

# JOURNAL

## OF EQUIPMENT LEASE FINANCING

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### Anticipated Changes to Commercial Law Should Make It Easier to Do Deals Digitally

*Future changes to our transactional practices, including if driven by technology or market practices, must fit within a legal framework, especially commercial laws. Paramount is the need for commercial laws that govern the rights, interests, and priorities of financing providers and investors. Forthcoming amendments to the Uniform Commercial Code seek to accommodate these concerns.*

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#### I. AS THE INDUSTRY CATCHES UP TO EMERGING TECHNOLOGY, SO DOES COMMERCIAL LAW

*“What new technology does is create new opportunities to do a job that customers want done.”*

– Tim O’Reilly<sup>1</sup>

As discussed in this journal and numerous other finance industry publications, fundamental changes to how we do business are likely to accelerate at a dizzying pace over the next few years. These changes are being driven by emerged and emerging technologies and are intended to accommodate the related business practices of customers and other market participants.

However, any changes to our transactional practices must still fit within a legal framework, especially commercial laws. Financing providers and investors must be confident that they can rely on laws that clearly establish their rights and remedies, especially the priority of their interests and the certainty of the customer’s payment obligations. As discussed in detail below, the “model” Uniform Commercial Code (UCC) serves as the basis for state laws that govern most commercial transactions originated in the United States.<sup>2</sup>

Recognizing the need to catch up to these emerging technologies and trends, a special committee of commercial lawyers has drafted amendments to the model UCC. These Amendments are intended to update the model UCC to reflect emerged and emerging technolo-

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*An executive summary for this article appears on pages 16 through 18.*

***The essential commercial laws applied by courts to determine the rights of parties to a commercial dispute include the common law, statutory law, or creditor’s rights laws of a particular state.***

gies including blockchain, virtual currencies, nonfungible tokens (NFTs) and other digital assets, and trends such as “servitization” (as defined on page 9).

The amendments (the “Amendments”) are in the process of being completed after having been approved and recommended by the Uniform Law Commission (ULC) for enactment in all of the states. After the final review by the ULC’s Committee on Style, the amendments will be ready for introduction to and, it is hoped, timely adoption by the states. The adoption process has already begun in some states and will commence in others.

After the effective date, which may be as soon as January 1, 2025,<sup>3</sup> the Amendments could have a transitional impact on equipment financing and leasing, capital markets transactions including securitizations and syndications, and other related matters. A similar transitional event occurred when revisions to the UCC were made in 1998 and 2010, relating to electronic signatures, records, and chattel paper. These digital transaction methodologies have become much more commonplace during the pandemic.

Informed industry participants will be able to achieve market advantages if they can successfully leverage these emerging technologies and practices and the contemplated changes to the commercial laws—and will likely encounter

competitive disadvantages if they do not. This article summarizes the purposes and transactional implications of these Amendments.

## **II. THE ROLE OF STATE LAW AND THE UCC**

The law governing commercial transactions in the United States is largely state law. The essential commercial laws applied by courts to determine the rights of parties to a commercial dispute include the common law, statutory law or creditor’s rights laws of a particular state. State procedural rules must be followed when enforcing claims or judgments in the courts of that state, and state statutory laws may apply when appropriate to protect creditors from fraud by debtors.

The common law associated with a particular state regarding issues governed by the laws of that state is derived from published court decisions that are considered as authority for deciding subsequent cases involving identical or similar facts, or similar legal issues. This type of common law is often referred to as *precedent*. Although bankruptcy laws are federal, bankruptcy courts often rely on state laws to determine the respective rights and interests of the debtor, creditors, and other participants in bankruptcy proceedings.

However, what might be precedent with respect to an issue under the law of a particular state might be very different from what might

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***In 2019, the Uniform Law Commission and the American Law Institute appointed a joint committee to consider whether changes to the UCC were advisable to accommodate emerging technologies such as artificial intelligence, distributed ledger technology, and virtual currency.***

be precedent with respect to that issue under the law of another state. In a transactional context, that nonuniformity of legal principles from state to state could lead to unintended and undesirable results, especially with respect to commercial transactions where predictability of legal disputes is essential.

### **The Model UCC**

Recognizing the disruptive nature of the nonuniformity of common laws among the states, the commercial bar developed the UCC in the 1960s as a model “uniform” commercial code. Whatever version of the UCC that is enacted by the legislature of a state serves as the body of statutory commercial laws of that state governing the matters covered in its various articles. Since its widespread enactment more than 50 years ago, and ultimately by all 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, and Guam, the commercial bar has sustained the UCC through periodic revisions to address changes in commercial practices.<sup>4</sup>

The applicable provisions of the UCC govern most commercial disputes among parties to sales or leases of goods (e.g., equipment or inventory), payment instruments, secured financings, and many other equipment finance-related transactions. The UCC is a primary driver when structuring, documenting, closing, managing, syndicating,

securitizing, and enforcing equipment finance transactions.

Parties often stipulate in the pertinent documents as to which state’s law is intended to govern the rights, obligations, and interests of the parties to the contemplated transactions. Regarding commercial matters, the stipulated state law would include that state’s version of the UCC. For example, if parties stipulate that “New York law” will govern the sale of an aircraft, the lease of a tractor or a loan financing of high-tech equipment, the applicable commercial laws could include, respectively, articles 2, 2A, and 9 of the UCC, as enacted by the New York legislature and interpreted by courts applying those laws.<sup>5</sup>

## **III. THE UCC AMENDMENTS**

### **Background**

In 2019, the ULC and the American Law Institute (ALI), the sponsors of the UCC (the sponsors), appointed a joint committee to consider whether changes to the UCC were advisable to accommodate emerging technologies, such as artificial intelligence, distributed ledger technology, and virtual currency. The joint committee ultimately received permission from the sponsors to act as a drafting committee (the committee) for amendments to the UCC dealing, predominantly, with aligning the UCC with emerging technologies.<sup>6</sup>

When the draft committee was first formed, invitations were sent to

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***The amendments and the associated official comments cover, among other things, digital assets, electronic money, chattel paper, bundled transactions, and other tech and nontech related commercial matters.***

large groups of potential stakeholders including trade organizations, financial institutions, technology companies, government agencies, and others to be “observers,” including observers from the equipment finance industry.<sup>7</sup>

### **The Amendments**

Since the commencement of this project, the committee has generated many drafts of the proposed amendments, related “official comments” and the committee reporter’s drafting notes (reporter’s notes), the most recent of which was the “Draft for Approval” submitted to the ULC on June 27, 2022 (the draft).<sup>8</sup> The draft was approved on July 13, 2022, in substantially the form as submitted.

The following is a nonexhaustive summary of the amendments, focused primarily on the amendments that might be of greatest interest to the equipment finance industry.

### **Generally**

The amendments and the associated official comments cover, among other things, digital assets, electronic money, chattel paper, bundled transactions, and other tech and nontech related commercial matters. Among the most significant Amendments is the creation of a new Article 12 covering the commercial law implications of digital assets.

However, as explained below, there are also many other proposed Amendments to the existing arti-

cles of the UCC, including Article 2A (leases) and Article 9 (secured transactions), which, if made, are likely to have an immediate commercial impact. Our discussion starts with those Amendments that are likely to have an immediate impact on equipment finance transactions, and is followed by a summary of the new Article 12 involving digital asset transactions.

### **Chattel Paper**

The amendments include many changes to Article 9 of the UCC, including a revised definition of *chattel paper* and updated provisions applicable to perfection of security interests in chattel paper. Among other things, clarity regarding what constitutes chattel paper and how to achieve priority when purchasing or securing interests in chattel paper is essential to capital markets transactions involving equipment financings.

That clarity is essential because, whether structured as a secured loan or a “true sale,” a transaction involving a conveyance of an interest in chattel paper is treated as a “security interest,” and the collateral assignee or purchaser is a “secured party” under Article 9.<sup>9</sup> So, irrespective of the structure, a lender or purchaser must “perfect” the interest granted or conveyed to it in accordance with the applicable provisions of Article 9 in order to achieve priority over third-party claims (including by a bankruptcy trustee) against the related chattel paper.

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***This new rule would cover chattel paper related to leases or secured financings of equipment that are evidenced by a mix of electronic and tangible records, records in one medium that replaced records in another medium.***

In a transactional context, as a closing condition to an assignment, securitization or other capital markets transaction involving equipment financings or leases, sellers and borrowers are often required to establish that the interest being granted or conveyed has been properly perfected and has first or sole priority.

**The New Definition.** As amended, the definition of *chattel paper* (see Section 9-102(11)) will no longer refer to the tangible or electronic record (i.e., the paper or electronic version of a document) evidencing the right to payment with respect to a secured financing or lease of equipment, inventory, or other property constituting “goods” under the UCC.<sup>10</sup> Instead, the term chattel paper will refer to the secured party’s or lessor’s right to “payment of a monetary obligation that is secured by a security interest in specific goods or owed under a lease of specific goods, if the right to payment and interest in the goods are evidenced by a record.”<sup>11</sup>

The definition has also been revised to allow for chattel paper treatment of the payment rights associated with “hybrid leases,” if the predominant purpose was to give the obligor (lessee) the right to possession and use of the equipment or other leased goods.<sup>12</sup> The definition of *hybrid lease* (sometimes referred to as a *bundled transaction*), and the extent to which Article 2A may be applied with respect to a hybrid lease, is explained later in this article.

**Perfection.** The amendments include a new Section 9-314A, which replaces the coverage in existing Section 9-314 as to the method of perfection by a purchaser or other secured party of an interest granted or conveyed to it in chattel paper. Although perfection may still be achieved by filing a financing statement, a purchaser or other secured party may also perfect its security interest by taking and retaining possession of each tangible, and “control” (the digital equivalent to taking possession) of each electronic, “authoritative” copy of the records evidencing the chattel paper.<sup>13</sup>

The general purpose of perfecting a security interest (including if purchasing chattel paper) under Article 9 remains the same, whether filing a financing statement or taking possession or obtaining control, enabling the public to determine that the chattel paper in question may be encumbered with a security interest.

New Section 9-314A is more flexible than the current related coverage under Article 9 because it provides a single rule under which a security interest in chattel paper can be perfected by taking possession of the authoritative tangible copies, if any, and obtaining control of the electronic authoritative copies, if any.<sup>14</sup> This new rule would cover leases or secured financings of equipment with respect to which some records evidencing the related chattel paper are electronic

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***The amendments also provide for perfection by possession or control by a third party on the purchaser's behalf.***

and some are tangible, or where a record in one medium is replaced by a record in another medium<sup>15</sup> (i.e., from electronic to paper, or vice versa).

As noted above, in order to perfect a security interest in chattel paper other than by filing, new Section 9-314A(a) requires a secured party to obtain control of all authoritative electronic copies and take possession of all tangible authoritative copies of a record evidencing chattel paper. The reference to tangible authoritative copies is similar to the requirement regarding perfection by control of the authoritative copy of electronic chattel paper under existing Section 9-105(b). However, neither new Section 9-314A(a) nor existing or amended Section 9-105(b) defines the term *authoritative*.

A purchaser asserting that it has possession of all authoritative tangible copies, and control of all authoritative electronic copies, of the records evidencing chattel paper can produce the tangible copies in its possession and prove control of the electronic copies and provide evidence that these are authoritative copies.<sup>16</sup> However, the purchaser need not prove that no other tangible authoritative copies exist.<sup>17</sup> Purchaser's possession of the tangible authoritative copies gives it the power to prevent others from taking possession or control of the copies and to transfer possession and control of the copies.<sup>18</sup>

The Amendments also provide for perfection by possession or control by a third party on the purchaser's behalf. Although Section 9-313(a) no longer covers possession of tangible chattel paper, new Section 9-314A(c) provides that a secured party may still rely upon subsection (c) of 9-313 to perfect its security interest in chattel paper if a third party acknowledges that it is holding possession on the secured party's behalf of the authoritative tangible copy of a record evidencing chattel paper. New Section 9-105(g) provides for a purchaser to obtain control of an electronic copy of an authoritative record by virtue of an acknowledgment by another person in control of the electronic copy.

Currently, when originating, transferring, and vaulting electronic records that are intended to be "electronic chattel paper," originators and funders that participate in capital markets transactions rely on technology systems that are designed to conform to the requirements of Section 9-105 so that a grant or purchase of an interest in that electronic chattel paper may be perfected by "control."

Among the practical considerations when relying on Section 9-105 to perfect by control is whether the related electronic record constitutes "electronic chattel paper." It is important to remember that an electronically signed lease or financing does not constitute electronic chattel paper unless it also

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***Even as amended, financing providers may still establish control by complying with subsections (a) or (b) of Section 9-105, which are substantially unchanged.***

meets the UCC's current definition of electronic chattel paper<sup>19</sup> and, in the hands of the purchaser or collateral assignee, satisfies the control requirement of Section 9-105, including by storing those electronic records in a third-party electronic vault (often referred to as an *e-vault*).

Further, control will not be achievable under Section 9-105 unless both the originator and purchaser or collateral assignee of the financing or lease transaction have compatible approaches and system technologies regarding the creation, execution, storage, transfer, and vaulting of the related electronic chattel paper.

Even as amended, financing providers may still establish control by complying with subsections (a) or (b) of Section 9-105, which are substantially unchanged. Most chattel paper purchasers or other secured parties rely on the safe harbor under existing Section 9-105(b) to establish perfection by control. However, Section 9-105(b) contemplates a "single authoritative copy" of an electronic record, which would not be the case with a record maintained on a blockchain or other distributed ledger.

New subsection 9-105(c) is intended to allow a purchaser to obtain control when there are multiple authoritative copies of a record. However, similar to subsection (b), a purchaser must prove that it has obtained control of an electronic copy of a record evi-

dencing chattel paper by being able to identify each electronic copy as authoritative or nonauthoritative, and identifying itself as the assignee of each authoritative copy.

Also similar to subsection (b), the purchaser must have the exclusive power both to prevent others from adding or changing an identified assignee and to transfer control of the authoritative copies of that electronic record. The meaning of *exclusive* is covered by new subsections 9-105(d) and (e), and a presumption of exclusivity is covered in new subsection 9-105(f).

The amendments contemplate that control of electronic records evidencing chattel paper under an existing system compliant with existing Section 9-105(b) would also satisfy the requirements for control under the amended version of Section 9-105.<sup>20</sup>

The drafting purpose underlying the revisions to Section 9-105, as explained in the official comments to new Section 9-314A, is as follows:

To accommodate current practices and future technology, parties are allowed considerable flexibility in determining the method used to establish whether a particular copy is authoritative, as long as third parties are able to reasonably identify the authoritative copies that must be possessed or controlled to achieve perfection.<sup>21</sup>

***Originators and investors must be aware of the related implications of the amendments, including as to how equipment leases and financings are created, executed, transferred, and held, and, if in an electronic medium, the attributes of the systems that they rely upon to do so.***

In larger capital markets transactions, perfection by possession or control by the purchaser of the related tangible or electronic records is often required because it could, together with the satisfaction of certain other criteria, afford the purchaser “superpriority” over competing third-party claims.<sup>22</sup>

Consistent with the provisions of new Section 9-314A, a purchaser may achieve superpriority under new Section 9-330 by taking possession of each authoritative tangible copy of the record evidencing the chattel paper. To achieve superpriority under new Section 9-330, the purchaser would still need to satisfy the new value, good faith, ordinary course, and absence of knowledge requirements in subsections (a) or (b), as applicable.

Another related addition to amended Article 9 that is likely to be meaningful to purchasers of chattel paper is new Section 9-317(f), pursuant to which a chattel paper buyer may take free of a security interest if, “without knowledge of the security interest and before it is perfected,” the buyer gives value, receives delivery of each authoritative tangible copy of the record evidencing the chattel paper, and obtains control of each authoritative electronic copy under Section 9-105.

**Transactional Considerations Regarding the Chattel Paper Amendments.** These Amendments will have a significant impact on

originating, purchasing, financing, and securitizing equipment leases and financings. Originators and investors must be aware of the related implications of the amendments, including as to how equipment leases and financings are created, executed, transferred, and held, and, if in an electronic medium, the attributes of the systems that they rely upon to do so.

Among other things, participants in capital markets transactions involving records maintained on distributive ledger technology (DLT), like blockchain, will need to be certain that the system technology clearly aligns with the related perfection and priority implications of new subsection (c) of Section 9-105.

Chattel paper originators and purchasers should develop systems and protocols where each tangible or electronic copy is designated as the authoritative or nonauthoritative copy by a stamp, legend, watermark, or other visible marking. Also, whether in tangible or electronic format, existing transaction template documents should be drafted or amended to reflect the new definition of chattel paper and the amendments relating to perfection by control of the authoritative copy of the related tangible and electronic records, including as to how to determine which copies are authoritative and which are not.

### **Hybrid (Bundled) Transactions**

For context, the prefatory note to the Amendments explains that

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**Many market integrated transaction documents look more like service agreements, with included equipment and extended payment terms, than they do equipment leases or financings.**

among the areas primarily focused on by the committee were “bundled” or “hybrid” transactions “consisting of the sale or lease of goods together with the sale, lease, or licensing of other property and the provisions of services as an integrated transaction.”<sup>23</sup> The related Amendments refer to these transactions as either a *hybrid transaction* if the integrated transaction includes a sale of goods or a *hybrid lease* if the integrated transaction includes a lease of goods.

However, there is currently a spectrum of transaction types (known by different names in the market, such as bundled transactions, managed solutions, and managed equipment services) involving goods and nongoods that might be considered bundled transactions for the purposes of these amendments, including “as a service” transactions.

Indeed, while these types of bundled transactions were viewed as outliers just a handful of years ago, they are now very common in the market, and they are expected to become even more prevalent in the near future.<sup>24</sup> The equipment finance industry has referred to this rapidly growing transactional trend as *servitization*, which term is intended to reflect the shift from a product-centric to a service-centric model.

Consistent with that approach, many market integrated transaction documents look more like service

agreements, with included equipment and extended payment terms, than they do equipment leases or financings. Examples of these transactions include (a) a tech services contract that includes a lease or sale of laptops and related access to servers and a license of the related software; (b) a copier lease or sales contract coupled with an agreement to provide related supplies, service, maintenance, and extended warranties; (c) an imaging availability agreement providing for a lease or sale of imaging equipment and an agreement to provide related consumables, maintenance, and software update services; and (d) an “energy as a service” agreement (also known as an *EaaS* agreement), which provides financing solutions for energy efficiency projects with little or no upfront capital costs.

The committee’s approach to covering the commercial law implications of this emerging trend toward integrated transactions was to expand the scope provisions of Article 2A (§ 2A-102) and Article 2 (§ 2-102) of the UCC in order to clarify when and the extent to which provisions of those articles should be applied either to hybrid leases under Article 2A or to hybrid transactions under Article 2. These new categories of transactions are briefly explained below.

### **Categories of Transactions**

**Leases.** New subsections (2) (a) and (b) of Section 2A-102 now

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***If enacted as currently drafted, amended Section 2A-102 should afford considerable advantages for lessors, financing providers, and investors participating in these types of integrated (bundled) transactions, assuming that the integrated lease is a “finance lease” under Article 2A.***

respectively provide that in a hybrid lease:

(a) If the lease-of-goods aspects do not predominate:

(i) only the provisions of this Article which relate primarily to the lease-of-goods aspects of the transaction apply, and the provisions that relate primarily to the transaction as a whole do not apply;

(ii) Section 2A-209 applies if the lease is a finance lease; and

(iii) Section 2A-407 applies to the promises of a person that is the lessee in a finance lease to the extent the promises are consideration for the right to possession and use of the leased goods.<sup>25</sup>

(b) If the lease-of-goods aspects of a hybrid lease predominate,

this Article applies to the transaction, but this does not preclude the application in appropriate circumstances of other law to the aspects of the lease which do not relate to the lease of goods.<sup>26</sup>

As discussed below, if Section 2A-407 applies to a lease, the lessee’s rent obligation would be statutorily hell or high water.

Related to that Amendment, the term *hybrid lease* has also been

added as subsection (1)(h.1) to the definitions in Section 2A-103, and as so defined means:

a single transaction involving a lease of goods and: (i) the provision of services; (ii) a sale of other goods; or (iii) a sale, lease, or license of property other than goods.<sup>27</sup>

The official comments include, as an example of a hybrid lease, a single agreement between a lessor and customer pursuant to which the lessor, in return for periodic payments from the customer, agrees to lease a copier for a term; and supply the paper, staples, and toner, and provide routine maintenance and repair services, all as needed to keep the copier operating during that period.

Clause (iii) of new subsection 1(h.1) of Section 2A-103 would cover, among other things, a lease of goods together with a license of the related software in a single transaction (e.g., a hybrid lease that includes a lease of imaging, energy savings or communications equipment, together with a license of the related software).

New subsection (2)(a)(iii) of Section 2A-102 should afford considerable advantages for lessors, financing providers, and investors participating in these types of integrated (bundled) transactions, assuming that the integrated lease satisfies the finance lease criteria in Section 2A-103(1)(g). Those criteria

***If one or the other of these new hybrid lease provisions is applicable, the lessee's promise to pay rent with respect to either the entire transaction or (at least) the integrated lease would be statutorily hell or high water.***

contemplate that a lessor under a finance lease is not the supplier but is acquiring equipment selected by a lessee, solely for the purpose of leasing it to that lessee.<sup>28</sup>

Having Section 2A-407 apply either to the entire hybrid lease under new subsection (2)(b) of Section 2A-102 or to the promises of the lessee of the type described in new subsection (2)(a)(iii) of Section 2A-102 could be a game changer for originators, financing providers, and investors participating in these transactions. Specifically, if one or the other of these new hybrid lease provisions is applicable, the lessee's promise to pay rent with respect to either the entire transaction or (at least) the integrated lease would be statutorily irrevocable and independent upon the lessee's acceptance of the leased equipment (i.e., hell or high water).

As context, using the above-referenced hybrid copier lease as an example, assuming that the lease of the copier aspects of that integrated transaction predominate, and that the copier lease is a finance lease, the lessee's obligation to pay the entire amount due under the hybrid lease should be hell or high water upon the lessee's acceptance of the copier. Or, if the lease of the copier aspects do not predominate, but the integrated copier lease is a finance lease, the lessee's obligation to pay the rent for the copier will be hell or high water.

Further, the related official comments in the Amendments provide some guidance as to how to structure and document a hybrid lease so as to support the application of these finance lease protections.<sup>29</sup>

**Sales.** As context, similar Amendments were made to Section 2-102, the scope provision of Article 2. As amended, the scope of Article 2 would include the application of its provisions to the entirety of a "hybrid transaction" under Section 2-102(2)(b) if "the sale-of-goods aspects predominate," but under Section 2-102(2)(a) if "the sale-of-goods aspects do not predominate, only the provisions of this [Article 2] which relate primarily to the sale-of-goods aspects of the transaction apply, and the provisions that relate primarily to the transaction as a whole do not apply."<sup>30</sup>

Related to that Amendment, the term *hybrid transaction* has also been added as new subsection (5) to the definitions in Section 2-106, and as so defined means "a single transaction involving a sale of goods and: (a) the provision of services; (b) a lease of other goods; or (c) a sale, lease, or license of property other than goods."

The official comments of the amended version of Section 2-102 explain, in the context of Article 2, that many ordinary transactions involve both a sale of goods and the provision of services; a lease of other goods; or a sale, lease,

*Because the quantity and cumulative value of hybrid transactions will continue to increase, the clarification of the commercial law implications provided by the draft UCC amendments is certainly welcome.*

or license of property other than goods; but the original Article 2 was silent on its applicability to such hybrid transactions. However, “. . . by defining a ‘sale’ as ‘the passing of title [to goods] from the seller to the buyer for a price,’ Section 1-206 arguably regarded such transactions as sales.”<sup>31</sup>

The official comments also explain the “predominant purpose” and “gravamen” approaches embraced by the revisions to Section 2-102.<sup>32</sup> Per the official comments, “most courts dealing with the issue” have principally applied the predominant purpose test, pursuant to which courts seek to determine “whether the hybrid transaction, at its inception, is predominantly about the goods.”<sup>33</sup> New subsection (2)(b) of revised Section 2-102 adopts this predominant purpose approach.<sup>34</sup>

Further per the official comments, when an issue relates solely to the goods aspect of the transaction (e.g., conformity of the goods to the contract), it is appropriate to apply Article 2 to that issue, even if the goods aspect of the transaction does not predominate.<sup>35</sup> The official comments note that this “bifurcation” approach has been adopted by some courts, and is adopted by new subsection (3) of revised Section 2-102.<sup>36</sup> Thus, a two-tiered test is created codifying the “predominant purpose” approach as the initial analysis and the “bifurcation” approach as the secondary step for those transactions where the non-goods aspects predominate.<sup>37</sup>

The official comments to revised Section 2A-102 do not include similar explanations and context regarding the different approaches regarding hybrid leases. Unlike with Article 2, there are very few reported cases that provide guidance as to how to apply the predominant purpose or bifurcation approaches to determine whether Article 2A or some other law (including under a different article of the UCC) should govern an integrated transaction that includes a lease of goods. With that in mind, the committee included extensive official comments regarding certain structural or documentation considerations that might be useful to support the characterization of an integrated transaction, and provide transactional examples of the same.<sup>38</sup>

If enacted as presently provided in the Amendments, these official comments and related examples are likely to be heavily relied upon by parties when considering the commercial implications of integrated transactions involving sales or lease of goods as an aspect of that transaction, and by courts with respect to any related disputes.

**Transactional Considerations Regarding the Scope Amendments.** With the expectation of a forthcoming increase in the quantity and cumulative value of hybrid transactions, the clarification of the commercial law implications provided by the Amendments is certainly welcome. Further, having

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**Generally, new Article 12 is intended to govern both the outright and collateral transfers of property rights in certain intangible digital assets, both existing and yet to be developed, using new technologies.**

statutory hell or high water status for all or a part of the payments under a hybrid lease would be a very meaningful achievement for the equipment finance industry. The amendments will significantly impact how these emerging transactions will be structured and documented, and they will have beneficial implications when the related receivables are included in asset-backed capital markets transactions.

**Digital Assets.** Generally, new Article 12 is intended to govern both the outright and collateral transfers of property rights in certain intangible digital assets, both existing and yet to be developed, using new technologies.<sup>39</sup> DLT, including blockchain technology, is the platform for many of the digital assets that currently exist and was a major impetus for the revision project.<sup>40</sup>

Certain of these electronic records have been assigned an economic value by the users of the platforms on which they are exchanged or stored, including certain types of virtual (non-fiat) currency (e.g., Ether or Bitcoin) and NFTs. Other electronic records have no assigned value, but they have embedded payment rights exercisable by the owner of that electronic record.

**Controllable Electronic Records.** The rules of Article 12 apply only to “controllable electronic records” (CERs) and to certain types of payment rights evidenced by CERs.<sup>41</sup>

A CER is a *record*, which term is defined in the UCC as “information that is retrievable in perceivable form,”<sup>42</sup> and is stored in an electronic medium<sup>43</sup> that can be subjected to “control” by complying with new Section 12-105.<sup>44</sup>

According to the prefatory note, the “principal function of Article 12 is to specify certain rights of a purchaser of a controllable record,” and a *purchaser* is “a person that acquires an interest in property by a voluntary transaction, such as a sale.”<sup>45</sup>

Keep in mind that as defined in the UCC, *purchase* includes not only an outright sale, but also a discount, negotiation, security interest, or any other voluntary transaction creating an interest in property.<sup>46</sup>

Article 12 is intended to promote the commercial utility of a controllable electronic record by affording “qualifying purchasers” of CERs the ability to acquire that CER free of third-party claims of a competing interest.<sup>47</sup> In order for a purchaser to be a qualifying purchaser so as to enjoy the benefits of this “take-free” right, it must obtain control of a CER for value, in good faith, and without notice of any claim of a property interest in the CER.<sup>48</sup>

**Control Under Article 12.** The attributes of control under Article 12 are intended to be consistent with the characteristics of the electronic records and the protocols of the systems on which they are recorded, but are not

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***Control of a controllable electronic record involves powers over it that are functionally equivalent to possession of tangible property. Having control is important to both a purchaser, to take free of competing claims, and to a secured party, for perfection and priority purposes.***

technology-specific. These system attributes include, with respect to an electronic record, a use that one person can enjoy to the exclusion of others, the ability to transfer and divest itself of that exclusive power to use, and the ability to demonstrate to others its power to use electronic records.

Similar to “control” under new Section 9-105(b) and (c) for the purpose of perfecting a security interest in an authoritative electronic copy of a record evidencing the chattel paper, control of a CER involves powers over a CER that are functionally equivalent to possession of tangible property. Having control is important to both a purchaser to take free of competing claims and a secured party for perfection and priority purposes.

Although CERs are essentially information in an electronic medium, certain CERs have inherent value because there is a market for those CERs and that market establishes its value. Virtual currencies like Ether and Bitcoin are examples of such CERs because they may be exchanged for cash or other valuable assets or may be held as investments. However, other CERs may have no inherent value, but they nevertheless evidence the rights of parties to a transaction. Article 12 generally applies only to records, and not to the rights evidenced or purported to be evidenced by those records.

As noted above, an exception to that general rule are certain pay-

ment rights related or “tethered” to CERs, referred to as *controllable accounts* and *controllable payment intangibles*. These digital payment rights should be familiar to participants in receivables financings, and they are a subset of “accounts” and “payment intangibles,” respectively. To qualify as a controllable account or controllable payment intangible, the related account debtor must agree to make payments to the person that has control of the CER evidencing the right to such payments.

The substantive provisions of Article 12 cover the rights of qualifying purchasers of CERs with tethered controllable accounts and controllable payment intangibles, as well as the rights and duties of the related account debtors and the rules on governing law. Concepts similar to these already existing in the UCC with respect to the nondigital forms of these payment rights (i.e., negotiable promissory notes) would allow these digital payment rights the attributes of “negotiability.” That would mean that a qualifying purchaser of a CER with a tethered controllable account or controllable payment intangible would take that CER and tethered payment rights free of third-party claims.

The Amendments also include many related amendments to Article 9 pertaining to purchases and other security interests in CERs, including as to controllable accounts and controllable payment intangibles. Purchasers and secured lenders may perfect (i.e., achieve

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***The digitization of the contracting process has already begun to impact how many equipment financing transactions are created, executed, transacted, financed, sold, maintained, and enforced.***

priority over third-party claims) their interests in these assets by obtaining control of the asset or filing a financing statement in the appropriate state's filing office. Similar to the chattel paper perfection provisions of Article 9, a security interest perfected by control can have priority over a security interest perfected by filing.

Both the new Article 12 and Amendments to Article 9 include new choice-of-law rules that could have an impact on how transactions within the scope of these articles are documented, or on how the associated rights and interests of a party may be protected or afforded priority.

***Transactional Considerations Regarding New Article 12.*** It is unlikely that Article 12 will have an immediate direct impact on the rights, remedies, validity, or syndication of equipment finance transactions. The intersection of equipment finance and new Article 12 is likely to relate to transactions involving payments by virtual currencies (e.g., payment of the purchase price to a vendor for the financed equipment), CERs with embedded payment rights (e.g., an assignment of a smart contract evidencing the right to payments associated with a software finance agreement), or NFTs as collateral. Certain transaction aspects (e.g., escrow arrangements) might also be managed on a DLT or other platform.

Market participants that have a practical understanding of the transactional opportunities afforded by new Article 12—whether involving CERs evidencing payment rights, payments by Bitcoin or other non-fiat cryptocurrencies or secured by other digital assets—could gain a competitive advantage by leveraging those.

#### **IV. CONCLUSION, STATUS OF THE PROCESS**

The digitization of the contracting process has already begun to impact how many equipment financing transactions are created, executed, transacted, financed, sold, maintained, and enforced. As noted above, this is especially true in the post-COVID world. This is no longer a nice-to-have functionality but increasingly a competitive requirement.

The Amendments being proposed are intended to keep pace with and reflect these market requirements. For example, the UCC has already been amended at least twice to cover electronic leases and other equipment financings originated, stored, transferred, and held for collateral purposes as electronic records.

As mentioned above, the Amendments have now been approved and recommended by the Uniform Law Commission for enactment in all of the states, and efforts are already underway in various states to introduce them for enactment.

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***The most industry-relevant amendments refer to chattel paper and “bundled transactions.”***

If the Amendments are enacted by most if not all of the states, transacting on blockchain platforms, financing digital payment rights, and relying on virtual currencies as an exchange of value will be facilitated and accelerated.

Further, the systems and practices in originating and financing receivables related to leases or secured financings of equipment, especially if digitized, will require

adjustments by the parties to those transactions.

Lastly, the emerging servitization trend in most of the equipment finance market should be much more attractive to originators, financing providers, and investors as a result of the statutory clarity regarding the reliability of the customer’s payment obligations. ■

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## EXECUTIVE SUMMARY

### LEASING/FINANCING LAW

The Uniform Commercial Code (UCC) is the core commercial law that impacts how equipment financings and leases are structured, documented, enforced, and traded in capital markets transactions across the 50 states.

### THE AMENDMENTS

The UCC is in the final stages of being amended and could become effective as soon as early 2025. The amendments cover certain fundamental equipment finance-related matters as well as a new set of commercial laws regarding digital assets and transactions (e.g., blockchain platforms, virtual currencies, and nonfungible tokens, or NFTs).

### EQUIPMENT FINANCE-RELATED AMENDMENTS

The most industry-relevant amendments relate to chattel paper and “bundled transactions.”

#### Chattel Paper

Establishing which copy of a financing or lease will satisfy the UCC chattel paper requirements as well as the priority expectations of purchasers, funders, and rating agencies is essential in capital markets transactions. The current law does not adequately fit the spectrum of industry practices.

The amendments clarify how an originator can accomplish that purpose whether using paper, electronic documents, or a blockchain platform, either alone or in combination. Related changes to documents, transaction practices, and technology systems should be considered to take advantage of the amended laws.

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### Bundled Transactions

The demand for *bundled transactions* (industry jargon for transactions that include both leases of equipment and something else related to the equipment—software, services, supplies, etc.) continues to increase, but financing them can be very challenging. The amendments, which refer to these transactions as *hybrid leases*, could make them much easier to finance. For example, hybrid leases meeting certain criteria could now be “chattel paper” for capital markets purposes.

Even better, the very lessor-favorable UCC provisions (Article 2A) could now apply to either the entire transaction (even the nonleasing part) or at a minimum the leasing part. That would depend upon whether the primary driver is the lease or the nonlease aspects of the transaction.

As amended, Article 2A is likely to be applied to a copier lease, which also includes some software, paper and maintenance. However, it would apply only to the lease of the laptops and servers that is a (smallish) part of a (larger) cloud services contract. That could be *huge* for originators and funders because a customer’s promise to make all or at least the lease-related payments under a hybrid lease *could be* hell or high water. *Wow, right?* Originators should note the hints in the amendment comments regarding structuring and documenting hybrid leases to achieve these benefits.

### DIGITAL ASSET-RELATED AMENDMENTS

To fill what is currently a technology gap in commercial law, the amendments add a brand new set of laws (new Article 12) and related amendments to existing law, to cover digital assets. The new and amended laws cover both outright transfers and financings of certain digital assets like virtual currencies, nonfungible tokens, and other “controllable electronic records” (CERs) existing on a blockchain platform. Certain CERs are likely to include an account or other payment right (e.g., the purchase price owed by a customer to a vendor).

The new law and the amendments will promote trade financing of these digital payment rights. They will also make it easier for parties to financings and leases to rely on a blockchain platform for escrow, payment, or other purposes, or to collateralize transactions by taking a security interest in digital assets on a platform. The new law and amendments could impact how transactions are structured as well as the closing and portfolio considerations, and result in time and cost savings, among other things.

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## CONCLUSION

The amendments should be extremely helpful for the equipment lease and finance industry. However, the industry must evolve and recognize and adjust to the transactional benefits that could be achieved from the amendments.

### Acknowledgment

The authors would like to thank Francisco K. Ishino, an associate in Vedder Price's Washington, DC, office, who supports the Global Transportation Finance practice group.

### Endnotes

1. Quote attributed to Tim O'Reilly, founder of O'Reilly Media and author of many tech-related books and publications.

2. U.C.C. and EMERGING TECHS. (UNIFORM L. COMMISSION, July 13, 2022) [hereinafter Amendments] (these "Amendments to the Uniform Commercial Code (2022)" were approved and recommended for enactment in all the states by the ULC on July 13, 2022, and are subject to revision by the Committee on Style of the National Conference of Commissioners on Uniform State Laws). Please note that the Amendments were published without "prefatory note" and "comments"; accordingly, our references in this article to the "prefatory note" and the various "official comments" are based on the prefatory note and official comments included in the draft titled, U.C.C. and EMERGING TECHS. (UNIFORM L. COMMISSION, June 27, 2022, Draft) [hereinafter Draft U.C.C.]. The Draft U.C.C. was submitted for a final reading and approval at the ULC's Annual Meeting on July 8–14, 2022, and was approved and recommended for enactment with very few revisions during that meeting.

3. See Amendments, *supra*, § A-101.

4. Draft U.C.C., *supra*, Prefatory Note to 2022 ULC Annual Meeting Draft, at 2.

5. N.Y. U.C.C. Law § Ch. 38, arts. 2, 2-A, 9.

6. Draft U.C.C., *supra*, Prefatory Note to 2022 ULC Annual Meeting Draft, at 2.

7. The authors of this article were among the active equipment finance industry observers.

8. Draft U.C.C., *supra*.

9. Under existing U.C.C. § 9-109(a)(1) and (3), respectively, Article 9 applies to both "a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract" and "a sale of chattel paper," unless otherwise provided in that scope provision.

10. *Id.* ("goods" in the context of a lease or security interest means, as applicable, § 2A-103(1)(h), "all things that are moveable at the time of identification to the lease contract, or are fixtures"); § 9-102(a)(44) ("all things that are moveable when a security interest attaches," including fixtures).

11. See Draft U.C.C., *supra*, § 9-101 cmt. 5.b.

12. *Id.*

13. See Draft U.C.C., *supra*, § 9-314A(a) and (b).

14. See Draft U.C.C., *supra*, § 9-101 cmt. 5.b.

15. *Id.*

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16. See Draft U.C.C., *supra*, § 9-314A cmt. 1.
17. *Id.*
18. *Id.*
19. Under the existing U.C.C. § 9-102(a) (31), “‘electronic chattel paper’ means chattel paper evidenced by a record or records consisting of information stored in an electronic medium.”
20. See Draft U.C.C., *supra*, § 9-105 cmt. 2.
21. *Id.* § 9-314A cmt. 1.
22. See Amendments, *supra*, § 9-330(a)–(c).
23. See Draft U.C.C., *supra*, Prefatory Note to 2022 ULC Annual Meeting Draft, at 3.
24. See *e.g.* Stephen T. Whelan, *Bundle Up!*, EQUIPMENT LEASING & FIN. (Mar.–Apr. 2021); Dominic A. Liberatore, *The Nuts and Bolts of Bundled Transactions*, EQUIPMENT LEASING & FIN. (Jan.–Feb. 2016).
25. See Amendments, *supra*, § 2A-102(2)(a).
26. See *id.* § 2A-102(2)(b).
27. See *id.* § 2A-103(1)(h.1).
28. See U.C.C. § 2A-407(1).
29. See Draft U.C.C., *supra*, § 2A-102 cmts. 4–8.
30. See Amendments, *supra*, § 2A-102(2)(a) and (b).
31. See Draft U.C.C., *supra*, § 2A-102 cmt. 2.
32. *Id.*
33. *Id.*
34. See Amendments, *supra*, § 2-102(b).
35. Draft U.C.C., *supra*, § 2-102 cmt. 2.
36. *Id.*
37. *Id.*
38. *Id.* §§ 2-102 cmts. 3–5, 2A-102 cmts. 4–5.
39. *Id.*, Prefatory Note to 2022 ULC Annual Meeting Draft, at 3.
40. *Id.*
41. *Id.*
42. See U.C.C. § 1-201(b)(31).
43. Amendments, *supra*, § 12-102(a) (1).
44. Amendments, *supra*, § 12-105.
45. See Draft U.C.C., *supra*, Prefatory Note to Article 12, at 252.
46. “‘Purchase’ means taking by sale, lease, discount, negotiation, mortgage, pledge, lien, security interest, issue or reissue, gift, or any other voluntary transaction creating an interest in property.” U.C.C. § 1-201(b)(29).
47. See Draft U.C.C., *supra*, Prefatory Note to Article 12, at 253.
48. Amendments, *supra*, § 12-102(a) (2).



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