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A New System of Electronic Chattel Paper: Notification of Assignment

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A NEW SYSTEM OF CONTROL OF ELECTRONIC CHATTEL PAPER: NOTIFICATION OF ASSIGNMENT

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I. INTRODUCTION: ELECTRONIC CHATTEL PAPER AS ASSIGNABLE PROPERTY INTERESTS

The 2001 revisions of Article 9 of the Uniform Commercial Code (the "UCC"), which became effective throughout the United States between July 1, 2001, and January 1, 2002,[1] governs both (a) the creation of security interests in almost all types of personal property, and (b) the sale of receivables.[2] An important type of these receivables[3] is chattel paper. The UCC defines "chattel paper" as "a record or records that evidence both a monetary obligation and a security interest in specific goods . . . [or] a lease of specific goods."[4] Chattel paper, a special kind of receivable that evidences an automobile loan or lease or an equipment loan or lease, is an important part of the finance industry. For example, the outstanding principal balance of automobile loans evidenced by chattel paper exceeded $1.15 trillion dollars as of the end of 2018.[5]

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1. *See* U.C.C. § 9-701 (AM. LAW INST. & UNIF. LAW COMM'N 2010). Revised Article 9 took effect in Connecticut on October 1, 2001, and in Florida, Mississippi, and Alabama on January 1, 2002. *See* SPECIALIZED LEGAL RESEARCH § 2-1.9 (Penny A. Hazelton ed., Supp. 2012). Revisions to Article 9 were adopted in 2010 and were enacted in all of the states and the District of Columbia (with some non-uniform amendments). *See* U.C.C. § 9-801 (establishing a uniform effective date of July 1, 2013); UNIF. LAW COMM'N, 2010 AMENDMENTS TO ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE: A SUMMARY 2 (2019) https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=dc75719f-5e51-3d7d-4508-4c2defd8c8ae&forceDialog=0 [https: //perma.cc/SHQ6-8GJS].

2. *See* U.C.C. § 9-109(a) (providing that, with exceptions not relevant here, Article 9 "applies to (1) a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract . . . [and] (3) a sale of accounts, chattel paper, payment intangibles, or promissory notes").

3. The other kinds of receivables are (i) account, which is primarily the traditional account receivable, that is, a right to payment for the sale of property or provision of services, *see id.* § 9-102(a)(2), (ii) promissory note, the predominant form evidencing single family mortgage loans, which is primarily a negotiable instrument, *see id.* § 9-102(a)(47), (65), and (iii) payment intangible, *id.* § 9-102(a)(61) (defining a "payment intangible" to mean "a general intangible under which the account debtor's principal obligation is a monetary obligation"); *id.* § 9-102(a)(42) (defining a "general intangible" to mean "any personal property, including things in action, other than accounts, chattel paper, . . . instruments," and all of the other Article 9 types of collateral).

4. *See id.* § 9-102(a)(11):

> "Chattel paper" means a record or records that evidence both 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.

5. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., Z.1 FINANCIAL ACCOUNTS OF THE UNITED STATES: FIRST QUARTER 2019, at 129 tbl.L.222 (2019), https://www.federalreserve.gov/releases/z1/20190606/html/l222.htm [https://perma.cc/HZ3E-

The rapid development of computer hardware and software during the last decades of the twentieth century and the constant competitive pressures on businesses and consumers to lower costs led the drafters of the 2001 revision of Article 9 to add provisions[6] that would enable parties to create chattel paper evidenced by an electronic record—a new subtype of collateral defined as "electronic chattel paper."[7] These provisions also strove to give to this newly created electronic chattel paper the same legal status enjoyed by chattel paper evidenced by a writing, which was renamed "tangible chattel paper."[8] These

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T87P]. Student loans account for the second largest category of consumer debt at more than $1.5 trillion. *Id.* at 129 tbl.L.222.

6. These provisions were added to the then-current draft of revised Article 9 in 1998. *See* Jane K. Winn, *Electronic Chattel Paper: Invitation Accepted*, 46 GONZ. L. REV. 407, 418 (2010). In addition, in 1999, the Uniform Law Commission promulgated the Uniform Electronic Transactions Act (UETA), UNIF. ELEC. TRANSACTIONS ACT (UNIF. LAW COMM'N 1999), and in 2000, Congress enacted the federal Electronic Signatures in the Global and National Commerce Act (eSign), 15 U.S.C. §§ 7001–7021 (2012). UETA has been adopted by 48 states and the District of Columbia with numerous non-uniform amendments. *See* UNIF. LAW COMM'N, ELECTRONIC TRANSACTION ACT https://www.uniformlaws.org/committees/community-home?CommunityKey=2c04b76c-2b7d-4399-977e-d5876ba7e034 [https://perma.cc/94PP-GM4E]. For a brief summary of the enactment of UETA and eSign to replace a variety of earlier state laws, see Robert A. Wittie & Jane K. Winn, *Electronic Records and Signatures under the Federal E-Sign Legislation and the UETA*, 56 BUS. LAW. 293, 294–97 (2000). UETA and eSign provide that a large variety of contracts could not be denied legal effect solely because they were evidenced by an electronic record instead of a written agreement. See Section 7 of UETA, which states:

> (a) A record or signature may not be denied legal effect or enforceability solely because it is in electronic form.
>
> (b) A contract may not be denied legal effect or enforceability solely because an electronic record was used in its formation.
>
> (c) If a law requires a record to be in writing, an electronic record satisfies the law.
>
> (d) If a law requires a signature, an electronic signature satisfies the law.

UNIF. ELEC. TRANSACTIONS ACT § 7. See also eSign, which states:

> Notwithstanding any statute, regulation, or other rule of law (other than this subchapter and subchapter II of this chapter), with respect to any transaction in or affecting interstate or foreign commerce—
>
> > (1) a signature, contract, or other record relating to such transaction may not be denied legal effect, validity, or enforceability solely because it is in electronic form; and
> >
> > (2) a contract relating to such transaction may not be denied legal effect, validity, or enforceability solely because an electronic signature or electronic record was used in its formation.

15 U.S.C. § 7001(a).

7. *See* U.C.C. § 9-102(a)(31) (defining "electronic chattel paper" to mean "chattel paper evidenced by a record or records consisting of information stored in an electronic medium").

8. *See id.* § 9-102(a)(79) (defining "tangible chattel paper" to mean "chattel paper evidenced by a record or records consisting of information that is inscribed on a tangible medium"); *see also* U.C.C. § 1-201(b)(43) (AM. LAW INST. & UNIF. LAW COMM'N 2001)

provisions permitted the authentication of electronic records to serve the same purposes of the signing of written records for a variety of purposes,[9] including the creation of enforceable security interests and therefore the creation of electronic chattel paper.[10]

Because of these legal developments, electronic chattel paper represents an important and growing subset of automobile loans and leases as well as other equipment loans and leases originated by sellers of property or by financial institutions financing sales to consumers and businesses. Like all receivables, electronic chattel paper constitutes important property items that the originators can sell or pledge to financial institutions to obtain funds for future originations or operations.

Article 9 of the UCC governs the assignment of chattel paper, whether the assignment is a grant of a security interest in a receivable to a lender to secure a loan or a sale of the receivable to a buyer.[11] The owner of a receivable, called the "debtor,"[12] can transfer it a lender to secure a loan or to sell it to a buyer, either of which is defined as the "secured party,"[13] pursuant to a "security agreement," which by definition also includes a sale agreement.[14] The security interest, including a buyer's interest, becomes

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("'Writing' includes printing, typewriting, or any other intentional reduction to tangible form. 'Written' has a corresponding meaning.").

9. *See* U.C.C. § 9-102(a)(70) (defining "record" to mean "information that is inscribed on a tangible medium or which is stored in an electronic or other medium and is retrievable in perceivable form"); *id.* § 9-102(a)(7) (defining "authenticate" to mean "(A) to sign; or (B) with present intent to adopt or accept a record, to attach to or logically associate with the record an electronic sound, symbol, or process"); *id.* § 9-102 cmt. 9.a ("In many, but not all, instances, the term 'record' replaces the term 'writing' and 'written.' . . . Given the rapid development and commercial adoption of modern communication and storage technologies, requirements that documents or communications be 'written,' 'in writing,' or otherwise in tangible form do not necessarily reflect or aid commercial practices.").

10. *See id.* § 9-203(b)(3)(A), quoted *infra* note 15.

11. *See id.* § 9-109(a), quoted *supra* note 2; U.C.C. § 1-201(b)(35) (providing that "security interest" means "an interest in personal property or fixtures which secures payment or performance of an obligation" and includes "any interest of . . . a buyer of accounts, chattel paper, a payment intangible, or a promissory note").

12. U.C.C. § 9-102(a)(28): "'Debtor' means: (A) a person having an interest, other than a security interest or other lien, in the collateral, whether or not the person is an obligor; [or] (B) a seller of accounts, chattel paper, payment intangibles, or promissory notes." *Id.*

13. *Id.* § 9-102(a)(73): "'Secured party' means: (A) a person in whose favor a security interest is created or provided for under a security agreement, whether or not any obligation to be secured is outstanding; . . . (D) a person to which accounts, chattel paper, payment intangibles, or promissory notes have been sold."

14. *Id.* § 9-102(a)(74) ("'Security agreement' means an agreement that creates or provides for a security interest."). Because a security agreement includes the interest of a buyer of receivables, a security agreement includes a sale agreement for receivables. *See id.* § 9-203(b)(3)(A).

effective against the debtor and third parties when it has "attached."[15] Further, the secured party can protect its security interest from creditors of and subsequent purchasers from the debtor (and the bankruptcy trustee of the debtor) by taking the necessary steps to "perfect" its security interest.[16]

For chattel paper, Article 9 provides for several methods of transferring and perfecting the transfer of chattel paper. First, the owner of the chattel paper, the debtor, can transfer an enforceable security interest (including an ownership interest) to the secured party (including a buyer) by "authenticating a security agreement," that is, by signing a written security agreement or otherwise authenticating an electronic security agreement that describes the

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15. *See id.* § 9-203:

(a) A security interest attaches to collateral when it becomes enforceable against the debtor with respect to the collateral, unless an agreement expressly postpones the time of attachment.

(b) . . . [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;

. . .

(D) the collateral is deposit accounts, electronic chattel paper, investment property, letter-of-credit rights, or electronic documents, and the secured party has control under Section 7-106, 9-104, 9-105, 9-106, or 9-107 pursuant to the debtor's security agreement.

16. *See id.* § 9-308(a) (providing that a "security interest is perfected if it has attached and all the requirements for perfection in Sections 9-310 through 9-316 have been satisfied"). Section 9-201 states that, except as otherwise provided in the UCC, "a security agreement is effective according to its terms between the parties, against purchasers of the collateral, and against creditors." However, numerous provisions subordinate an unperfected security interest. *See, e.g.*, *id.* § 9-317(a), (b) (subordinating an unperfected security interest to lien creditors (which includes a bankruptcy trustee, see *id.* § 9-102(a)(52)(C), quoted *infra* note 42, and to certain buyers, lessees and licensees of collateral); *id.* § 9-322(a)(2) (subordinating an unperfected security interest to a perfected security interest), quoted *infra* note 43.

chattel paper.[17] The secured party/buyer may perfect its security interest, including a buyer's interest, by filing a financing statement.[18]

Second, as further discussed below in subpart II.A and Part III, for tangible chattel paper, a secured party can obtain and perfect a security interest by possession,[19] a long-standing concept legal concept. Further, possession of tangible chattel paper can give a purchaser superior rights over a secured party previously perfected by filing.[20]

Third, for electronic chattel paper, a secured party can obtain and perfect a security interest by "control" as defined in Section 9-105, a new concept introduced into Article 9 in 2001.[21] Further, in an attempt to mirror the treatment of tangible chattel paper in the market place, Article 9 also provides that control of electronic chattel paper can give a purchaser comparable superior rights over another secured party previously perfected by filing.[22]

The original definition of "control"[23] in Article 9 contained a set of requirements that attempted to mimic for electronic chattel paper the essence of possession of tangible chattel paper containing a wet-ink signature by identifying specific attributes of possession of an original, signed writing—which by its very nature is a single, unique, and identifiable record that is unalterable without the consent of the possessor—and applying them to an electronic record. This definition of control required a system that would recognize a "single authoritative copy" of the electronic record which is "unique," identifiable, and unalterable in most instances without the secured

17. *See id.* § 9-203(b)(3)(A) (providing for an authenticated security agreement), quoted *supra* note 15; *id.* § 9-102(a)(7) (defining "authenticate"), quoted *supra* note 9. The term "sign" refers only to authenticating a writing. U.C.C. § 1-201(b)(37), (43) (AM. LAW INST. & UNIF. LAW COMM'N 2001) ("'Signed' includes using any symbol executed or adopted with present intention to adopt or accept a writing.").

18. *See* U.C.C. §§ 9-109(a), -310(a) (providing that, with exceptions stated in subsection (b) and section 9-312(b), which are not relevant for accounts or payment intangibles, "a financing statement must be filed to perfect all security interests").

19. *See id.* § 9-203(b)(3)(B) (permitting creation of security interest by possession pursuant to a security agreement, which need not be an authenticated security agreement), quoted *supra* note 15; *id.* § 9-310(b) ("The filing of a financing statement is not necessary to perfect a security interest . . . (6) in collateral in the secured party's possession under Section 9-313."); *id.* § 9-313(a) ("A secured party may perfect a security interest in tangible negotiable documents, goods, instruments, money, or tangible chattel paper by taking possession of the collateral.").

20. *See id.* § 9-330(a), quoted *infra* in text accompanying note 52.

21. *See* U.C.C. § 9-105(a) (2001) (AM. LAW INST. & UNIF. LAW COMM'N, amended 2010), quoted *infra* note 66.

22. *See* U.C.C. § 9-330(a) (AM. LAW INST. & UNIF. LAW COMM'N 2010), quoted *infra* note 52; *id.* § 9-330(b), quoted *infra* note 53; *see also id.* § 9-105 cmt. 2.

23. *See* U.C.C. § 9-105 (2001) (AM. LAW INST. & UNIF. LAW COMM'N, amended 2010).

party's consent.[24] In one sense, this definition is physically impossible to meet. Unlike a wet-ink signed writing, an electronic record can be perfectly copied numerous times. Accordingly, providing for control of electronic chattel paper comparable to the possession of tangible chattel paper under Article 9 has been challenging. Nevertheless, as discussed in Part III below, the market place has responded by creating vaulting systems that meet the original definition.

The 2010 revisions to Article 9 amended Section 9-105 and provided a more flexible standard for control that retained the original definition as a safe harbor.[25] To date, however, for chattel paper that originated as an electronic record, the current systems of control depend greatly on satisfying the requirements of the original definition.

Although the safe harbor under UCC Section 9-105(b) relies on a possessory paradigm, the general rule in UCC Section 9-105(a) is not so constrained. Part IV of this Article proposes a new method for control under the more flexible definition of control that does not depend on a possessory paradigm: notification to the obligor of the assignment of electronic chattel paper to the assignee with instructions to pay the assignee.

Notification of assignment currently plays a significant role in ensuring that assignees of receivables receive payments. As a legal matter, if an obligor is notified of an assignment of a receivable other than a promissory note, the obligor is bound to pay the assignee.[26] As a practical matter, the ability of an assignee to receive the value of any receivable, including a promissory note, also depends on notification to the obligor.

Also, notification is a venerable method for assuring the effectiveness of an assignment of receivables. This new method of control follows the law governing receivables finance in effect in many jurisdictions for the perfection of the assignment of ordinary contract rights to payment before the enactment of Article 9 throughout the United States in the 1960s. Part IV explains why notification with payment instructions establishes the assignment of electronic

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24. *See id.* § 9-105.

25. *See* U.C.C. § 9-105(a) (AM. LAW INST. & UNIF. LAW COMM'N 2010), quoted *infra* note 66.

26. *See id.* § 9-406(a):

> [A]n account debtor on an account, chattel paper, or a payment intangible may discharge its obligation by paying the assignor until, but not after, the account debtor receives a notification, authenticated by the assignor or the assignee, that the amount due or to become due has been assigned and that payment is to be made to the assignee. After receipt of the notification, the account debtor may discharge its obligation by paying the assignee and may not discharge the obligation by paying the assignor.

chattel paper to a specific person as reliably as the delivery of possession of tangible chattel paper, if not more so.

II. WHY CONTROL

Article 9 of the UCC introduced the concept of control of electronic chattel paper to replicate the characteristics and purpose of possession of tangible chattel paper.[27] Possession or control of chattel paper gives the automobile loan financing industry super-priority over dealers' inventory secured creditors, which is critical to the automobile loan financing industry.

Chattel paper, which from the beginning of Article 9 of the UCC until 2001 was always written,[28] developed in the 1900s. As I have discussed in greater detail elsewhere, from the very beginning of its drafting in 1948 through its enactment throughout the United States in the 1960s, Article 9 included chattel paper as a new type of collateral to facilitate the continuation of business practices that had developed in the middle decades of the twentieth century for financing the purchase of automobiles and other kinds of expensive consumer and business goods.[29] As discussed in subpart II.A below, the possession of tangible chattel paper was and is critical to the functioning of the predominant form of automobile financing in the United States.[30] As already noted, automobile loan financing is a substantial financial industry sector.[31]

The vast majority of automobile loans have and continue to originate through what is known as the "indirect origination" model.[32] When a customer purchases an automobile or other motor vehicle from a dealer, the customer often pays all or part of the purchase price by executing a promise to pay the agreed amount and granting a security interest in the motor vehicle to secure the promise.[33] In other words, the customer creates chattel paper in favor of

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27. *See* U.C.C. § 9-105 cmt. 2 (2001) (AM. LAW INST. & UNIF. LAW COMM'N, amended 2010).

28. *See* U.C.C. § 9-105(b) (1962) (amended 1972, superseded 2001) (AM. LAW INST. & UNIF. LAW COMM'N, amended 2010) (defining chattel paper to mean "a *writing* or *writings* which evidence both a monetary obligation and a security interest in or a lease of specific goods" (emphasis added)).

29. *See* Thomas E. Plank, *Evolution of Chattel Paper: From Possession to Control*, 46 U.C.C. L.J. 1, 9–14 (2014).

30. *See* discussion *infra* Section II.A.

31. *See supra* note 5 and accompanying text.

32. *See* STANDARD & POOR'S RATING SERVS., LEGAL CRITERIA FOR U.S. STRUCTURED FINANCE TRANSACTIONS 66–67 (2006) (discussing issues presented by the origination of indirect automobile loans); Plank, *supra* note 29, at 9–4, 26–27.

33. Similarly, a dealer may lease an automobile to a customer pursuant to a lease. The dealer may then assign the lease, as well as the legal title to the automobile, to an automobile

the dealer. The dealer will have arranged to sell the chattel paper to one of any number of financial institutions, including banks and finance companies.[34] The dealer will not typically accept the chattel paper from the customer unless the intended financial institution has approved the loan. Further, the customer will execute the form of chattel paper prescribed by the financial institution.[35] This method of origination is also used to finance other kinds of expensive goods, such as boats or other equipment.[36] This method predominates, I believe, because of its convenience and efficiency. Although customers could obtain financing separately through their bank or other finance company, the indirect origination method presents the convenience of one-stop shopping. This convenience makes it easier for dealers to sell their goods.

Before the enactment of Article 9, it was common for dealers in automobiles and other types of more expensive equipment to deliver the written contracts that were the precursors to chattel paper to financial institutions, which notified the customers of the assignments and collected the payments due on the contract.[37] On the other hand, it was also common for dealers in goods to assign these written contracts to financial institutions to obtain financing but to retain possession and to collect the payments on behalf of the financial institutions.[38]

Accordingly, the initial drafts of Article 9 specifically included two methods of assigning and perfecting a security interest in chattel paper, including a buyer's interest: (1) signing a security agreement and filing a financing statement or (2) transferring possession of the chattel paper.[39] These

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financing company or a tilting trust of which the financing company is the general beneficiary and receive the full purchase price for the automobile from the finance company.

34. *See* Plank, *supra* note 29.

35. *See id.*

36. The indirect origination of equipment loans precedes the drafting and enactment of Article 9 of the UCC. *See* Homer Kripke, *The "Secured Transactions" Provisions of the Uniform Commercial Code*, 35 VA. L. REV. 577, 596 (1949).

37. *See* 2 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 25.5, at 668 (1965). Grant Gilmore was the primary reporter responsible for the drafting of the original Article 9. *See also* Kripke, *supra* note 36, at 596 (noting that such dealers delivered the contracts to the financers, which gave notice of assignment to and collected from the obligors). Today, the volume of indirect origination of non-automobile chattel paper is, based on my experience in providing legal advice for chattel paper financing transactions, substantially less than the indirect origination of automobile loans. Standard and Poor's rating criteria for structured finance transactions references indirect origination of chattel paper only in the context of automobile loans, recreational vehicle loans and marine loans. STANDARD & POOR'S RATING SERVS., *supra* note 32, at 66.

38. *See* 2 GILMORE, *supra* note 37, § 25.5, at 668–69; Kripke, *supra* note 36, at 597.

39. *See* Plank, *supra* note 25, 7 n.36, at 11–14 (describing the evolution of the drafting of these provisions).

alternatives have remained part of Article 9.[40] For the indirect origination of automobile loans, possession is both a convenience for perfection and a necessity for the super-priority of the interests of the financing company.

A. Perfection Without Filing a Financing Statement

For purposes of perfection, many automobile loan financers take advantage of the possessory alternative. Because these automobile loan financers may have arrangements with hundreds or thousands of automobile dealers, taking possession of the tangible chattel paper eliminates the costs of filing financing statements against a large number of dealers located in many states.[41] Perfection by possession then is necessary to protect these automobile financers that acquire the chattel paper from a dealer against the unsecured creditors or the bankruptcy trustee of the dealer[42] or against subsequent secured parties that acquire a security interest (including an ownership interest) from the dealer.[43]

B. Super-Priority over Security Interest of Inventory Financer

Avoidance of filing, however, is not the primary purpose of taking possession. Possession is critical to the indirect origination of tangible chattel paper for another reason. Dealers in goods finance the acquisition of their inventory by granting to a lender a security interest in their inventory that is

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40. *Supra* note 15 and accompanying text.

41. By itself, possession by an automobile loan financer to perfect its security interest as against each dealer is not necessarily less costly for the automobile loan financer than filing against each dealer, and over time, possession is likely more costly. However, as discussed *infra* Section IV.B, possession by the automobile loan financer is essential to obtaining priority over each dealer's inventory secured lender. Accordingly, because possession for purpose of priority also provides perfection of the automobile loan financer's interest, there is no need for the automobile loan financer to incur the costs of preparing and filing a financing statement against each dealer.

42. *See* U.C.C. § 9-317(a)(2) (AM. LAW. INST. & UNIF. LAW COMM'N 2010) (providing that most lien creditors have priority over unperfected security interests); *id.* § 9-102(a)(52) (defining a lien creditor to include "(A) a creditor that has acquired a lien on the property involved by attachment, levy, or the like . . . [and] (C) a trustee in bankruptcy from the date of the filing of the petition"); 11 U.S.C. § 544(a)(1) (2012) (providing that the bankruptcy trustee has all of the rights and powers of a hypothetical lien creditor).

43. *See* U.C.C. §§ 9-317(a)(1), -322(a)(2) (providing that a perfected security interest has priority over conflicting unperfected security interests). Because a "security interest includes the interest of a buyer of chattel paper," U.C.C. § 1-201(b)(35) (AM. LAW. INST. & UNIF. LAW COMM'N 2001), quoted *supra* note 11, a buyer's unperfected interest will be subordinate to subsequent perfected secured creditors or perfected buyers of the chattel paper.

perfected by the filing of a financing statement.[44] When a dealer sells a good in exchange for chattel paper as all or part of the purchase price, the chattel paper constitutes proceeds of the good that was subject to the inventory lender's security interest.[45] The inventory secured party will acquire a perfected security interest in those proceeds.[46]

More importantly, the inventory secured party will often have filed its financing statement before the purchase of the chattel paper by the finance company. Under the basic first-to-file-or-perfect priority rule of Article 9, the filed financing statement in the inventory would ordinarily give the inventory secured party priority over any subsequent creditor or purchaser of the secured party.[47] Accordingly, any automobile loan financer purchasing the chattel paper would take subject to the inventory secured party's security interest. This subordination of the automobile loan financer's interest would essentially preclude financing of the dealer's chattel paper by anyone other than the inventory secured party. The automobile loan financer could have priority only if it had filed a financing statement before the inventory secured party, if the inventory secured party releases its security interest in the chattel

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44. *See* U.C.C. § 9-203(b) (providing for creation of security interest), quoted *supra* note 15; *id.* § 9-310(a) (requiring filing for perfection in most cases), quoted *supra* note 18. Even for goods that are subject to a certificate of title statute, such as automobiles, for which compliance with those statutes is necessary for perfection of a security interest and for which filing a financing statement is neither necessary nor sufficient for perfection. *See id.* § 9-311(a)(2), (b). The security interest in such goods that constitute inventory may be perfected by filing. *See id.* § 9-311(d).

45. *See id.* § 9-102(a)(64)(A) (defining "proceeds" to mean "whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral").

46. *See* U.C.C. § 9-315(a)(2) (providing that, except as otherwise provided in Article 9 or UCC § 2-403, "a security interest attaches to any identifiable proceeds of collateral"); *id.* § 9-315(c) (providing that a "security interest in proceeds is a perfected security interest if the security interest in the original collateral was perfected"); *id.* § 9-315(d)(1) (providing the "perfected security interest in proceeds becomes unperfected on the 21st day after the security interest attaches to the proceeds unless . . . (A) a filed financing statement covers the original collateral; (B) the proceeds are collateral in which a security interest may be perfected by filing in the office in which the financing statement has been filed; and the proceeds are not acquired with cash proceeds"). In this case the security interest in the original collateral, inventory, was perfected by a filing with the state filing office specified in section § 9-501(b) of the applicable state UCC, and a security interest in chattel paper can be perfected by filing in the same state filing office. Normally, a security will also continue in collateral notwithstanding sale of the collateral by the applicable debtor, *see id.* § 9-315(a)(1), but in the case of inventory, a buyer in ordinary course will take free of the security interest, *see id.* § 9-320(a).

47. *See* U.C.C. § 9-322(a)(1) ("Conflicting perfected security interests and agricultural liens rank according to priority in time of filing or perfection. Priority dates from the earlier of the time a filing covering the collateral is first made or the security interest or agricultural lien is first perfected, if there is no period thereafter when there is neither filing nor perfection."). Also, a perfected security interest has priority over conflicting unperfected security interests. *See id.* § 9-322(a)(2).

paper and files a partial release of the chattel paper from its financing statement, or if the inventory secured party otherwise enters into a subordination agreement to subordinate its security interest in the chattel paper.[48] These alternatives are not practical.[49]

To permit the robust financing of chattel paper acquired by dealers upon the sale of their inventory, beginning with the earliest drafts[50] to the current version of Article 9, a purchaser that takes possession of tangible chattel paper can acquire rights in the chattel paper that are superior to the inventory secured party, giving tangible chattel paper a form of quasi-negotiability[51]. Specifically, Section 9-330(a) provides:

> 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 chattel paper or obtains control of the chattel paper under Section 9-105; and

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48. *See id.* § 9-315(a)(1) ("A security interest . . . continues in collateral notwithstanding sale, lease, license, exchange, or other disposition thereof unless the secured party authorized the disposition free of the security interest"); *id.* § 9-512(a) (providing that a person may delete collateral from a filed financing statement by filing a financing statement amendment); *id.* § 9-509(d)(1) (requiring the secured party of record to authorize the filing of a financing statement amendment deleting collateral); *id.* § 9-521(b) (form of financing statement amendment); *see also* Int'l Ass'n of Commercial Adm'rs, Instructions for UCC Financing Statement Amendment (Apr. 20, 2011), https://www.iaca.org/wp-content/uploads/UCC3FinancingStatement Amendment-2.pdf [https://perma.cc/7XNK-DHF8] (collateral change, with choices for adding, deleting or restating collateral); U.C.C. § 9-339 ("This article does not preclude subordination by agreement by a person entitled to priority.").

49. The necessity for super-priority does not arise in the direct origination of chattel paper, that is when a lender loans funds to a customer, and the customer then purchases an automobile or other specific good from a dealer. In the direct origination, the lender does not acquire chattel paper but creates the chattel paper. The chattel paper is not proceeds of the automobile or other specific good purchased by the customer.

50. *See* Plank, *supra* note 29, at 7 n.36, 11–14 (describing the evolution of the drafting of these provisions).

51. The ability to transfer the right to payment embodied in chattel paper by delivery of the paper and the ability of a subsequent purchaser that acquires possession to obtain priority over a prior perfected secured party represent some but not all of the benefits that negotiable instruments enjoy over rights to payments evidenced by ordinary contract rights, that is, accounts and payment intangibles. Possessors of chattel paper, however, do not enjoy a primary important benefit of a negotiable instrument—the ability of a holder in due course of the negotiable instrument to take the instrument free of most claims and defenses.

> (2) the chattel paper does not indicate that it has been assigned to an identified assignee other than the purchaser.[52]

In addition, Section 9-330(b) extends the quasi-negotiable, super-priority for chattel paper to good faith purchasers for new value of chattel paper which is claimed other than merely as proceeds if, in lieu of the chattel paper itself indicating assignment, the purchaser takes possession "without knowledge that the purchase violates the rights of the secured party."[53]

C. The 2001 Addition of Electronic Chattel Paper

When the drafters of the 2001 revised Article 9 expanded the original definition of chattel paper to include the new, distinct subtype of electronic chattel paper evidenced by an electronic record,[54] they needed to give to the purchasers of electronic chattel paper the same benefits that purchasers of tangible chattel paper could obtain. To accommodate the existing indirect origination model of chattel paper financing, Article 9 had to provide secured parties acquiring electronic chattel paper the same priority over inventory secured parties that would otherwise have priority in the chattel paper as proceeds of inventory for which they had filed a financing statement.[55] They also desired to provide secured parties acquiring electronic chattel paper a method of perfection other than by filing.[56]

Article 9 could have accomplished these goals in several ways. For example, Article 9 could have provided for super-priority for purchasers of

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52. U.C.C. § 9-330(a).

53. *Id.* § 9-330(b):

> 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 chattel paper or obtains control of 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.

The knowledge requirement for super-priority for chattel paper claims merely as proceeds, that is, the absence of a notation on the chattel paper, *see id.* § 9-330(a)(2), is less stringent than for other transactions. *Compare id.* § 9-330(a)(2) (requiring that "the chattel paper does not indicate that it has been assigned to an identified assignee other than the purchaser") *with id.* § 9-330(b) (requiring that purchaser be "without knowledge that the purchase violates the rights" of the prior assignee); *see also id.* § 9-330(f) (providing that if chattel paper "indicates that it has been assigned to an identified secured party other than the purchaser, a purchaser of the chattel paper . . . has knowledge that the purchase violates the rights of the secured party").

54. *See* U.C.C. § 9-102 cmt. 5(b).

55. *See supra* Section II.B.

56. *See supra* Section II.A.

chattel paper that would include chattel paper as proceeds of inventory by special rule.[57] Article 9 has had long-standing rules for super-priority for purchase money security interests in goods.[58] The 2001 revision added newer rules for super-priority of security interests in security entitlements for securities intermediaries,[59] and also for super-priority of security interests in collateral governed by the special rules for double debtors[60] and new debtors.[61] Article 9 could also have provided for the automatic perfection of the assignment of electronic chattel paper as it had provided for the automatic perfection of sales of accounts and promissory notes.[62]

Instead, the drafters of Article 9 added a specific definition of "control" of electronic chattel paper in Section 9-105 that differed from the concepts of control of investment property or deposit accounts.[63] As discussed in Part III in greater detail, the definition of "control" of the electronic record evidencing

57. In 1994, as the revision of Article 9 was starting, I published an article that criticized the use of misleading defined terms to incorporate the sale of accounts and chattel paper under the then current version of Article 9 and the many drafting errors in that revision. *See* Thomas E. Plank, *Sacred Cows and Workhorses: The Sale of Accounts and Chattel Paper Under Article 9 of the U.C.C. and the Effects of Violating a Fundamental Drafting Principle*, 26 CONN. L. REV. 397 (1994). The article included a proposed draft of a revision that would use terms of sale and ownership to govern sales of accounts and chattel paper. My proposed draft included provisions for giving purchase money security interest status to secured parties and buyer of accounts and chattel paper that incorporated the essential element of a purchase money interest—the provision of new value to enable the debtor or seller to acquire the specific collateral. *Id.* at 504 (revising the definition of purchaser money security interest in U.C.C. § 9-107 (1972) (AM. LAW. INST. & UNIF. LAW COMM'N, amended 2010)); *id.* at 516–18 (adding to U.C.C. § 9-312 (1972) (AM. LAW. INST. & UNIF. LAW COMM'N, amended 2010) substantive provisions for priority for purchaser money security interest in accounts and chattel paper). This proposal, however, would not have benefitted purchaser of chattel paper that was proceeds of inventory.

58. *See* U.C.C. § 9-324 (AM. LAW. INST. & UNIF. LAW COMM'N 2010) (providing different rules for purchase money security interests in goods other than inventory and for inventory).

59. *See id.* § 9-328(3) ("A security interest held by a securities intermediary in a security entitlement or a securities account maintained with the securities intermediary has priority over a conflicting security interest held by another secured party.").

60. *See id.* § 9-325 (addressing the priority problem that arises when a person acquires property that becomes subject to a security interest granted by the person to one secured party from another person that had subjected the property to a security interest granted to another secured party). *See also id.* cmts. 2–3.

61. *See id.* § 9-326 (addressing the priority problem that arises in collateral acquired by a "new debtor" who has granted a security interest to one secured party but has become bound by a security agreement entered into by another debtor in favor of another secured party).

62. *See* U.C.C. § 9-310(b)(2) (providing that the "filing of a financing statement is not necessary to perfect a security interest . . . (2) that is perfected under Section 9-309 when it attaches); *id.* § 9-309(3)–(4) (providing that the "following security interests are perfected when they attach: . . . (3) a sale of a payment intangible; [and] (4) a sale of a promissory note").

63. *See id.* § 9-105 cmt. 3.

the chattel paper sought to replicate the characteristics of possession of the writing evidencing tangible chattel paper.[64]

III. CURRENT METHOD OF CONTROL

To confer the same degree of negotiability to electronic chattel paper that tangible chattel paper had, Section 9-105 created the concept of "control" of electronic chattel paper. As discussed elsewhere in greater detail,[65] this definition required a system that would identify a single, unique, authoritative copy of the electronic record evidencing the electronic chattel paper, that would make the single authoritative copy unalterable without the consent of the secured party, and that would identify any other copy as a non-authoritative copy.[66] The original definition of control mirrors the concept of possession of an original signed writing by identifying the attributes of

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64. As Professor Mooney has pointed out, the systems for control of electronic chattel paper under Article 9 of the UCC as well as the UNCITRAL Model Law on Electronic Transferable Records are private registry systems, but systems that "explicitly replicate paper instruments and documents under applicable law." Charles C. Mooney, *Fintech and Secured Transactions Systems of the Future*, 81 L. & CONTEMP. PROBS. 1, 9 (2018). *See generally* U.N. COMMC'N ON INT'L TRADE LAW, UNCITRAL MODEL LAW ON ELECTRONIC TRANSFERABLE RECORDS (2018) (providing guidance on the use of electronic transferable records in international law). Professor Moringiello has criticized the reliance on a possessory paradigm to solve legal problems arising from electronic assets, including criticizing the original definition of control in U.C.C. § 9-105 that relies on the possessory paradigm. Juliet M. Moringiello, *False Categories in Commercial Law: The (Ir)relevance of (In)tangibility*, 35 FLA. ST. L. REV. 119, 154–56 (2007); *see also* Christopher K. Odinet, *Bitproperty and Commercial Credit*, 94 WASH. U. L. REV. 649, 700–01 (2017) (criticizing the reliance on the possessory paradigm to establish control of electronic chattel paper).

65. *See* Plank, *supra* note 29, at 32–39 (analyzing in greater detail control of original electronic chattel paper under the original definition).

66. *See* U.C.C. § 9-105 (2001) (AM. LAW. INST. & UNIF. LAW COMM'N, amended 2010):

> A secured party has control of electronic chattel paper if the record or records comprising the chattel paper are created, stored, and assigned in such a manner that:
>
> (1) a single authoritative copy of the record or records exists which is unique, identifiable and, except as otherwise provided in paragraphs (4), (5), and (6), unalterable;
>
> (2) the authoritative copy identifies the secured party as the assignee of the record or records;
>
> (3) the authoritative copy is communicated to and maintained by the secured party or its designated custodian;
>
> (4) copies or revisions that add or change an identified assignee of the authoritative copy can be made only with the participation of the secured party;
>
> (5) each copy of the authoritative copy and any copy of a copy is readily identifiable as a copy that is not the authoritative copy; and
>
> (6) any revision of the authoritative copy is readily identifiable as an authorized or unauthorized revision.

possession of an original signed writing—which by its very nature is a single, unique, and identifiable record that is unalterable without the consent of the possessor—and applying them to an electronic record.

This definition presents challenges. A writing that contains a signature is, in essence, a unique physical object that can be possessed. Possession gives the possessor exclusive dominion over the writing. An electronic record is stored in an electronic medium and can be perfectly replicated many times. Accordingly, under the original definition of control, it appears that the only way to provide for a single, unique, authoritative copy of the electronic record is to isolate it in an electronic vault pursuant to a system that protects the specific electronic record from unauthorized copying or alteration.

An electronic vault is the functional equivalent to a physical storage facility in which each separate tangible property item or related items can be stored.[67] Maintenance of an electronic record in an electronic vault mimics the storage of a tangible object in a safety deposit box for which a specific key is required inside a secure structure to which only individuals with certain credentials can be admitted. The information in an electronic vault could be stored on just one physical storage facility for an electronic record, such as a single hard drive or server.[68] However, the information need not be stored on just one server and is often distributed and duplicated among multiple servers at multiples storage facilities to protect the electronic information from destruction in the case of failure of one or more storage facilities.[69]

The key to satisfying this safe harbor is using computer processes in a controlled environment to ensure that, electronically, the information that can be retrieved in perceivable form pursuant to these processes constitutes the single, unique, authoritative copy.[70] These processes can be quite elaborate because of the necessity of ensuring that unauthorized individuals cannot access the electronic record and either copy it, alter it, or transmit it outside of the electronic vault.

To ameliorate the constraints of the original definition of control under Section 9-105, in 2010, the Uniform Law Commission and American Law

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67. *See, e.g.*, ABA Cyberspace Comm. Working Grp. on Transferable Records, *Emulating Documentary Tokens in an Electronic Environment: Practical Models for Control and Priority of Interests in Transferable Records and Electronic Chattel Paper*, 59 BUS. LAW. 379, 383 (2003) [hereinafter *Emulating Documentary Tokens*].

68. *See, e.g.*, *id.* ("An authoritative copy stored within a controlled-access system may . . . be held in a specified or other location that makes it distinguishable from other copies.").

69. *Id.* at 381–82.

70. *See generally* Working Grp. on Transferability of Elec. Fin. Assets et al., *Framework for Control over Electronic Chattel Paper—Compliance with UCC § 9-105*, 61 BUS. LAW. 721 (2006); *Emulating Documentary Tokens*, *supra* note 67.

Institute revised this definition to introduce a more general standard for control in Section 9-105(a) and made the original definition of control a safe harbor in Section 9-105(b).[71] Section 9-105(a) states: "A secured party has control of electronic chattel paper 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."[72] All states and the District of Columbia, other than the State of New York, have enacted this revised definition.[73]

The new general standard does provide flexibility for electronic chattel paper produced by converting tangible chattel paper to an electronic record by a scanning or imaging process that produces a reasonably unalterable image of the tangible chattel paper. If the scanned image shows an assignment by the owner of the chattel paper, which is the original secured party under the chattel paper, to an assignee/secured party,[74] then the conversion process and

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71. *See* U.C.C. § 9-105(a) (AM. LAW INST. & UNIF. LAW COMM'N 2010). The original Section 9-105 became subsection (b) with minor changes (shown below) as follows:

> (b) A system satisfies subsection (a), and a secured party has control of electronic chattel paper, if the record or records comprising the chattel paper are created, stored, and assigned in such a manner that:
>
> (1) a single authoritative copy of the record or records exists which is unique, identifiable, and, except as otherwise provided in paragraphs (4), (5), and (6), unalterable;
>
> (2) the authoritative copy identifies the secured party as the assignee of the record or records;
>
> (3) the authoritative copy is communicated to and maintained by the secured party or its designated custodian;
>
> (4) copies or ~~revisions~~ amendments that add or change an identified assignee of the authoritative copy can be made only with the ~~participation~~ consent of the secured party;
>
> (5) each copy of the authoritative copy and any copy of a copy is readily identifiable as a copy that is not the authoritative copy; and
>
> (6) any ~~revision~~ amendment of the authoritative copy is readily identifiable as ~~an~~ authorized or unauthorized ~~revision~~.

Id. § 9-105(b).

72. *See id.* § 9-105(a) (emphasis added); *supra* note 71 and accompanying text.

73. *See* UNIF. LAW COMM'N, *supra* note 1. New York enacted the 2010 amendments but did not enact the revisions to Section 9-105. *See* 2014 N.Y. Laws 1345 (showing § 28 of the Act, amending U.C.C. § 9-203, immediately following § 27 of the Act, amending U.C.C. § 9-104 and omitting the amendments to U.C.C. § 9-105 that appear in the Official Text of the 2010 revisions that immediately follow U.C.C. § 9-104).

74. In discussing assignments of chattel paper, which is a two-tiered transaction, it is important to keep in mind the different roles that the parties play. Under the chattel paper, the obligor is also the debtor in the first-tier transaction because the debtor has an interest in the specific good and has granted to the payee a security interest to secure the payment of a monetary obligation. The payee is the secured party in the first-tier transaction but is also the owner of the chattel paper. If the payee assigns the chattel paper, the payee is the debtor in the second tier,

transmission process would constitute a system that reliably establishes "the secured party as the person to which the chattel paper was assigned" and, therefore, would establish that the designated assignee obtained control.[75]

For this kind of electronic chattel paper, there would be no need to ensure that there was only one unique copy of the electronic record. Indeed, unlike tangible chattel paper, the debtor/assignor secured party having a copy of the electronic record would not defeat the control of the assignee secured party. That record would show that the chattel paper had been assigned to the assignee secured party, and the debtor/assignor secured party could not transfer that record to a third party without that notice of the assignment.

For chattel paper that is originated as an electronic record, however, the current method of control relies on the requirements of the safe harbor.[76] The next Part discusses a system that does reliably establish that the secured party is the person to which the chattel paper has been assigned without relying on a system that attempts to replicate the physical attributes of possession. This new method of control is also a venerable method of perfection and priority: notification to the obligor of assignment of the electronic chattel paper with instructions to pay the assignee.

IV. A NEW METHOD OF CONTROL: NOTIFICATION OF ASSIGNMENT

As discussed in Part IV.A below, notification to the obligor of an assignment of accounts, payment intangibles and chattel paper to an assignee and instructions to pay the assignee is necessary to ensure that the assignee of the receivable realizes its value. Also, as discussed in Part IV.B below, a robust legal history and tradition considered notification a reliable means of establishing the transfer of ownership and giving priority over other claimants which were not the first to be notified. The practical consequence of notification with payment instructions—as well as the legal history—justifies using notification as a system that reliably establishes the transfer of electronic chattel paper to a secured party because notification of the transfer gives that secured party priority over earlier purchasers not receiving notification of assignment and, therefore, should give the secured party "control."

Also, as discussed in Part IV.C below, control by notification of electronic chattel paper is conceptually similar to control for investment property and deposit accounts: A secured party obtains control of a deposit account, an

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because it has an interest in the chattel paper or it is a seller of the chattel paper, and the assignee is the secured party in the second-tier transaction.

75. Plank, *supra* note 29, at 46–49 (analyzing in greater detail control of converted electronic chattel paper under the general standard); Plank, *supra* note 57, at 410.

76. *See* Plank, *supra* note 29, at 29–49 (explaining that the control provision includes the restrictive safe harbor).

uncertificated security, and a security entitlement when the respective obligor has agreed or is otherwise obligated to follow the instructions of the secured party. To be sure, the nature of the obligors—banks in the case of deposit accounts, issuers in the case of uncertificated securities, or securities intermediaries in the case of security entitlements—are different. These differences, however, do not negate the principle. When an assignee of an intangible right to payment is the first to provide notice of assignment, such notice confirms the assignee's right to payment and ensures the receipt of any payments made. Notification in the case of such intangible rights to payment, including electronic chattel paper, operates in the same way as a secured party's control of a deposit account or a purchaser's rights to an uncertificated security or security entitlement.

A. The Importance of Notification Versus Possession

1. Notification Necessary to Obtain Payment

Notification with payment instructions plays a critical role in the transfer of accounts, chattel paper, and payment intangibles. Specifically, under UCC Section 9-406(a), if the payee under a receivable consisting of an account, chattel paper, or payment intangible assigns the receivable to an assignee, the obligor on the receivables—the "account debtor"[77] under Article 9—may nevertheless discharge its obligation to pay the receivable by paying the assignor.[78] The obligor becomes obligated to pay the assignee only if the obligor receives notification of the assignment of the receivable with instructions to pay the assignee before the obligor makes such payment.[79]

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77. *See* U.C.C. § 9-102(a)(3) (AM. LAW. INST. & UNIF. LAW COMM'N 2010) (defining an account debtor to mean "a person obligated on an account, chattel paper, or general intangible").

78. See *id.* § 9-406(a).

> Subject to subsections (b) through (i), an account debtor on an account, chattel paper, or a payment intangible may discharge its obligation by paying the assignor until, but not after, the account debtor receives a notification, authenticated by the assignor or the assignee, that the amount due or to become due has been assigned and that payment is to be made to the assignee. After receipt of the notification, the account debtor may discharge its obligation by paying the assignee and may not discharge the obligation by paying the assignor.

Notification is not effective in the circumstances specified in Section 9-406(b). These circumstances are the following: (1) failure of the assignment reasonably to identify the rights assigned; (2) an agreement enforceable under other law to pay only the payee; or (3) at the option of the account debtor, an assignment of less than the full amount of any installment. Subsection (c) addresses proof of the assignment and the remaining subsections of Section 9-406 relate to the abrogation of anti-assignment provisions in most of these receivables. *See id.* § 9-406(c)–(j).

79. *See id.* § 9-406(a), quoted *supra* note 78.

Moreover, the obligor may still pay the assignor after notification if, after the obligor's request, the assignee does not provide sufficient proof of the assignment.[80]

Accordingly, if an assignee wants to ensure that it will be paid without reliance on the assignor to forward payments it collects, it must notify the obligor of the assignment and instruct the obligor to whom to make payments. As a practical matter, even in the case of tangible chattel paper, notification is more valuable than possession because notification is necessary for the payment of each tangible chattel paper. Possession only becomes important if there are multiple claimants to the chattel paper, such as other assignees, lien creditors, or a bankruptcy trustee of the assignor.

Specifically, in a contest between a first assignee, SP-1, who obtains possession, and thereby becomes the first to perfect by possession, but does not provide notification, and a subsequent assignee, SP-2, who perfects by filing later but who first notifies the obligor, SP-1 will have the superior property interest because of its possession.[81] But until SP-1 notifies the obligor, SP-2 will receive the payments on the chattel paper because of its notification to the obligor.[82] When SP-1 notifies the obligor of the assignment to it, the obligor will, at that point, not know whether to pay SP-2 or SP-1 because it has no basis for assessing the rights of SP-1 or SP- 2.[83] SP-1 will then have to assert its right to superior ownership against the obligor and SP-2. Ultimately, SP-1 would win as to future payments,[84] but unless

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80. *See id.* § 9-406(c):

> Subject to subsection (h), if requested by the account debtor, an assignee shall seasonably furnish reasonable proof that the assignment has been made. Unless the assignee complies, the account debtor may discharge its obligation by paying the assignor, even if the account debtor has received a notification under subsection (a).

Subsection (h) provides: "This section is subject to law other than this article which establishes a different rule for an account debtor who is an individual and who incurred the obligation primarily for personal, family, or household purposes." *Id.* § 9-406(h).

81. *See id.* § 9-322(a)(1) (giving priority to the first secured party to file or perfect).

82. *See id.* § 9-406(a) (providing that after the account debtor receives a notification of assignment, the account debtor may discharge its obligation only by paying the assignee).

83. At this point, an account debtor could file an action for interpleader and pay the amount due into court. *See, e.g.*, Avant Petroleum, Inc. v. Banque Paribas, 853 F.2d 140, 143 (2d Cir. 1988) (citing Lockhart v. Garden City Bank & Trust Co., 116 F.2d 658, 661 (2d Cir. 1940)) ("Once the interpleader fund has been deposited with the district court, the court holds it for whichever party it determines is the rightful owner. . . The court will normally adjudicate the rights of the claimants as of the time the interpleader fund is deposited with the court.").

84. To the extent that the obligor has made payments to SP-2 with funds from a deposit account, such as a check or electronic transfer, the funds that had been credited to the deposit account and that were received by SP-2 would be proceeds of the chattel paper in which SP-1 would have a security interest. *See id.* § 9-102(a)(64)(B) (defining "proceeds" to include "whatever is collected on, or distributed on account of, collateral"). Nevertheless, SP-2 will take the payments free of SP-1's security interest. *See id.* § 9-332(b) (providing that a "transferee of

everyone agreed, the costs of establishing SP-1's priority for future payments would be significant.

2. *Exaggeration of Possession of Tangible Rights to Payment*

An immediate objection to the use of notification as control is that notification of assignment does not provide the type of notice to the world that possession by the assignee of a tangible object, such as tangible chattel paper, provides. Also, comment 4 to UCC Section 9-330 suggests a test of "whether possession or control of the record would afford the public notice contemplated by the possession and control requirements."[85] On the other hand, comment 3 to Section 9-105 does state that the definition of control is to be flexible.[86]

The transfer of possession of tangible chattel paper by the assignor to an assignee does prevent the assignor from transferring possession to a subsequent assignee. Although possession by the assignee does not prevent the assignor from purporting to assign an interest in the tangible chattel paper to a different assignee, in theory, the subsequent assignee can protect itself by determining if the assignor has possession. In the case of the assignment of a single tangible chattel paper, such determination may be more certain and less costly for the purchaser than determining whether the obligor received notification of assignment and whether the assignor is no longer receiving payment by the obligor.[87]

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funds from a deposit account takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party"). This subsection would presumably preclude SP-1 recovering from SP-2 on the grounds of conversion. Similarly, if an obligor made payments on the chattel paper to SP-2 with a check (or other negotiable instrument), and SP-2 qualified as a holder in due course of the check, which is likely, then SP-2 would take the check free of SP-1's security interests. *See id.* § 9-331(a) & cmt. 5.

85. *Id.* § 9-330 cmt. 4.

86. *See id.* § 9-105 cmt. 3.

87. The treatment of promissory notes that are assigned is dramatically different. Promissory notes by definition are evidenced by a written record. *See id.* § 9-102(a)(65) (definition of "promissory note," a subtype of "instrument" under Article 3); *id.* § 9-102(a)(47) (definition of instrument as a "negotiable instrument" under Article 3 or certain other writings); *id.* § 3-104(a), (e) (AM. LAW INST. & UNIF. LAW COMM'N 2002) (defining a "negotiable instrument" that is a note as a "promise"); U.C.C. § 3-103(a)(9) (defining a "promise" as a signed writing). Only a person in possession of the note can enforce a promissory note (except in the case of enforcement of a stolen or lost note, for which there are many additional requirements). *See* U.C.C. § 3-301 (1990) (AM. LAW INST. & UNIF. LAW COMM'N, amended 2002) (defining a "person entitled to enforce" to include a "holder" or a "nonholder in possession" of the instrument); U.C.C. § 1-201(b)(21) (AM. LAW. INST. & UNIF. LAW COMM'N 2001) (defining "holder" to mean "the person in possession of a negotiable instrument" meeting

This almost romantic notion of possession, however, does not comport with the reality of the practice of the marketplace for the assignment of tangible chattel paper. I estimate that as of the end of 2018, there were more than 70 million automobile loans outstanding,[88] the overwhelming number of which have been originated by dealers and assigned at least once.[89] Checking each item of tangible chattel paper by potential assignees is costly. In the case of the indirect origination of automobile loans, finance companies as a matter

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other requirements); The maker of the promissory note is obligated to pay a person entitled to enforce. *See* U.C.C. § 3-412 (1990) (AM. LAW INST. & UNIF. LAW COMM'N, amended 2002). Under UCC Section 3-602 of the 1990 version of Article 3 of the UCC in effect in most states, when a promissory note is assigned by the original payee to a person entitled to enforce the instrument, payment by the maker of the note to the original payee does not discharge the obligation of the maker to pay the note. In most cases, the maker remains obligated to pay the transferee that is a person entitled to enforce. *See id.* § 3-602(a). The maker can protect itself by demanding that the person to whom payment is being made to exhibit the note and either surrender the note to the maker or place a notation on such payment on the note. *See id.* § 3-501(b)(2). Moreover, if the maker makes a payment to the person entitled to enforce and therefore discharges the payment obligation but does not obtain possession or have notation of payment marked on the note, and the note is then transferred to a person that has the rights of a holder in due course, the maker could not assert the discharge against the person with the rights of a holder in due course without notice of the discharge. *See id.* § 3-601(b). The official text of Article 3 was revised in 2002, and as of July 1, 2019, has been adopted in 11 states and the District of Columbia. *See* UNIF. LAW COMM'N, UCC ARTICLE 3, NEGOTIABLE INSTRUMENTS AND ARTICLE 4, BANK DEPOSITS, AMENDMENTS TO (2002), https://www.uniformlaws.org/committees/community-home?CommunityKey=d6a2022c-ae5d-4fda-baf5-c1628a68168e [https://perma.cc/2LHP-WXAB]. The 1990 revision of Article 3 remains in effect in most of the states (but not New York, which still uses the 1962 version of Article 3 with some modifications). The 2002 revision of Article 3 included notification as a requirement to the right to payment of a person entitled to enforce the instrument and essentially incorporated the notification rule for accounts, chattel paper and payment intangibles discussed above. *See* U.C.C. § 3-602(b), (c) (AM. LAW. INST. & UNIF. LAW COMM'N 2002). These rules also provided that a transferee, including a holder in due course, is "deemed" to have notice of discharge by a payment if a maker that had not received notification of the transfer made a payment to the transferor. *See id.* § 3-602(d).

88. As noted above, the aggregate outstanding balance of auto loans as of the end of 2018 was approximately $1.15 trillion. *See supra* note 5 and accompanying text. During 2014-2018, the average initial balance of new car loans financed by finance companies increased from approximately $26,300 to $30,500. *Federal Reserve Statistical Release G.19, Consumer Credit Outstanding*, BD. OF GOVERNORS OF THE FED. RES. SYS. (June 7, 2019), https://www.federalreserve.gov/releases/g19/20190607/ [https://perma.cc/2ZG7-EKWX]. The aggregate balance of $1.15 billion consists of amortizing loans whose remaining term will vary from one month to the entire original term of 48, 60, or 66 months. *Id.* The weighted average balance of a pool of loans that amortizes over two to five years is 53% of the original principal of the loans. *See id.* Accordingly, the aggregate original principal balance of auto loans as of the end of 2018 equals approximately $2.16 billion. *Id.* Dividing this amount by an assumed average balance of $30,000 would produce a rough estimate of at least of 72 million automobile loans outstanding. *See id.*

89. *See supra* notes 32–36 and accompanying text.

of course, must check to ensure that they have received possession of the tangible chattel paper because possession is necessary to ensure that they have a superior interest in the automobile loan.[90] This necessity and the costs involved led to an industry-wide desire for the creation of electronic chattel paper. However, when finance companies in possession of automobile loans sell or pledge these automobile loans to obtain financing for their operations, including the acquisition of more chattel paper, assignees that have confidence in the integrity and financial soundness of the finance companies do not require the subsequent transfer of possession to the assignees.[91]

Assignees seeking to acquire a pool of automobile loans will perform due diligence on the pool of chattel paper. The assignees typically do not check to see that the financing companies have possession of all of the automobile loans being assigned to them, although they may check a sample of the loans. In the context of most commercial transactions involving the assignment of large numbers of receivables in a single transaction, the costs of determining possession of each tangible possession are high. For this reason, the presumed publicity of possession loses its advantage over notification.

In the commercial world, because of the relative costs of due diligence, possession by the assignor of large numbers of tangible chattel paper on which the subsequent purchaser is presumed to rely would not provide more notice of the assignor's interests than the assignor's records indicating the receipt of the payments on the chattel paper. For a subsequent assignee, the records of an assignor that had assigned the chattel paper to a prior assignee and had given notice of assignment with instructions to pay the prior assignee would show that the assignor was no longer receiving payments on the chattel paper, even if the assignor's records did not show the assignment.

To illustrate this point, consider the minimum due diligence necessary for any potential purchaser of tangible chattel paper. The potential purchaser would examine the records of the owner of the chattel paper to ascertain the amount owed by the obligor, the maturity dates, the payment dates, the interest rates, the identity of the obligor, and the payment history.[92] This due diligence

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90. *See* U.C.C. § 9-313(a) (AM. LAW INST. & UNIF. LAW COMM'N 2010) (stating that a party may perfect a security interest in tangible chattel paper by taking possession of the collateral), quoted *supra* note 19 and accompanying text; *id.* § 9-330(a), (b) (providing that a purchaser that takes possession will have a superior interest to a secured party that is perfected other than by possession), *quoted and discussed supra* notes 52–53 and accompanying text).

91. *See* STANDARD & POOR'S RATING SERVS., *supra* note 32, at 66 (discussing the necessity of financing institutions acquiring electronic chattel paper from dealers to obtain control but stating that subsequent transfers can be perfected by filing a financing statement).

92. The first four items define the basic attributes of receivable. A purchaser will also look at other types of information. For example, as part of Standard and Poor's criteria on rating securities payable from automobile loans, it noted the importance of "the origination, underwriting, and risk management tools and policies" of an indirect originator of the

of the records is less costly than inspecting the actual tangible chattel paper. The purchaser could review the original writings for certain purposes, such as to determine that it existed or that it at least had not been assigned to a prior purchaser, that it had been signed by the obligor, and that there was no statement within the writing or added to the writing indicating that the tangible chattel paper has been assigned to another person.[93] But such physical inspection would not necessarily be as reliable as examining the payment history for the chattel paper.

A potential purchaser of electronic chattel paper would review the current owner's books and records for the same information. Such a purchaser could also review the actual electronic records evidencing the electronic chattel paper. Because of the nature of electronic chattel paper, however, review of the actual records would not provide assurance that the person purporting to own the electronic chattel paper had not previously assigned the chattel paper to a prior purchaser. A more reliable form of assurance is a review of the owner's books and records showing that the owner has been collecting the payments on the chattel paper.[94]

Additionally, notification accompanied by instructions to pay is particularly suited to the primary means of originating automobile loans—the indirect origination method. This method depends on the assignment of the automobile loans from the automobile dealers who originate the chattel paper as part of the purchase price for the automobile, notification to the obligor of the assignment to the automobile finance company, and instruction to pay the finance company, which will collect the payments and otherwise service the loans. Because dealers are in the business of selling and servicing automobiles and need funds to purchase more inventory or to pay down the balance of their inventory loan so that they can then finance future purchases of inventory,

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automobile loans, and listed as important factors that it considers "[o]bligor credit criteria, including minimum FICO credit score, income, payment-to-income and debt-to-income ratios, and other variables that indicate ability and willingness to pay debt obligations." STANDARD & POOR'S RATING SERVS., ABS: GENERAL METHODOLOGY AND ASSUMPTIONS FOR RATING U.S. AUTO LOAN SECURITIZATIONS ¶ 92 (rev. 2018).

93. *See* U.C.C. § 9-330(a)(2) (providing as a condition for giving super-priority to a purchaser of chattel paper that is claimed merely as proceeds of inventory subject to a security interest that "the chattel paper does not indicate that it has been assigned to an identified assignee other than the purchaser"), quoted *supra* text accompanying note 52; *see also id.* § 9-330(b) (providing as a condition for giving super-priority to a purchaser that the purchaser of chattel paper not claimed merely as proceeds take "without knowledge that the purchase violates the rights" of a prior assignee), quoted *supra* text accompanying note 53.

94. A potential purchaser could also send a questionnaire or estoppel letter to all or a sample of the obligors on the chattel paper requesting confirmation that the obligor has been paying the owner. Such a questionnaire or estoppel letter is not typical in most transactions involving the assignment of chattel paper by a financing institution.

dealers will rarely retain the chattel paper. Typically, the forms of the chattel paper will be dictated by the finance company. Also, the chattel paper will not be finally created until the finance company agrees to the terms of the chattel paper and agrees to take the assignment. As discussed below, reliance on notification of assignment as a method of control would comport with current business practices and expectations.

More importantly, in the case of tangible chattel paper, the focus on possession as a means of ensuring the value of the chattel paper is overblown. The essence of tangible chattel paper is a promise to pay.[95] The promise to pay is intangible. In the case of tangible chattel paper, the promise to pay has been reified into a tangible record that can be possessed. The value of the tangible record, however, is not the value of the medium by which the intangible promise to pay is evidenced. The value lies in the willingness and ability of the obligor to pay. Until the advent of electronic transactions, transfer of possession provided a convenient and reasonably secure way of assigning the intangible rights.[96] But possession of the tangible chattel paper does not have the same importance as possession of a tangible good. In the case of goods, possession is typically the basis for the value of the tangible item. Possession of a watch, a car, or a drill press is necessary to realize the value of the watch, the car, or the drill press. An owner of tangible chattel paper need not have possession to receive the benefits of ownership—the cash flow from the tangible chattel paper and specifically the yield produced by the tangible chattel paper. For example, if a secured creditor takes possession of the tangible record to perfect a security interest to secure a debt, a common practice, the debtor retains the ownership of the cash flow.[97]

Electronic chattel paper uses a different medium to evidence its intangible essence—again, the willingness and ability of the obligor to pay. The electronic records, however, are not tangible. They consist of electronic charges stored in a special, tangible medium.[98] They are also "intangible" in that they cannot be possessed, although they are physical in a way that an unrecorded oral promise to pay is not. In any event, they can be replicated perfectly many times, unlike a tangible writing that bears a wet ink signature.

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95. *See* U.C.C. § 9-102(11) (defining "chattel paper" as a record that evidences a monetary obligation as well as a security interest in or lease of a specific good), quoted *supra* note 4.

96. Delivery of possession will satisfy the requirement for attachment of a security interest without a signed security agreement and the requirement for perfection without the filing of a financing statement. *See supra* note 19 and accompanying text.

97. A secured creditor will acquire a security interest to secure the payment of an obligation but will not acquire ownership. The debtor retains ownership of the chattel paper.

98. U.C.C. § 9-102(a)(70) (defining "record" to mean "information that is inscribed on a tangible medium or which is stored in an electronic or other medium and is retrievable in perceivable form"). The "medium" for an electronic record, however, will be a tangible item, like a "hard drive," that is specially designed to maintain the electronic information.

Accordingly, although it is natural to start with a system of control of chattel paper that, if in a tangible medium, would be considered tangible chattel paper, a system of control need not rely on a possessory paradigm. It need not rely on the dynamics of possession to establish the reliability of ownership or transfer of electronic chattel paper.

There is no perfect way to establish assignment. In the case of notification, there is the risk that the obligor notified of an assignment may not pay the chattel paper at all. Also, because chattel paper, like most consumer receivables, usually requires monthly payments, there will be a lag of usually a month or so from the time of assignment and notification until the next payment date. In the case of possession, there is the risk that tangible chattel paper is destroyed or lost during or after delivery. However, in the case of tangible chattel paper, loss or destruction may not become evident for some time. In the case of notification of assignment, if the obligor failed to pay, then the assignee would soon know that it is not receiving payments on the chattel paper.

B. Notification as Tantamount to Possession Before the UCC

Before the enactment of the Uniform Commercial Code throughout the United States and also before the enactment of assignment of accounts statutes in most states beginning in the 1940s,[99] factors of accounts and accounts receivable finance companies perfected their interests in one of two ways. In New York and other states that followed the "American Rule," a transferee's interests in receivables was perfected automatically upon assignment.[100] In

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99. *See* Dan T. Coenen, *Priorities in Accounts: The Crazy Quilt of Current Law and a Proposal for Reform*, 45 VAND. L. REV. 1061, 1071-73 (1992) (describing the methods the accounts receivables statutes used to perfect assignments: automatic perfection upon assignment, recordation notice, and in one case the marking of the assignor's books); Plank, *supra* note 57, at 413–16 (describing the enactment of statutes governing perfection of assignments of accounts and, in some cases, chattel paper as the result of the Supreme Court's decision in *Corn Exchange National Bank & Trust Co. v. Klauder*, 318 U.S. 434, 436–37 (1943)) The *Klauder* case had interpreted—correctly—a provision in § 60 of the then Bankruptcy Act of 1898 that made every assignment of accounts that relied on the notification for perfection, discussed below, a potentially preferential transfer). *See* Plank, *supra* note 57, at 413–15.

100. *See* 2 GILMORE, *supra* note 37, § 25.6, at 670–71; Maximilian Koessler & John Hanna, *Assignment of Accounts Receivable: Confusion of the Present Law, the Impact of the Bankruptcy Act, and the Need for Uniform Legislation*, 33 CALIF. L. REV. 40, 63–65 (1945); Coenen, *supra* note 99, 45 VAND. L. REV. at 1069–71 (providing a summary of the differences between the American Rule and the English Rule); comment, *Multistate Accounts Receivable Financing: Conflicts in Context*, 67 YALE L.J. 402, 407–08 (1958). As Koessler & Hanna, *supra*, noted, however, in some states the courts made exceptions to the automatic perfection rule, summarized in the so-called Massachusetts rule, set forth in the RESTATEMENT OF CONTRACTS § 173 (AM. LAW. INST. 1932), giving a second assignee priority if the first assignment was

Pennsylvania and other states that followed the "English Rule," a transferee's interests in receivables was perfected upon notification to the account debtor of the assignment to and the identity of the new payee.[101]

For interesting historical reasons, Article 9 of the Uniform Commercial Code, which went into effect in the United States in the 1960s but the basic outlines of which were established in early drafts of the late 1940s and early 1950s,[102] replaced the American rule or the English rule with a requirement that filing of a financing statement is necessary to perfect a non-possessory transfer of accounts and chattel paper.[103]

The English rule gave the first assignee of a receivable to have notified the obligor priority over a prior assignee.[104] The rationale for this rule was that notification was comparable to and served the same purpose as possession of tangible property items. Many commentators have traced the English Rule to the 1831 English case of *Dearle v. Hall*.[105] In the case, Zachariah Brown had received a life interest in a portion of his father's estate that was invested in securities and that produced £93 per annum for his life, payable by the executors of his father's will.[106] In 1808, Brown absolutely assigned the sum of £37 per annum for the rest of his life to William Dearle for a payment of

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revocable or if the second assignee was a bona fide purchaser without notice who first obtained payment, a judgement, a novation or delivery of a writing the surrender of which was necessary for enforcement. The RESTATEMENT OF TRUSTS § 163 (AM. LAW. INST. 1935) had appeared to adopt the American Rule but the comments incorporate the substance of the exceptions set forth in the Restatement of Contracts.

101. *See* 2 GILMORE, *supra* note 37, § 25.6, at 671; Koessler & Hanna, *supra* note 100, at 63–65.

102. *See e.g.*, U.C.C. §§ 311(2), 362(2) (AM. LAW INST. & UNIF. LAW COMM'N, Tentative Draft No. 2, 1947), *reprinted in* 5 UNIFORM COMMERCIAL CODE DRAFTS 138–39, 148 (Elizabeth S. Kelly & Ann Puckett eds., 1984) [hereinafter UCC DRAFTS]; U.C.C. §§ 7-305, -319 (AM. LAW. INST. & UNIF. LAW COMM'N, May 1949 Draft), *reprinted in* 8 UCC DRAFTS, *supra*, at 111–12, 125–26; U.C.C.§§ 8-402(1)(d), 8-402(b) (AM. LAW. INST. & UNIF. LAW COMM'N, Sept. 1949 Revisions), *reprinted in* 8 UCC DRAFTS, *supra*, at 332–33; U.C.C. § 8-303 (Oct. 1949 Revisions), *reprinted in* 8 UCC DRAFTS, *supra*, at 504–05; U.C.C. § 9-303 (Proposed Final Draft, Spring 1950), 9 UCC DRAFTS, *supra*, at 425–26. I discuss the history of the drafting in Plank, *supra* note 57, at 423–25. *See also supra* note 99.

103. *See* U.C.C. § 9-310(a) (AM. LAW INST. & UNIF. LAW COMM'N 2010) (requiring filing for perfection in most cases); *id.* § 9-312(a) (providing that a "security interest in chattel paper . . . may be perfected by filing"). The 2001 revision of Article 9 also created the new subtypes of "promissory note," *id.* § 9-102(a)(65) and "payment intangibles," *id.* § 9-102(a)(61), which required the filing of a financing statement to perfect a security interest in a payment intangible to secure payment of an obligation and permitted perfection of a security interest in promissory notes to secure a debt by filing.

104. *See* 2 GILMORE, *supra* note 37, § 25.7, at 671.

105. Dearle v. Hall, 3 Russ. 1, 38 Eng. Rep. 475 (Ch. 1828).

106. *Id.* at 1–5, 38 Eng. Rep. at 475–77 (providing a summary of the facts); *id.* at 5–22, 38 Eng. Rep. at 478–83 (providing a more detailed discussion of the evidence).

£204. The following year, Zachariah Brown absolutely assigned the sum of £27 per annum for the rest of his life to Caleb Sherring for a payment of £150. The executors did not receive notice of the assignments and Brown made the required payments to the assignees through the first part of 1811.

Notwithstanding these assignments, in early 1812 Brown advertised for sale his life interest of £93 per annum as an unencumbered interest. After conducting due diligence through his attorney, including inquiring of the executors to establish the validity of the life interest, on March 20, 1812, Joseph Hall purchased the life interest of £93 per annum for approximately £711. In the instrument of assignment, Brown warranted that he had not encumbered the amounts due. On April 25, 1812, Joseph Hall served written notice on the executors of the assignment, requiring them to pay the £93 per annum to Hall as assignee of Brown. In July, the executors remitted the first quarterly payment to Hall, but then in October they received notification of the prior assignments to Dearle and Sherring. Thereafter, they refused to make any payments until the rights of the claimants could be ascertained.

Dearle and Sherring then sued Hall, Brown, and certain sureties for payment of the amounts due to them. The Master of the Rolls ruled that Hall had the superior interest.[107] First, the Master of the Rolls recalled the law of England that personal property is delivered by possession and "and it is possession that determines ostensible ownership."[108] The Master then stated:

> It is true that a chose in action does not admit of tangible actual possession, and that neither Zachariah Brown nor any person claiming under him were entitled to possess themselves of the fund which yielded the £93 a-year. But in Ryall v. Rowles the Judges held, that, in the case of a chose in action, you must *do every thing towards having possession which the subject admits*; you must do that which is *tantamount to obtaining possession*, by placing every person, who has an equitable or legal interest in the matter, under an obligation to treat it as your property. For this purpose, *you must give notice* to the legal holder of the fund; in the *case of a debt, for instance, notice to the debtor is, for many purposes, tantamount to possession.*[109]

A related consideration is that notification to the obligor on a receivable prevents the owner of the receivable from committing fraud by effecting multiple assignments. Several courts have relied on the notion that notification

107. *See id.* at 27–29, 38 Eng. Rep. at 485.
108. *Id.* at 23, 38 Eng. Rep. at 483.
109. *Id.* at 22–23, 38 Eng. Rep. at 483–84 (emphasis added).

in the case of an intangible chattel paper is "tantamount to possession" or constitutes "constructive possession"[110] of the receivables.

The English rule prevails in England to a great extent. First, notification of assignment is necessary for an absolute assignment, that is, a true sale, of a legal interest in receivables.[111] Second, the rule of *Dearle v. Hall* still prevails for both absolute and collateral assignment[112] of receivables except in the case

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110. *See, e.g.*, Am. Fire & Cas. Co. v. First Nat'l City Bank of N.Y., 411 F.2d 755, 757–58 (1st Cir. 1969) (holding that under Puerto Rico law, a bank to which a subcontractor had assigned its right to progress payments from a contractor had priority to progress payments over a surety's reimbursement rights under an indemnity agreement for the surety's payment and performance bonds because the bank had been the first to notify the contractor of the assignment, stating that it "may be argued that notification to the debtor is the best form of constructive possession"); Graham Paper Co. v. Pembroke, 56 P. 627, 628 (Cal. 1899) (quoting *Dearle*, 3 Russ. at 24, 38 Eng. Rep. at 484); Boulevard Nat'l Bank of Miami v. Air Metals Indus., 176 So. 2d 94, 97, 98–99 (Fla. 1965) (holding that a subsequent assignee of an account receivable who first gave notice has priority over a prior assignee of the same account receivable, and after quoting *Dearle v. Hall*, stating that notice to the debtor of the assignment is a manifestation of delivery that "fixes the accountability of the debtor to the assignee instead of the assignor and enables all involved to deal more safely."); Lambert v. Morgan, 72 A. 407, 408–09 (Md. 1909) (quoting *Dearle*, 3 Russ. at 24, 38 Eng. Rep. at 484); Greeley Cty. v. First Nat'l Bank Cozad, 254 N.W. 502, 504–05 (Neb. 1934) (quoting *Dearle*, 3 Russ. at 24, 38 Eng. Rep. at 484).

111. Law of Property Act 1925, 15 & 16 Geo. 5 c. 20, § 136 (Eng.):

> (1) Any absolute assignment by writing under the hand of the assignor (not purporting to be by way of charge only) of any debt or other legal thing in action, of which express notice in writing has been given to the debtor, trustee or other person from whom the assignor would have been entitled to claim such debt or thing in action, is effectual in law (subject to equities having priority over the right of the assignee) to pass and transfer from the date of such notice—
>
> (a) the legal right to such debt or thing in action;
>
> (b) all legal and other remedies for the same; and
>
> (c) the power to give a good discharge for the same without the concurrence of the assignor.

Section 136 contains the following proviso:

> Provided that, if the debtor, trustee or other person liable in respect of such debt or thing in action has notice
>
> (a) that the assignment is disputed by the assignor or any person claiming under him; or
>
> (b) of any other opposing or conflicting claims to such debt or thing in action; he may, if he thinks fit, either call upon the persons making claim thereto to interplead concerning the same, or pay the debt or other thing in action into court under the provisions of the Trustee Act, 1925.

The passing of Section 136 of the Law of Property Act of 1925 reenacted Section 25(6) of the Judicature Act of 1873, with minor changes. *See* Simpson v. Norfolk & Norwich Univ. Hosp. NHS Tr., [2011] EWCA (Civ.) 1149 (UK).

112. *See, e.g.*, E. Pfeiffer Weinkellerei-Weineinkauf GmbH & Co. v. Arbuthnot Factors Ltd., [1988] 1 W.L.R. 150 (Eng.) (holding that a factor that had purchased from a wine importer accounts arising from the sale of wine by the importer had priority over a German exporter that had sold the wine under a reservation of title clause to the importer/assignor and was therefore

of a collateral assignment by a company that registers a "charge" over the receivables assigned.[113]

C. *Comparability of Notification to Control of Investment Property and Deposit Accounts*

Notification of assignment with instructions to pay the assignee is conceptually the same as control of deposit accounts, uncertificated securities, and security entitlements. As discussed in this subpart IV.C, for each of these types of collateral, the obligor on the collateral is required to make payment to or follow the instructions of the person that has control.

A deposit account established by a customer at a bank is a contractual relationship in which the bank promises to pay to the order of the customer the amount of funds that the customer has provided to the bank.[114] A secured party may perfect a security interest in the customer's rights to instruct the bank regarding the disposition of funds credited to the deposit account—which I have called the "deposit entitlement"[115]—only by obtaining control of the deposit account unless the deposit account is cash proceeds of other

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entitled to receive proceeds of any sales of wine by the importer because the factor had notified the obligors on the accounts of the assignment to it and the exporter had neither notified the obligors of its interest or had registered a charge on the proceeds against the creditors of the importer/assignor).

113. *See* ROY GOODE & LOUSE GULLIFOR, GOODE AND GULLIFER ON LEGAL PROBLEMS OF CREDIT AND SECURITY ¶ 5-08, at 181–82 (6th ed. 2017). The authors consider the rule from *Dearle v. Hall* "wholly unsuitable to modern receivables financing." *Id.* They do not say why, but they endorse reform proposals that would base priority on the date of registration. *Id.* They do not specifically address the appropriateness of the rule for absolute assignments, that is, true sale of receivables.

114. *See, e.g.*, U.C.C. § 9-102(a)(29) (defining a "deposit account" as "a demand, time, savings, passbook, or similar account maintained with a bank," but not including "investment property or accounts evidenced by an instrument"). The term "bank means a person engaged in the business of banking . . . includ[ing] a savings bank, savings and loan association, credit union, and trust company." U.C.C. § 1-201(b)(4) (AM. LAW INST. & UNIF. LAW COMM'N 2001); *see also* U.C.C. § 4-104(a)(1), (5) (1990) (AM. LAW. INST. & UNIF. LAW COMM'N, amended 2002) (defining an "account" as "any deposit or credit account with a bank, including a demand, time, savings, passbook, share draft, or like account, other than an account evidenced by a certificate of deposit" and a "customer" as "a person having an account with a bank or for whom a bank has agreed to collect items, including a bank that maintains an account at another bank"); *See generally* Bruce A. Markell, *From Property to Contract and Back: An Examination of Deposit Accounts and Revised Article 9*, 74 CHI.-KENT L. REV. 963, 966–74 (1999) (providing a brief history of the law governing deposit accounts); Thomas E. Plank, *Security Interests in Deposit Accounts, Securities Accounts and Commodity Accounts: Correcting Article 9's Confusion of Contract and Property*, 69 OKLA. L. REV. 339, 347–57 (2017) (describing the nature of a deposit account as a debtor-creditor relationship and how different provisions of Article 9 correctly and incorrectly reflect the nature of the deposit account).

115. *See* Plank, *supra* note 114, at 345, 347–57.

collateral.[116] One method by which a secured party can obtain control is if "the debtor, secured party, and bank have agreed in an authenticated record that the bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the debtor."[117] A secured party that has control over a deposit account has priority over a secured party that does not have control.[118]

Structurally, granting a security interest in deposit account under Article 9—or more correctly, granting a security interest in the grantor's deposit entitlement—is the same as the payee and owner of any receivable, including electronic chattel paper, granting a security interest to an assignee. Similarly, using a control agreement[119] to perfect the secured party's security interest is comparable to notification of assignment of an account with payment instructions. The bank is the obligor on the deposit account. Once the bank has agreed, the secured party can direct the bank—the obligor—to pay to the secured party the funds credited to the deposit account without the consent of the customer, the assignor. The bank's obligation is comparable to the obligation of the obligor on a receivable, including electronic chattel paper, to pay the assignee upon receipt of notification with payment instructions.[120]

Finally, there are two types of intangible investment property, an uncertificated security and a security entitlement. A secured party may perfect a security interest in each subtype of investment property by "control."[121] A

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116. *See* U.C.C. § 9-312(b)(1) ("Except as otherwise provided in Section 9-315(c) and (d) for proceeds: (1) a security interest in a deposit account may be perfected only by control under Section 9-314"); *id.* § 9-314(a) ("A security interest in . . . deposit accounts . . . may be perfected by control of the collateral under Section 9-104."); *id.* § 9-315(c)–(d) (providing that a security interest in proceeds is a perfected security interest if the security interest in the original collateral was perfected and the proceeds are identifiable cash proceeds); *id.* § 9-102(a)(9) (defining "cash proceeds" as "proceeds that are money, checks, deposit accounts, or the like").

117. *Id.* § 9-104(a)(2).

118. *Id.* § 9-327(1) ("A security interest held by a secured party having control of the deposit account under Section 9-104 has priority over a conflicting security interest held by a secured party that does not have control.").

119. With a control agreement, the debtor, the secured party, and the bank are separate parties. The secured party can also obtain control be becoming the bank that maintains the account and therefore the obligor on the account or by becoming the customer and therefore the owner of the deposit account. *See id.* § 9-104(a)(1) (providing that the secured party has control if "the secured party is the bank with which the deposit account is maintained"); *id.* § 9-104(a)(3) (providing that the secured party has control if "the secured party becomes the bank's customer with respect to the deposit account").

120. *See supra* Section IV.A.

121. *See id.* § 9-314(a) ("A security interest in investment property . . . may be perfected by control of the collateral under Section . . . 9-106."); *id.* § 9-106(a) ("A person has control of a certificated security, uncertificated security, or security entitlement as provided in Section 8-

secured party with control over investment property has priority over any secured party perfected other than by control.[122]

An uncertificated security is evidenced not by a certificate but by entry on the books of the issuer.[123] Under Section 8-106(c), a purchaser, which includes a secured party, has control of an uncertificated security if:

> (1) the uncertificated security is delivered to the purchaser; or
> (2) the issuer has agreed that it will comply with instructions originated by the purchaser without further consent by the registered owner.[124]

An uncertificated security is "delivered" if the issuer registers the purchaser (or an agent of the purchaser) as the registered owner.[125] The registered owner is entitled to all of the rights specified in the security.[126] In either case, a secured party obtains control when the issuer becomes obligated to follow the instructions of the secured party either because the secured party (or its agent) has become the registered owner or is the beneficiary of a control agreement.

106."). Investment property described in Section 9-314(a) includes "a security, whether certificated or uncertificated, [or] security entitlement." *Id.* § 9-102(a)(49).

122. *Id.* § 9-328(1) ("A security interest held by a secured party having control of investment property under Section 9-106 has priority over a security interest held by a secured party that does not have control of the investment property.").

123. *See* U.C.C. § 8-102(a)(15) (AM. LAW INST. & UNIF. LAW COMM'N 1994) (defining a "security" as "an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer: (i) which is represented by a security certificate in bearer or registered form, or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer" and meets certain other requirements); *id.* § 8-102(a)(18) (defining an "uncertificated security" as "a security that is not represented by a certificate").

124. *Id.* § 8-106(c).

125. *See id.* § 8-301(b), stating:

> Delivery of an uncertificated security to a purchaser occurs when:
> (1) the issuer registers the purchaser as the registered owner, upon original issue or registration of transfer; or
> (2) another person, other than a securities intermediary, either becomes the registered owner of the uncertificated security on behalf of the purchaser or, having previously become the registered owner, acknowledges that it holds for the purchaser.

126. *See id.* § 8-207(a), stating:

> Before due presentment for registration of transfer of a certificated security in registered form or of an instruction requesting registration of transfer of an uncertificated security, the issuer or indenture trustee may treat the registered owner as the person exclusively entitled to vote, receive notifications, and otherwise exercise all the rights and powers of an owner.

A security entitlement is "the rights and property interest of an entitlement holder with respect to a financial asset" specified in Part 5 of Article 8.[127] Section 8-501 provides that a person acquires a security entitlement when a securities intermediary credits financial assets to the person's securities account.[128] Part 5 of Article 8 specifies the duties of a securities intermediary to the entitlement holder. Under Section 8-106(d), a purchaser, which includes a secured party, has control of a security entitlement if the purchaser (or its agent) becomes the entitlement holder or the securities intermediary has agreed that it will comply with entitlement orders originated by the purchaser (or its agent) without further consent by the entitlement holder.[129]

There are differences between these items of collateral and receivables that reflect the differences in their nature. First, to accommodate the needs of a customer on a deposit account to order the bank to make multiple payments to multiple parties or the need of a registered holder of an uncertificated security or the entitlement holder of a security entitlement to continue to deal with the uncertificated security or the entitlement holder of a security entitlement, the relevant control provisions provide that a secured party does not lose control simply because the customer, registered owner, or the entitlement holder may continue to exercise its rights with respect to a deposit account, uncertificated security or security entitlement.[130] In the case of a receivable, the obligor on a receivable that has received notification of

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127. *Id.* § 8-102(a)(17).

128. *See id.* § 8-501(b). A "securities intermediary" is "(i) a clearing corporation or (ii) a person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity." U.C.C. § 102(a)(14) (AM. LAW INST. & UNIF. LAW COMM'N 2001). A "securities account" is "an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset." U.C.C. § 8-501(a).

129. *Id* § 8-106(d): "A purchaser has "control" of a security entitlement if: (1) the purchaser becomes the entitlement holder; or (2) the securities intermediary has agreed that it will comply with entitlement orders originated by the purchaser without further consent by the entitlement holder."

130. *See* U.C.C. § 9-104(b) (AM. LAW INST. & UNIF. LAW COMM'N 2010) (providing that, in the case of case of control of a deposit account under § 9-104(a), "[a] secured party that has satisfied subsection (a) has control, even if the debtor retains the right to direct the disposition of funds from the deposit account."); U.C.C. § 8-106(f) (providing that " [a] purchaser who has satisfied the requirements of subsection (c) [control of uncertificated security] or (d) [control of a security entitlement] has control, even if the registered owner in the case of subsection (c) or the entitlement holder in the case of subsection (d) retains the right to make substitutions for the uncertificated security or security entitlement, to originate instructions or entitlement orders to the issuer or securities intermediary, or otherwise to deal with the uncertificated security or security entitlement.").

assignment has no discretion over the payment due to the assignee. It must pay the assignee to discharge its obligation under the receivable.

Second, neither a bank on a deposit account, the issuer of an uncertificated security nor the securities intermediary for a security entitlement is obligated to enter into an agreement to act upon the instructions of the secured party. Again, the obligor on a receivable had no choice in the matter once the obligor receives notification with payment instructions.[131] These differences are not material, however, to the point that the secured party has control because the obligor on the deposit account, uncertificated security, security entitlement, and the receivable is required to pay the secured party when instructed or notified to do so.

D. Limitations on Use of Notification as Control

Notification with payment instructions is a viable method of control when the transferor of electronic chattel paper will not continue to service the chattel paper, that is, to collect the payments. Hence, in the indirect origination of electronic chattel paper, which is the dominant form of origination of automobile loans, notification is a viable alternative to the vaulting of the electronic chattel paper through a third party vaulter. However, to the extent that the transferor of the electronic chattel paper retains the servicing of the chattel paper, there is typically no notification of assignment.

This limitation on assignors that continue to service the assigned electronic chattel paper could be answered by a notification of assignment with instructions to continue to pay the transferor in its capacity as servicer of the chattel paper. Before the enactment of the 2001 revision of Article 9, which created the payment intangible as new subtype of receivable and extended Article 9 to the sale of payment intangibles and promissory notes, the only way to perfect a sale of a right to payment that was a general intangible—that is, not an account, chattel paper or instrument in the form of a note—was to comply with the common law rules for perfection.[132] The safest way to ensure such perfection was to assume that the English Rule was the applicable rule. Hence, the seller provided notice of assignment even though the seller continued to service the receivables. However, the notice would expressly state that the seller was now acting only as servicer for the

131. *See infra* Section IV.A.

132. A secured party perfected a grant of a security interest in a general intangible to secure a debtor by filing a financing statement. *See* U.C.C. § 9-302(1) (1972) (AM. LAW. INST. & UNIF. LAW COMM'N, amended 2010) (providing that, except for certain types of collateral that are not relevant, a "financing statement must be filed to perfect all security interests").

buyer/assignee.[133] Such notification was sufficient to perfect the transfer as against a lien creditor or bankruptcy trustee.

To be comfortable that this arrangement would be sufficient to establish control would require a more extensive level of due diligence. I defer any analysis of this possibility because the primary reason for establishing control of electronic chattel paper is to accommodate the needs of the indirect origination model of chattel paper that predominates the automobile financing industry, a model that provides that the assignee finance company will be servicing the automobile loans and obligor will have received notice of assignment to the assignee financing company.

V. CONCLUSION

No system that seeks to ensure the effectiveness of a transfer of a property interest to a particular person as against the transferor or the transferor's creditors or purchasers is perfect. Transfer of possession is cumbersome and costly. Tangible objects consisting of paper can be and are lost, stolen, or destroyed.[134] Control through an electronic vault may have a higher degree of certainty, but that certainty depends on the reliability and the security of the computer processes and systems and the individuals who operate them. Notification of assignment with instructions to pay depends upon the understanding of and compliance by the obligor. Also, there will be a lag between notification and the actual payment, which confirms the effectiveness of the notification.

Nevertheless, because of the importance of notification of assignment in many types of receivables financing, including in particular the indirect

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133. The finance companies did not like sending these notices because they worried about confusing the obligor on the receivables that they had originated. When the transferees of such receivable, however, required a legal opinion that the transfer was perfected, the lawyers insisted required that such notification be given as a condition for and the basis for such a legal opinion. The instructions to continue to pay the assignor as servicer for the assignee also provided assurance the obligor would continue to deal with the originator, the original contracting party.

134. Indeed, these phenomena are common enough for promissory notes, which are evidenced by writings, that Article 3 has provisions that permit a person that had been a holder but no longer had possession because the promissory note had been lost, stolen or destroyed to enforce the promissory. *See* U.C.C. § 3-301(iii) (1990) (AM. LAW. INST. & UNIF. LAW COMM'N, amended 2002) (defining a "person entitled to enforce" to include "a person not in possession of the instrument who is entitled to enforce the instrument pursuant to Section 3-309 or 3-418(d)"); *id.* § 3-309(a)(3) (providing that, among other requirements for enforcement by such person, "the person cannot reasonably obtain possession of the instrument because the instrument was destroyed, its whereabouts cannot be determined, or it is in the wrongful possession of an unknown person or a person that cannot be found or is not amenable to service of process"); *see also* U.C.C. § 9-102(a) (AM. LAW. INST. & UNIF. LAW COMM'N 2010).

origination of automobile loans, and the historical recognition of the significance of notification from a property law perspective, notification of assignment with instructions to pay the assignee, should be considered a system for evidencing the transfer of interests in the chattel paper that "*reliably establishes* the secured party as the person to which the chattel paper was assigned."[135] Therefore, such notification gives control to the secured party within the meaning of Article 9 of the UCC. Notification with payment instructions offers, to a substantial segment of the electronic chattel paper market, an alternative to reliance on a vaulting system that seeks to emulate the attribute of possession.

135. U.C.C. § 9-105(a).