



Register now for your free, tailored, daily legal newsfeed service.

Questions? Please contact customerservices@lexology.com

[Register](#)

The UCC Catches up to Emerging Technology

USA | April 21 2022

A special committee is in the process of amending the model commercial code which serves as the basis for state laws that govern most commercial transactions originated in the United States. These amendments, which are intended to update the model commercial code to reflect emerged and emerging technologies like blockchain, virtual currencies, nonfungible tokens (NFTs) and other digital assets, are expected to be finalized and offered for enactment by the states as early as the fall of 2022. When enacted, the amendments will have a transitional impact on the spectrum of commercial transactions, especially secured financing and personal property leasing, capital markets transactions and other matters of interest to participants in asset financing transactions. Informed financiers, investors, lessors and others will be able to achieve market advantages if they can successfully employ the systems and practices supported by these amendments. Provided below is a summary explanation of the purposes and transactional implications of these amendments.

The role of state law and the Uniform Commercial Code.

The law governing commercial transactions in the United States is largely state law. Although bankruptcy laws are federal, the other essential commercial laws applied by courts to determine the rights of parties to a commercial dispute include the common law, statutory law or creditor's rights laws of a particular state. Common law is essentially the legal precedent based on published opinions by courts that previously considered the pertinent legal principles and facts. A state's creditor's rights laws include both procedural rules that must be followed when enforcing claims or judgments in the courts of that state, and statutes intended to protect creditors from fraud by a debtor. The state law that is applicable to commercial disputes among parties to sales or leases of goods (e.g., equipment or inventory), payment instruments, secured financings and many other commercial matters, is statutory. That statutory law is referred to as the Uniform Commercial Code (the "UCC") and is a set of commercial laws based on a model "uniform" code, a version of which has been enacted by the governing law state. For example, the "New York law" governing a sale of an aircraft, the lease of a locomotive or a loan financing of high-tech equipment would be, respectively, Articles 2, 2A and 9 of the UCC, as enacted by the New York legislature.

The UCC Amendments.

Background. The UCC has been enacted in all 50 states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands. Since its widespread enactment in the 1960s, the UCC has been periodically revised to address changes in commercial practices. In 2019, the Uniform Law Commission (ULC) and The American Law Institute (ALI), the sponsors of the UCC (the "Sponsors"), appointed a Joint Committee to consider whether changes were advisable to accommodate emerging technologies, such as artificial intelligence, distributed ledger technology and virtual

currency. The Joint Committee ultimately received permission of the Sponsors to act as a drafting committee (the “Committee”) for amendments to the UCC dealing, predominantly, with aligning the UCC with emerging technologies. *The Draft Amendments.* The Committee has generated a number of drafts (the most recent of which was in April of 2022; the “Draft”) containing the proposed amendments. The Draft is intended to reflect the various comments discussed during such Committee meetings last month, and should approximate what is likely to be the final version. The following is a quick, non-exhaustive summary of the Draft, focused primarily on the most impactful equipment finance-related amendments: *Generally.* The Draft amendments and the associated Official Comments cover, among other things: digital assets (controllable electronic records), electronic money, chattel paper, so-called “bundled transactions” (consisting of the sale or lease of goods together with licensing of software and the provision of services as an integrated transaction), documents of title, payment systems and miscellaneous (non-emerging tech) UCC amendments. Among the most significant amendments is the creation of a new Article 12 covering the commercial law implications of digital assets. However, as explained below, there are also many other proposed amendments to existing Articles 1, 2, 2A, 3, 4, 8 and 9 of the UCC, and if made are likely to have a commercial impact. *Digital Assets.* New Article 12 is intended to govern the transfer of property rights in certain intangible digital assets (“*controllable electronic records*”; “CERs”) that have been or may be created using new technologies. Distributive ledger technology, including blockchain technology, is the platform for many of the digital assets that currently exist and that, according to the Prefatory Note [to new Article 12], “were a major impetus for the revision project.” These digital assets include certain types of virtual (non-fiat) currency (e.g., bitcoin) and NFTs, but expressly exclude electronic chattel paper. Under new Article 12, CERs must be subject to “control.” Similar to “control” over chattel paper, control of a CER involves powers over a CER that are functionally equivalent to possession of tangible property. New Article 12 also covers certain payment rights “tethered” to CERs - “*controllable accounts*” and “*controllable payment intangibles*.” These digital payment rights should be familiar to participants in receivables’ financings, and are a subset of “accounts” and “payment intangibles,” respectively. To qualify as a controllable account or controllable payment intangible, the related account debtor must agree to make payments to the person that has control of the CER evidencing the right to such payments. The substantive provisions of Article 12 include the rights of “*qualifying purchasers*” of CERs, the rights and duties of account debtors on controllable accounts and controllable payment intangibles and rules on governing law. Concepts similar to these already existing in the UCC with respect to the non-digital forms of these payment rights (i.e., compliant promissory notes) would allow these digital payment rights the attributes of negotiability. Many of the Article 9 amendments relate to purchases and other security interests in CERs, including as to controllable accounts and controllable payment intangibles. Purchasers and secured lenders may perfect (i.e., achieve priority over third-party claims) their interests in these assets by obtaining “control” of the asset or filing a financing statement in the appropriate state’s filing office. Similar to the chattel paper perfection provisions of Article 9, a security interest perfected by control can have priority over a security interest perfected by filing. Both the new Article 12 and amendments to Article 9 include new choice-of-law rules that could have an impact on how transactions within the scope of these Articles are documented, or the associated rights and interests of a party may be protected or afforded priority. *Transactional Considerations.* The digitization of the contracting process will ultimately impact how aspects of most of the asset financing transactions involving all types of equipment, including transportation and tech assets, are created, executed, transacted, financed, sold, maintained and enforced. Whether an asset is a controllable electronic record (and therefore within the scope of Article 12) depends on whether the characteristics of the asset and the protocols of any system on which the asset is recorded make it suitable for the application of Article 12’s substantive rules. Market participants who intend to transact using smart contracts on a blockchain platform, including digital payment instruments and payments by non-fiat cryptocurrencies, must have a

practical understanding of the related commercial law implications in order to gain a competitive advantage by leveraging the opportunities related to these emerging technologies. *Chattel Paper*. There are a number of proposed amendments to Article 9 of the UCC, including a revised definition of “chattel paper” and updated provisions applicable to perfection of security interests in chattel paper. *The new definition*. As amended, the definition of “chattel paper” (see §9-102(11)) will no longer refer to the tangible or electronic record evidencing the right to payment and associated goods securing that payment or being leased in consideration of that payment. Instead, the term “chattel paper” will refer to the secured party’s or lessor’s associated right to payment of a monetary obligation either secured by specific goods or owed by a lessee under a lease agreement with respect to specific goods, in either case if evidenced by a tangible or electronic record. The definition has also been revised to allow for chattel paper treatment of the payment rights associated with a “bundled transaction,” either in its entirety or with respect to the goods being financed or leased. The coverage of “bundled transactions” in the context of chattel paper includes a “predominant purpose” test similar to what is now included in the amended scope provision in Article 2A with respect to “hybrid leases,” as explained below. *Perfection*. The Draft also amends (as new § 9-314A) the manner by which a purchaser or other secured party may perfect its security interest in chattel paper. Although perfection may still be achieved by filing a financing statement, a purchaser or other secured party may perfect its security interest and, if it satisfies the other related requirements, achieve “super-priority,” by having “control” of all tangible and electronic authoritative copies of the records evidencing the chattel paper. This amendment is intended to cover payment rights even if evidenced by more than a single record (e.g., a tangible supplement or addendum to an electronic record, or vice versa) or if a record in one medium is replaced by a record in another medium. *Control*. “Control” is then achieved by taking possession of any tangible authoritative copy or control of any electronic authoritative copy, of the record evidencing the chattel paper. Subsections (a) and (b) of Section 9-105 are substantially unchanged. The revised conditions of “control” provided in new subsection (c) are meant to reflect the attributes of records maintained on a blockchain platform or other distributed ledger technology, including the existence of multiple authoritative copies of that record. The safe harbor under existing Section 9-105(b) contemplates a “single authoritative copy,” which would not be the case with a record maintained on a blockchain or other distributed ledger. Subsection (c) allows a purchaser to obtain control when there are multiple authoritative copies. However, similar to subsection (b), a purchaser must prove that it has obtained control of an electronic copy of a record evidencing chattel paper by being able to identify each electronic copy as authoritative or nonauthoritative, and identifying itself as the assignee of each authoritative copy. Also similar to subsection (b), the purchaser must have the exclusive power to both prevent others from adding or changing an identified assignee, and transfer control of the authoritative copies of that record. The amendments, however, ensure that control of electronic chattel paper under an existing system compliant with existing Section 9-105(b) would also satisfy the requirements for control under the amended version of Section 9-105. The drafting purpose underlying these amendments, as explained in the Reporter’s Note to new Section 9-314A, is: “*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.*” Transactional Considerations. These amendments will have a significant impact on asset-backed receivables that will be financed or purchased in capital markets transactions. Originators of and investors in securitized receivables will need to be aware of the implications of the amendments as to how the related transactions are created, executed, transferred and held, and also the attributes of the systems that they rely upon to do so. Among other things, participants in capital markets transactions involving leases or secured financings of receivables evidenced by records maintained on a distributed ledger, like blockchain, will need to be certain that the system technology clearly align with the related perfection

and priority implications of new subsection (c) of Section 9-105. *Hybrid (“Bundled”) Transactions.* For context, the Reporter’s Note describes “bundled transactions”, generally, as transactions in which the passing of title to goods from the seller to the buyer in return for a price (i.e., a sale), or the transfer of the right to possession and use of goods for a term in return for consideration (i.e., a lease), is part of a larger transaction. The related amendments in the Draft refer to these transactions as either “hybrid transactions” if the integrated transaction includes a sale of goods or a “hybrid lease” if the integrated transaction includes a lease of goods. However, there are currently a spectrum of transaction types involving goods and non-goods that might be considered bundled transactions for the purposes of these amendments, including “*as a service*” transactions. The equipment finance industry has referred to this rapidly growing transactional trend as “servitization.” Examples of these transactions could include: a tech services contract which includes a lease or sale of laptops; related access to servers and a license of the related software; a copier lease or sales contract coupled with an agreement to provide related supplies and maintenance; and an imaging availability agreement providing for a lease or sale of imaging equipment and an agreement to provide related consumables and maintenance and software update services. The Committee’s approach to covering the commercial law implications of this emerging trend towards these integrated transactions was to expand the scope provisions of Article 2A (see § 2A-102) and Article 2 (§ 2-102) of the UCC in order to clarify when and the extent to which provisions of those Articles should be applied to “hybrid leases” under Article 2A or “hybrid transactions” under Article 2. These new categories of transactions are briefly explained below: *Leases.* As amended in the Draft, Section 2A-102 now provides that: the entirety of Article 2A applies to the transaction if “*the lease-of-goods aspects of a hybrid lease predominate*” (see new Subsection (2)); and if “*the lease-of-goods aspects of a hybrid lease do not predominate: (A) only the provisions of this [Article 2A] which relate primarily to the lease-of-goods aspects of the transaction and not to the transaction as a whole apply*” (see new Subsection (3)(A)). Further, new Subsection (3)(C) provides that if “*the lease-of-goods aspects of a hybrid lease do not predominate: (C) Section 2A-407 applies to the promises of a person that is the lessee in a finance lease to the extent the promises are consideration for the right to possession and use of the leased goods.*” Related to that amendment, the term “hybrid lease” has also been added as subsection (1)(aa) to the definitions in Section 2A-103, and as so defined means “*a single transaction involving a lease of goods and: (i) the provision of services; (ii) a sale of other goods; or (iii) a sale, lease, or license of property other than goods.*” The Official Comment includes as an example of a hybrid lease, a single transaction involving a lease of a copier by the lessor together with a sale of paper, staples and toner, and the provision of routine maintenance and repair services, all in return for periodic payments by the lessee. If enacted as currently drafted, new Subsection (3)(C) of the amended scope provision of Article 2A should afford considerable advantages for lessors, financing providers and investors participating in these types of integrated (bundled) transactions, assuming that the integrated lease satisfies the “finance lease” criteria in Section 2A-103(1)(g) (essentially, the lessor is merely the financier and not the supplier of the leased equipment). The significance of having Section 2A-407 apply to either the entire hybrid lease under Section 2A-102(3)(A), or to the promises of the lessee of the type described in Section 2A-102(3)(C), is that the lessee’s promise to pay rent with respect to either the entire transaction or at least the integrated lease would be statutorily irrevocable and independent upon the lessee’s acceptance of the copier (i.e., “*hell or highwater*”). As context, using the above-referenced hybrid copier lease as an example, assuming that the lease of the copier aspects of that integrated transaction predominate, and that the copier lease is a “finance lease,” the lessee’s obligation to pay the entire amount due under the hybrid lease should be “*hell or high water*” upon the lessee’s acceptance of the copier. Or, if the lease of the copier aspects do not predominate, but the integrated copier lease is a “finance lease,” the lessee’s obligation to pay the rent for the copier will be “*hell or high water.*” Further, the related Official Comment in the Draft provides some guidance as to how to structure and document a hybrid lease so as to support the application of

these finance lease protections. *Sales.* As context, similar amendments were made to Section 2-102, the scope provision of Article 2. As amended in the Draft, the scope of Article 2 would include the application of its provisions to the entirety of a hybrid transaction under Section 2-102(2) if “*the sale-of-goods aspects of a hybrid transaction predominate,*” but under Section 2-102(3) if “*the sale-of-goods aspects of a hybrid transaction do not predominate, only the provisions of this [Article 2] which relate primarily to the sale-of-goods aspects of the transaction and not to the transaction as a whole apply.*” Related to that amendment, the term “*hybrid transaction*” has also been added as subsection (5) to the definitions in Section 2-106, and as so defined means “*a single transaction involving a sale of goods and: (A) the provision of services; (B) a lease of other goods; or (C) a sale, lease, or license of property other than goods.*” Useful Reporter’s Notes were included in the Draft following the amended version of Section 2-102 that are intended to provide guidance as to the scope amendments under both Article 2 and Article 2A. The Notes explain, in the context of Article 2, what might be considered a “*hybrid transaction*” – “*transactions that cover both goods and non-goods, such as transactions that involve the sale of goods and either the provision of services or the transfer of property other than goods. (These transactions are often referred to as “hybrid,” “mixed,” or “bundled” transactions.)*” The Notes also explain the “*predominant purpose*” and “*gravamen*” approaches embraced by the revisions to Section 2-102. Per the Reporter, “[a]s a general matter, courts have applied Article 2 to such transactions when the goods aspect of the transaction predominates and have declined to apply this Article when the non-goods aspect predominates,” and new Subsection (b) of revised Section 2-102 adopts this “*predominant purpose*” approach. Further per the Reporter, when an issue relates solely to the goods aspect of the transaction (e.g., conformity of the goods to the contract), it is appropriate to apply Article 2 to that issue, even if the goods aspect of the transaction does not predominate. The Reporter notes that this “*gravamen*” approach has expressly been applied by some courts and implicitly adopted by others, and is adopted by new Subsection (c) of revised Section 2-102. The Reporter also notes the trepidation regarding certain aspects of the amendments. The Reporter’s Note to Section 2A-102 cross-references but does not repeat the explanations in the Reporter’s Note to Section 2-102. *Transactional Considerations.* The Reporter’s Note explains the purpose of these scope amendments as follows: “*Operating on the assumption that, in part due to emerging technologies, hybrid transactions are increasing and will continue to increase – in total numbers, in the dollar amount of their collective price, and as a percentage of number transactions involving a sale or lease of goods – the draft seeks to provide more clarity to the law by adopting the bifurcation approach and providing extensive comments on how to apply it.*” As mentioned above, if ultimately accepted and included in the final version of the UCC amendments, achieving finance lease - “*hell or highwater*” status of all or a part of a hybrid lease would be a very meaningful achievement for the equipment finance industry. The amendments will significantly impact how these emerging transactions will be structured and documented, and will have beneficial implications when the related receivables are included in asset-backed capital markets transactions. *Conclusion: Status of the Process.* The ALI/ULC Committee will continue to refine the Draft. The Committee’s current plan is for the amendments to be finalized in 2022 with a view to obtaining approval of the ALI membership at the ALI Annual Meeting in May 2022 and of the ULC at its Annual Meeting in July 2022. The amendments would then be offered for enactment by the states. If the amendments as currently drafted are enacted by most if not all of the states, transacting on blockchain platforms, financing digital payment rights, and relying on virtual currencies as an exchange of value will be facilitated and accelerated. Further, the systems and practices in originating and financing receivables related to leases or secured financings of equipment, especially if digitized, will require adjustments by the parties to those transactions. Lastly, the emerging “*servitization*” trend in most of the equipment finance market should be much more attractive to originators, financing providers and investors as a result of the statutory clarity regarding the reliability of the customer’s payment obligations. When the Committee was first formed, invitations were sent to large groups of potential

stakeholders including trade organizations, financial institutions, technology companies, government agencies and others were invited to be “observers.” The author of this article is one of the few “observers” invited to provide guidance to the Committee regarding equipment finance matters, and one of the three industry lawyers who participated in a working group with the chair of the Committee and the Reporter and Associate Reporter focusing on hybrid transactions and sales, and contributed significantly to the text of the amendments to Section 2A-102 and the related Official Comments and examples. We will continue to share developments and perspectives in future GTF newsletters regarding all of the amendments that are likely to be impactful to industry participants.

Vedder Price PC - Edward K. Gross

Powered by

LEXOLOGY.