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To: Article 9 Joint Review Committee

From: Thomas J. Buiteweg

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Re: Hybrid Chattel Paper

This memorandum describes the issue I raised at our last meeting in Chicago related to chattel paper that is evidenced in both electronic records (for example, the original contract) and tangible records (“hybrid chattel paper”).

Hybrid chattel paper results when electronic records are modified using a paper agreements. This occurs frequently in practice. For example, paper records are often used to document the extension or rescheduling of payments due under an electronic retail installment sale contract or lease.

Issuers attempting to securitize portfolios of hybrid chattel paper have encountered an issue about whether a purchaser of such chattel paper can maintain priority under § 9-330 via control of the electronic records and possession of the tangible ones. Some practitioners are concerned that a court might interpret § 9-330 as requiring perfection with respect to all of the records evidencing the chattel paper by one or the other method. § 9-330(a)(1) gives priority to a purchaser that “takes possession of the chattel paper *or* obtains control of the chattel paper” (emphasis added). A court might interpret the “or” as being inclusive rather than exclusive. This interpretation seems out of step with the UCC policy under § 9-103 that the Code be liberally construed to “permit the continued expansion of commercial practices.” Article 9 already recognizes that chattel paper can be evidenced by more than one record. There is no policy reason to compel that records be either all electronic or all paper as a condition of priority. The interests of third parties are not harmed if the purchaser has control of the electronic records and possession of the tangible ones. These parties will receive notice of the purchaser's claim that is comparable if not greater than they would have received had the chattel paper existed in a single medium.

Unfortunately, the concern about this possible interpretation has prompted at least one rating agency to require issuers to perfect their interest in chattel paper exclusively by one method. This requires that the records evidencing the chattel paper to be either all electronic or all tangible. To comply with this requirement, the issuer has three unappealing choices.

1. The issuer can rely exclusively on electronic records to document all amendments to electronic chattel paper and comply with 9-105's control requirements with respect to those amendments. Obviously, this option is not available for existing hybrid chattel paper. In addition, it will not be an attractive alternative for many issuers as to future transactions. Most of the electronic chattel paper systems in place and on the drawing-board rely on sophisticated software and hardware at the original creditor's place of business to capture and control the electronic components of the chattel paper. These systems presume that the account debtor will be physically present at the time the electronic components are created. It would be difficult and costly to extend these systems for use with amendments occur during the term of the chattel paper when the account debtor is usually not present.
2. The issuer can convert the tangible records used to amend the electronic chattel paper to electronic form and obtain control of them pursuant to § 9-105 requirements. However, this conversion will add substantial expense and complexity to these systems.
3. The issuer could convert the authoritative copy of the electronic chattel paper into a tangible record. Again, the conversions will add substantial expense and complexity to these systems.

I think this problem can be solved with a brief addition to the Official Comments to § 9-330 stating that if the chattel paper is evidenced by both electronic and tangible records, the purchaser may maintain its priority by obtaining control of the electronic records and taking possession of the tangible records. The Committee should also consider whether a comment is needed in § 9-105 and/or § 9-310 to clarify that a secured party may perfect an interest in such chattel paper by this combination of methods even when it is not relying on § 9-330 for priority.

Thank you for your consideration.