper~~, or letter-of-credit rights is perfected by control under Section 9-104, ~~9-105~~, or 9-107 when the secured party obtains control and remains perfected by control only while the secured party retains control.

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Reporter's Note

1. Perfection by control of electronic chattel paper has been deleted from this section. Instead, new Section 9-314A would govern perfection by possession and control.

Section 9-314A. Perfection by Possession and Control of Chattel Paper.

(a) **[Perfection by possession and control.]** A secured party may perfect a security interest in chattel paper by taking possession of the tangible authoritative copy, if any, of the record evidencing the chattel paper and obtaining control of the electronic authoritative copy, if any, of the electronic record evidencing the chattel paper.

(b) **[Time of perfection; continuation of perfection.]** A security interest is perfected under subsection (a) when the secured party takes possession and obtains control and remains perfected under that subsection only while the secured party retains possession and control.

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Reporter's Note

1. “*Authoritative copy.*” Existing Section 9-105(b) distinguishes between authoritative and nonauthoritative copies of electronic chattel paper. Like current law, the draft refers to copies that are “authoritative.” And, like current law, the draft does not define the term. However, the draft would apply this concept also to tangible records that evidence chattel paper.

This section of the draft provides that to perfect a security interest in chattel paper other than by filing, a secured party must obtain control of all electronic authoritative copies and take possession of all tangible authoritative copies.

As explained above, perfection of a security interest in chattel paper by taking possession of the collateral was understood to mean taking possession of the wet-ink “original.” Experience has shown that the concept of an original breaks down when one allows for the possibility of the same monetary obligation being evidenced in different media over time, such as where electronic records evidencing the chattel paper “papered out” (replaced with tangible records evidencing the same chattel paper) or tangible records are “converted” to electronic records.

To accommodate current practices and future technology, the draft would allow the parties considerable flexibility in determining the method used to establish whether a particular copy is authoritative, as long as third parties are able to reasonably identify the authoritative copies that must be possessed or controlled to achieve perfection. For example, the parties could develop a system or protocol where each copy is watermarked as authoritative or nonauthoritative or where the terms of the records themselves describe how to determine which copies are authoritative and which are not.

2. *Time of perfection.* Subsection (b) is modeled on Sections 9-313(d) and 9-314(b).

**Section 9-317. Interests That Take Priority Over or Take Free of Security Interest
or Agricultural Lien.**

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(b) **[Buyers that receive delivery.]** Except as otherwise provided in subsection (e), a buyer, other than a secured party, of ~~tangible chattel paper~~, documents, goods, instruments, or a security certificate takes free of a security interest or agricultural lien if the buyer gives value and receives delivery of the collateral without knowledge of the security interest or agricultural lien and before it is perfected.

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(d) **[Licensees and buyers of certain collateral.]** A licensee of a general intangible or a buyer, other than a secured party, of accounts, ~~electronic chattel paper~~, general intangibles, or investment property other than a certificated security takes free of a security interest if the licensee or buyer gives value without knowledge of the security interest and before it is perfected.

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(f) **[Buyers of chattel paper.]** A buyer, other than a secured party, of chattel paper takes free of a security interest if, without knowledge of the security interest and before it is perfected, the buyer gives value and receives delivery of the tangible authoritative copy, if any, of the record evidencing the chattel paper and obtains control of the electronic authoritative copy, if any, of the record evidencing the chattel paper.

Section 9-330. Priority of Purchaser of Chattel Paper or Instrument.

(a) **[Purchaser's priority: security interest claimed merely as proceeds.]** A purchaser of chattel paper has priority over a security interest in the chattel paper which is claimed merely as proceeds of inventory subject to a security interest if:

(1) in good faith and in the ordinary course of the purchaser's business, the purchaser gives new value and takes possession of the authoritative tangible copies, if any, of the record evidencing the chattel paper ~~or~~ and obtains control of the authoritative electronic copies, if any, of the record evidencing the chattel paper ~~under Section 9-105~~; and

(2) the ~~chattel paper~~ authoritative copies of the record evidencing the chattel paper do not indicate that ~~it has~~ they have been assigned to an identified assignee other than the purchaser.

(b) **[Purchaser's priority: other security interests.]** A purchaser of chattel paper has priority over a security interest in the chattel paper which is claimed other than merely as proceeds of inventory subject to a security interest if the purchaser gives new value and takes possession of the authoritative tangible copies, if any, of the record evidencing the chattel paper ~~or~~ and obtains control of the authoritative electronic copies, if any, of the record evidencing the chattel paper ~~under Section 9-105~~ in good faith, in the ordinary course of the purchaser's business, and without knowledge that the purchase violates the rights of the secured party.

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Concluding Note

As noted above in footnote 2, a right to payment that is evidenced by an Article 3 negotiable instrument is different from a right to payment that is evidenced by a nonnegotiable record. This is because the obligation to pay a negotiable instrument is "embodied in" or "travels with" the negotiable instrument. For this reason, the definition of "account debtor" excludes the obligor on a negotiable instrument, even if the negotiable instrument constitutes part of chattel paper.

The reason that Article 9 distinguishes negotiable instruments that are secured by a security interest in specific goods or that relate to a lease of specific goods from other negotiable instruments is unclear. Perhaps it arose because the drafters of former Article 9 wanted to create an exception to the general rule that a security interest in a negotiable instrument could not be perfected by filing. Regardless, under revised (current) Article 9, a security interest in a negotiable instrument, like a security interest in chattel paper, may be perfected by filing or possession. Many other Article 9 rules apply to both chattel paper and negotiable instruments. Perhaps the main exception appears in Section § 9-330, under which the “superpriority” rules applicable to chattel paper (§ 9-330(a) through (c)) differ from the rule applicable to negotiable instruments (§ 9-330(d)).

Question: Should a right to payment evidenced by a negotiable instrument be excluded from the definition of “chattel paper,” even if the accompanying records evidence a security interest or lease of specific goods?