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## The Importance of Investing in Leadership

*By Lani Van Dusen*

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## Special Considerations For Perfection Opinions Covering Electronic Chattel Paper As Collateral

*By Margo H.K. Tank and R. David Whitaker*

The equipment leasing industry is expanding its use of electronic records and signatures to document equipment leases. Inclusion of electronic chattel paper in a perfection opinion will require the attorney preparing the opinion to understand both the structure for establishing "control" under UCC Section 9–105 and the technology platform being used to manage the electronic chattel paper and transfer control.

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# The Importance of Investing in Leadership

By Lani Van Dusen

Many equipment leasing and finance organizations have been investing in leadership, but at varying levels. This article provides evidence that the level of investment has a direct relationship to the level of leadership effectiveness. In turn, the level of leadership effectiveness has a direct relationship to organizational performance.

*Editor's note: This article is based on the December 2014 Foundation study by the Full Circle Group titled* Leadership—The Next Productivity Frontier. *The study is available at www.leasefoundation.org.*

In today's volatile and competitive market, equipment leasing and finance organizations are looking for ways to meet the challenges. One promising possibility is for leadership to evolve in a way that is both intentional and capable enough to effectively capitalize on the opportunity embedded in the complexity. This evolution requires a substantial investment in leadership and begs the question, Is there a notable return on this investment? The purpose of this article is to answer this question by isolating the relationship between investment and leadership effectiveness and between leadership effectiveness and organizational performance.

The findings presented in this article are based on a larger research study conducted by the author during 2014 for the Equipment Leasing and Finance Foundation. The Foundation recruited 26 organizations of varying size and type to participate in the study. Data were collected using three methods:

1. Individual interviews were conducted with executives from all 26 equipment leasing and finance organizations to assess the nature and scope of leadership challenges, current investment strategies, satisfaction with leadership development efforts, and perceived impact of leadership.
2. Key performance indicators from organizational documents (e.g., annual reports) and extant data (e.g., customer satisfaction survey results) were reviewed and summarized for 20 of these organizations, providing a measure of current organizational performance.
3. The Leadership Culture Survey™, which is a professional assessment tool for measuring the competencies and styles of the leadership culture. It was administered to 162 leaders in 17 of these organizations. This instrument validly and reliably measures both ideal and actual leadership effectiveness and provides a percentile score that compares performance results with that of a nationally normed database of leaders from across industries.

Details about the methodology employed as well as additional findings beyond the scope of this article can be found in the Foundation report titled *Leadership—The Next Productivity Frontier.*

## CHARACTERISTICS OF EFFECTIVE LEADERSHIP

To fully comprehend the impact of investing in leadership, it is important to understand what effective leadership looks like. The top 10 leadership competencies consistently identified as necessary for success in the equipment leasing and finance industry include:

- **Sustainable productivity.** Leadership achieves results in a way that maintains or enhances the overall long-term effectiveness of the organization. This includes the ability to balance human and technical resources and to maintain a long-term perspective that permits the organization to build on achievement as opposed to simply maximizing temporary gains.
- **Decisiveness.** Leadership makes decisions in a timely manner and is comfortable moving forward in uncertainty. This includes the ability to focus in quickly on the key issues and to make efficient use of data to arrive at decisions.

- **Fosters team play.** Leadership fosters high-performance teamwork across the organization. This includes the ability to create a positive climate that supports people doing their best.
- **Strategic focus.** Leadership establishes and follows a thorough discipline of strategic planning that focuses the organization on the "right stuff." This includes an understanding of the organization's strengths and weaknesses as well as current market trends, and the ability to use this understanding to develop business strategies that will be successful in the marketplace.
- **Purposeful and visionary.** Leadership provides a clearly communicated organizational purpose and vision, aligns the organization, and models commitment to this direction. This includes the ability to remain optimistic, see the possibilities (through thinking outside the box), and inspire others to follow along.
- **Interpersonal intelligence.** Leadership interacts effectively with others, demonstrating trust and respect. This includes the ability to engage others through listening skills and honest and direct feedback.
- **Mentoring and developing.** Leadership enhances the professional growth of others through mentoring and providing development opportunities. This includes empowering employees to take on challenging tasks and delegating to them the responsibility for completing tasks.
- **Composure.** In the midst of conflict and high-tension situations, leadership remains composed and centered. This includes the ability to handle stress and pressure well by maintaining a calm, focused perspective.
- **Personal learner.** Leadership demonstrates a strong and active interest in learning and notices when a new direction is needed. This includes the ability to learn from mistakes and a willingness to remain open to change.
- **Courageous authenticity**. Leadership is willing to take risks and deal with challenges head on. This includes the ability to confront others in a constructive manner and surface issues so that problems can be resolved quickly.

Taken together, these competencies suggest that effective leadership creates a compelling vision, and then translates that vision into strategies, strategies into goals, and goals into actions that achieve results. This is accomplished through leadership skills in developing individuals and teams, creating a supportive climate that inspires others to strive and improve, and establishing cooperative collaborations through effective communication and interpersonal abilities.

## NATURE AND SCOPE OF LEADERSHIP INVESTMENT

The key aspects of leadership investment can be classified into three categories: financial and strategic commitment, professional development practices, and performance and feedback. However, within these areas, the form and level of investment varies widely among equipment leasing and finance organizations. Examples of high-level and low-level investment in each of these areas are included in Table 1.

### Financial and Strategic Commitment

Commitment reflects the extent to which an organization has incorporated leadership into its organizational identity. This category includes:

- Budgetary considerations
- Strategic goals for leadership
- Level of, and amount of support for, participation in leadership development

For some equipment leasing and finance organizations, a focus on leadership has become an integral part of the business. These organizations strongly encourage and support leadership development, including creating a line item for development in the budget and providing numerous opportunities for employees to engage in development activities. Other equipment leasing and finance organizations, particularly startup companies, are just now becoming aware of the importance of leadership and they have yet to set organizational leadership goals or budget for leadership work.

In addition, equipment leasing and finance organizations with hierarchical structures (e.g., banks and larger independents) are more likely to embrace the need to address leadership and budget accordingly than organizations with flatter structures (e.g., smaller independents) that may only have a few leaders or owners and little or no potential for promotion among the employee population. However, there are some notable exceptions among flat-structured organizations, in which leadership strategy includes providing professional leadership training to all employees, regardless of function or position in the organization, as a way of improving overall organizational performance.

There are some notable exceptions among flat-structured organizations, in which leadership strategy includes providing professional leadership training to all employees, regardless of function or position in the organization.

### Professional Development Practices

Most of the leadership investment an organization makes is centered on providing opportunities for leaders to develop and improve the quality of their

**Table 1.** Distinctions in Nature and Scope of Investment in Equipment Leasing and Finance Organizations Making High-Level or Low-Level Investments in Leadership

| Area of investment | High-level investment | Low-level investment |
|---|---|---|
| Financial and strategic commitment | ▪ Leadership development is one of the "Top 5" priorities.<br>▪ Operating budgets include monies committed to leadership development.<br>▪ Has an articulated leadership strategy or widely accepted practices that have been communicated throughout the organization.<br>▪ Encourages or requires all leaders in the organization to engage in leadership development.<br>▪ Provides two or more weeks of time for professional development. | ▪ Leadership development is not a priority (or is outside the "Top 10").<br>▪ No specific budget has been developed for leadership work and when required, money is taken from discretionary funds.<br>▪ Has no leadership strategy or organizational goals related to leadership.<br>▪ Leaves it up to individuals as to whether or not they pursue leadership development.<br>▪ Provides less than one week of time for professional development. |
| Professional development practices | ▪ The organization has identified internal resources or external partners that are dedicated to facilitating leadership development.<br>▪ Leadership performance is regularly assessed and used to tailor professional development.<br>▪ Uses many different development approaches, with a heavy emphasis on peer coaching and mentoring and includes both individual and collective leadership training in which leaders throughout the organization work on common goals.<br>▪ A significant portion of professional development content is focused on leadership skills and closing leadership effectiveness gaps.<br>▪ Potential leaders are identified and placed into accelerated development programs. | ▪ Leadership development occurs on a catch-as-catch-can basis.<br>▪ Professional development is based on canned programs or left up to the individual to determine.<br>▪ When professional development is offered, it is typically focused on individual improvement and relies heavily on didactic and on-the-job training.<br>▪ Most professional development content is focused on operational training (e.g., systems, processes, and techniques).<br>▪ Has not addressed talent awareness. |
| Performance and feedback | ▪ Leadership development is a formal part of the performance review process.<br>▪ Leaders create individualized development plans and solicit feedback on progress.<br>▪ Leaders regularly meet together to discuss leadership issues and hold one another accountable for results.<br>▪ Both direct and indirect measures of leadership performance are assessed quarterly or yearly. | ▪ There is no accountability for performance specifically tied to leadership improvement.<br>▪ Indirect measures of leadership performance (e.g., customer and employee satisfaction surveys) are assessed every three to five years, or not at all. |

*Source:* Based on findings from the Foundation study conducted by the author.

skills and performance as a leader. This includes investments focused on:

- Acquiring resources for delivery of professional development
- Choosing and implementing a development approach(es)
- Selecting and/or tailoring development content
- Identifying potential leaders to include in a development program

Some equipment leasing and finance organizations use an informed and intentional approach to leadership development. These organizations spend extensive time in generating a comprehensive development plan based on assessments of the performance and needs of their leaders. They are thoughtful about the specific approaches they will employ, being sure to include interpersonal approaches (such as peer coaching) that foster deeper leadership conversations. They also tailor content to address both individual and collective leadership goals so that leadership for the entire organization improves.

Other equipment leasing and finance organizations fly by the seat of their pants, spending much less time and resources on professional development practices. These organizations tend to rely more on prescribed development programs, which are typically focused on operational goals for improving business systems, processes, and techniques. Such practices require less investment but also run the risk of not effectively targeting leadership needs.

Making significant investments in this area can be costly in terms of both time and resources. As a consequence many equipment leasing and finance organizations—particularly smaller organizations that do not have an HR department and large companies with multiple offices requiring coordination of development efforts—choose to focus only on individual development with a small group of leaders. However, there are exceptions – for example, one small, captive organization excels in providing both individual and collective training focused on common leadership goals.

## Performance and Feedback

The final category of investment reflects the time and effort

Some equipment leasing and finance organizations have invested in formal practices that increase individual and collective accountability for leadership progress.

required to determine the success of leadership development efforts and to hold leaders accountable for progress. This category includes:

- Assessing leadership performance
- Providing feedback to leaders on areas in need of improvement
- Incorporating leadership goals and progress into business and team conversations

Some equipment leasing and finance organizations have invested in formal practices that increase individual and collective accountability for leadership progress. These organizations use a combination of measures (including performance reviews and 360–degree assessments—ratings from individuals in the leader's work circle) to understand what components of current leadership development are working well and where revision is needed. Further, individual leaders in the majority of these organizations are encouraged to develop a personalized plan for building on their strengths and addressing their challenges.

Other equipment leasing and finance organizations have made only minimal investments in this area, typically using feedback from corporate-generated satisfaction surveys to attempt to draw conclusions about the success of development efforts. The differences in investment in this area appear to have little to do with the size or type of organization and much more to do with the knowledge and capability of employees to design and implement meaningful assessment. Those organizations with significant investments in this area often rely on external resources to generate the necessary feedback.

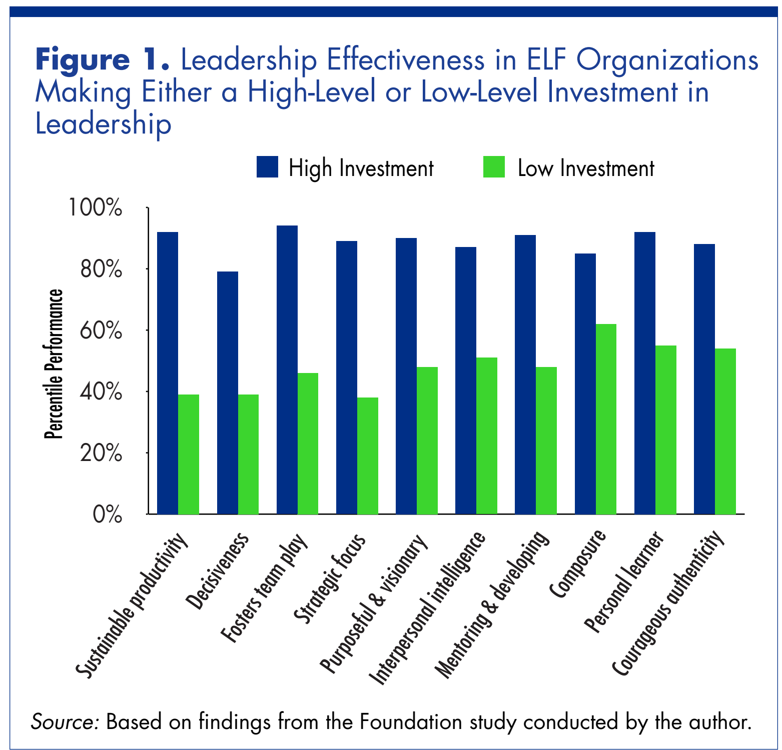
## RELATIONSHIP OF INVESTMENT AND LEADERSHIP EFFECTIVENESS

It is uncommon to find an equipment leasing and finance organization with significant levels of investment in all of the areas mentioned above. It is equally uncommon to find such organizations that have not made at least a minimal investment in one or more of the areas described above. Although any given equipment leasing and finance organization may not look exactly like either the high-investment or the low-investment profile presented in Table 2, some equipment leasing and finance organizations closely resemble (differing by only one or two elements) the two distinctive patterns. When the leadership effectiveness (as measured by performance on competencies) of organizations with a high-level investment is compared to that of organizations with a low-level investment, a significant, and perhaps not surprising, pattern of effectiveness emerges, as illustrated in Figure 1.

Clearly, the greater the investment in leadership, the more likely the most desirable leadership characteristics will be expressed. Interestingly, even capabilities that may be a more innate expression of leadership, such as composure, appear to improve through concerted development efforts. Other related findings suggest that significant levels of investment result in:

- Quality leaders across all levels of the organization
- Better collective leadership, particularly in terms of leadership integration and communication

**Figure 1.** Leadership Effectiveness in ELF Organizations Making Either a High-Level or Low-Level Investment in Leadership




*Source:* Based on findings from the Foundation study conducted by the author.

## RELATIONSHIP OF LEADERSHIP EFFECTIVENESS AND ORGANIZATIONAL PERFORMANCE

As the performance of leaders improves, the impact leadership has on the organization increases. The correlation between leadership effectiveness performance and executive ratings of leadership impact in equipment leasing and finance organizations is illustrated in Figure 2. The correlation is quite strong ($r = .73$, $p < .002$) and suggests that leadership effectiveness accounts for 53% of the variance in impact on equipment leasing and finance organizational performance.

Further, when comparing key performance indicators of equipment leasing and finance organizations with more and less effective leadership, several significant differences emerge, as summarized in Table 2.

Leadership is influencing these organizational outcomes in five key ways.

- **Leadership influences the culture in which employees work.** Effective leadership fosters a unified and empowered culture in which employees thrive and productivity soars. Less effective leadership produces a culture that is stale and fractionated, with little trust and no open exchange of ideas. Further, because less effective leadership is often engaged in micromanaging the work, processes and results are slowed down, productivity suffers, and the ability to retain quality employees decreases.
- **Leadership sets the strategic direction for the organization.** Effective leadership creates a compelling vision, clearly communicates and engages workers around expectations, and ensures that there is alignment throughout the organization, increasing the likelihood that organizational objectives and long-term results will be achieved. In contrast, less effective leadership lacks a clear understanding of where the company needs to go and how progress will be measured, focusing instead on leading from a firefighting mentality that drains resources and creates a demoralizing environment.
- **Leadership is one of the core drivers of organizational economic growth and positioning in the industry.** Effective leaderships stays alert to shifts in the market and is sensitive to customer/shareholder needs and so can adapt to changes, solve problems quickly, and balance resources to meet customer needs. Less effective leadership is resistant to change, is unaware of current market trends, or lacks a customer focus, often operating from a survival mode. This in turn results in little growth and may ultimately spell the demise of the organization.
- **Leadership either reinforces or devalues the organization's values by the example it sets.** Effective leadership serves as a good role model, subsequently inspiring others to strive for excellence and continuous improvement. Less effective leadership does not always adhere to the organization's values, subsequently increasing distrust and diminishing unity, often resulting in a lack of accountability and mediocre organizational performance.
- **Leadership is responsible for developing future leaders.** Effective leadership takes the time to identify potential leaders and develop that talent (often growing this talent internally), ensuring the sustainability of the organization.

**Figure 2.** Correlation of Leadership Effectiveness with Impact on Organizational Performance

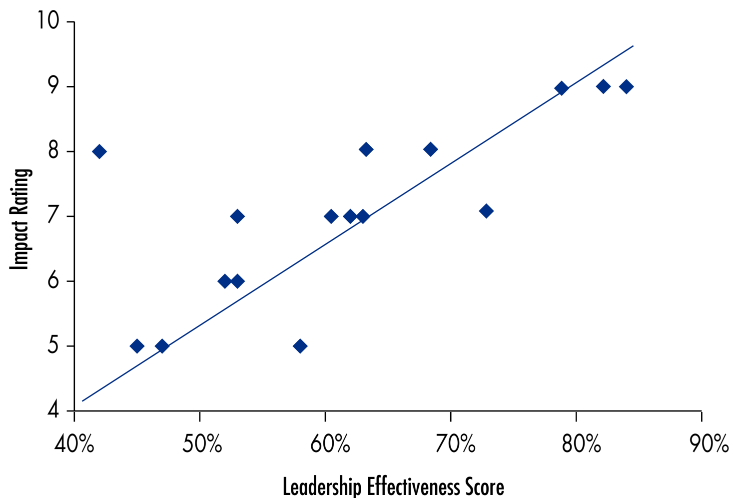



**Table 2.** Differences in Key Performance Indicators for Equipment Leasing and Finance Organizations with More and Less Effective Leadership

| Equipment leasing and finance organizations with more effective leadership | Equipment leasing and finance organizations with less effective leadership |
|---|---|
| Growth in revenue in the last year averaged 11% | Growth in revenue in the last year averaged 2.7% |
| Turnover rates averaged less than 3% | Turnover rates averaged close to 6% |
| High employee satisfaction (typically in the 90–95% range) and good customer satisfaction, often accompanied by citations/accommodations from outside agencies | Often don't measure employee or customer satisfaction and/or results are only moderately high |
| Innovative and quick to adapt | Slow to respond to changing conditions |
| Have leaders in the pipeline | Have no succession plan |
| Continuously high levels of employee productivity | Moderate or periodically high levels of productivity |
| Candid, frequent communications that keep everyone informed | Inauthentic communications that hide results |
| Culture is unified and strategically aligned | Culture is fractionated and leaders are working in silos |

*Source:* Based on findings from the Foundation study conducted by the author.

Less effective leadership rarely engages in succession planning, which creates a leadership void that overburdens the few existing leaders (running the risk of burnout or low productivity) and discourages the retention of quality talent, who may see the lack of opportunity for advancement as a reason to seek employment elsewhere.

## INCREASING NEED FOR EFFECTIVE LEADERS

Several trends within the equipment leasing and finance industry intensify the need for effective leadership. Organizations with leadership that is inadequate to these challenges may find that they are no longer competitively viable.

### Maturation of Startup Companies

As startup companies become established, they must focus on creating the company infrastructure and carving out a niche in the marketplace. Success in meeting these challenges depends on the effectiveness of leaders in creating a compelling vision and translating that vision into actionable direction. That effectiveness includes making decisions about the necessary roles and responsibilities: skills that are embedded within the Purposeful and Visionary, Strategic Focus, and Decisiveness competencies.

### Changing Landscape

Leadership must creatively adapt to an ever-changing environment (e.g., evolving technologies, shifting regulatory requirements, acquisitions and mergers of different cultures). Success in meeting this challenge is highly dependent on leaders being aware of the changes. Leaders must be creative, innovative, flexible, and willing to take risks, while also maintaining a long-term perspective that will allow the organization to achieve strategic objectives. Those skills are embedded within the Personal Learner, Courageous Authenticity, and Sustainable Productivity competencies.

### Need to Attract and Retain High-Quality Talent

As the baby boomer exodus continues to deplete organizations' workforces, leadership will need to attract and retain millennials and future generations of high-potential employees who can productively deliver. Success in meeting this challenge depends on the effectiveness of leadership to actively engage and relate to these individuals and foster a culture of teamwork that empowers employees: skills that are embedded within the Interpersonal Intelligence and Fosters Team Play competencies.

### Widening Generational Leadership Gap

Because of a lack of emphasis on succession planning within a majority of equipment leasing and finance organizations, there now exists a generational gap between the most capable leaders who are age 50+ and the bulk of the workforce who are younger. As senior leaders retire, these organizations may find that the gap quickly turns into a leadership void. Success in meeting this challenge depends on the effectiveness of senior leaders to mentor emerging leaders, sharing their knowledge and experience and delegating leadership responsibilities: skills that are embedded within the Mentoring and Developing competency.

### Next Steps

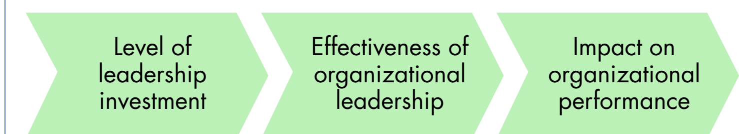
Each of the trends mentioned above underscores the importance of making a strong investment in leadership. As Figure 3 illustrates, equipment leasing and finance organizations that have a high level of leadership investment are more likely to grow competent leaders, and leaders who possess strong creative competencies are more likely to foster a thriving culture in which organizational performance is maximized. Equipment leasing and finance organizations may want to consider using the help of external partners in designing (and possibly delivering) their leadership development. These external partners should be experienced in development practices that contribute to leadership effectiveness and should be briefed on the leadership qualities that are most important to success in the equipment leasing and finance industry (as identified in the first section of this report).

As leadership effectiveness improves, organizations will become more competitive in

As startup companies become established, they must focus on creating the company infrastructure and carving out a niche in the marketplace. Success in meeting these challenges depends on the effectiveness of leaders in creating a compelling vision.

securing capital (both human and financial) and finding solutions to the often complex and volatile problems that occur within the equipment leasing and finance industry.

**Figure 3.** Relational Links between Leadership Investment and Organizational Performance




*Source:* Author.

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Lani Van Dusen specializes in designing and conducting both quantitative and qualitative assessments of organizational systems, culture, leadership effectiveness, and human performance. As director of the Full Circle Group Assessment Center, she works with both consultants and clients using best-practice research and evaluation technologies to provide meaningful and actionable information to leaders, their teams, and the organizations they serve. (The Full Circle Group is headquartered in Salt Lake City.) Ms. Van Dusen has more than 25 years of experience in developing and using comprehensive research databases, designing and implementing measurement systems, and conducting large-scale research and evaluation projects. As president of the Worldwide Institute for Research and Evaluation, she has designed and conducted 138 studies for government agencies, educational institutions, and for-profit and nonprofit organizations in 23 countries. She has published more than 150 journal articles, technical reports, and book chapters in the areas of learning, evaluation, and performance. She serves as a consultant to several national boards and corporate leadership groups on building internal leadership capacity and enhancing strategic vision. Ms. Van Dusen holds a PhD in experimental psychology from the University of Georgia, Athens.

# The Impact of Alternative Finance on the Equipment Finance and Leasing Industry

By Charles B. Wendel

Alternative finance companies are increasing their lending. This article examines why and describes their typical business models. It also looks at how they can best work with equipment leasing and finance firms to serve more borrowing clients and increase revenues.

*Editor's note: This article is based on the February 2015 Foundation study by FIC Advisors Inc. titled* The Impact of Alternative Finance on the Equipment Leasing and Finance Industry: Maximizing Opportunities and Managing Threats. *The study is available at www.leasefoundation.org.*

Over the past few years, alternative finance (AF) companies have been increasing their lending activities, particularly in the small business and lower-end middle-market spaces. In 2014, the Equipment Leasing and Finance Foundation (Foundation) commissioned FIC to prepare a report that focuses on why AFs are increasing in importance, describes the typical business models they use to operate, and, based on past history and expected opportunities, suggests their likely future paths.

Perhaps of greatest importance to Equipment Leasing and Finance Association members, this report also highlights ways in which AFs and member companies can work together to serve more borrowing clients and build revenues. This article summarizes the key issues discussed in the report and incorporates recent activities within the AF segment, as more players enter and others refocus their approaches.

Today, analysts estimate that AFs capture less than 2% of the small business market or $5 billion to $6 billion in outstanding loans. However, this number appears to be growing quickly with, as we discuss below, substantial growth potential and increased market disruption based on both direct lending opportunities and the opportunity for AFs to work with traditional lenders, including equipment finance companies.

## WHY IS ALTERNATIVE FINANCE INCREASING IN IMPORTANCE?

AF companies are nonbanks, often financed by private equity firms that provide debt to small businesses and consumers. Sam Graziano, CEO of Fundation, an alternative lender, characterizes AFs as "digitally enabled lending," that is, lending that delivers credit through the web and mobile enabled processes, leverages business process automation to increase lending efficiencies, and uses data aggregation and analytics both to enhance the quality of risk management and generate risk-based profitability.[1]

Four main factors have resulted in the increased growth and attractiveness of alternative finance companies:

- Limits in the appetite of banks to lend to small businesses
- The willingness of more borrowers to work with AFs
- The ability of AFs to apply technology and data analytics to streamline processes and expand their lending universe
- Ready access to funding and capital

### Limited Bank Focus

While many banks continue to proclaim their interest in small business lending, credit losses suffered during the last downturn have resulted in a narrowing of the "credit box" in which banks operate and make loans. Many banks have tightened their requirements to a more limited group of industries and loan types while requiring stronger bottom-line performance from potential borrowers.

Table 1 (next page) estimates that, given internal requirements related to industry, time in business, credit risk, and other elements, banks consider only about 10% of all small businesses to be qualified borrowers. The other 90%, not all of which are creditworthy, represent a potential loan market for alternative lenders in excess of $1.7 trillion.

Multiple internal and external factors drive bank constraints related to small business lending, including increased capital requirements facing banks and the inability of most banks to offer loans with risk-based pricing. As Table 2 indicates, the costs of origination, underwriting, and ongoing monitoring and compliance result in many small business loans being value destroyers or at best marginally profitable.

**Table 1.** Banks Limit Their Small Business Focus

**Banks focus on about 10% of total small business customers.**

| Bank qualified and non-qualified business | | | | |
|---|---|---|---|---|
| **Category** | **Number of businesses (millions)** | **Potential dollar loan value (billions)** | **% of businesses** | **% of value** |
| Qualifying | 3.7 | $544 | 10.2% | 23.8% |
| Not qualifying | 32.4 | $1,745 | 89.8% | 76.2% |
| Total | 36.1 | $2,289 | 100.0% | 100.0% |

*Source:* Oxxford Information Technology and FIC Advisors Inc. analysis.

**Table 2.** Many Small Business Loans Lose Money or Are Marginally Profitable

**$100,000 loan example**

| Item | | |
|---|---|---|
| Loan origination | $1,000–1,500 | |
| Underwriting | $1,000 | |
| Loan review | $100 | |
| Operations | $250 | |
| Monitoring | $500 | |
| Compliance | $250–500 | |
| Total | $3,100–3,850 | |
| Interest income (assume 6.25% loan) | | $6,250 |
| Loan cost to charges bank unit (3%) | | $3,000 |
| Total noninterest costs to generate loan | | $3,100–3,850 |
| **Net income** | | **($600) to +$150** |

*Source:* FIC Advisors analysis.

Although a few of the biggest banks have developed streamlined processes and introduced decision modeling that reduces operating costs and improves pricing, many regional and community banks continue to sell to and service small businesses with the same cost structure they apply to middle-market loans. One banker who reviewed Table 2 commented that his bank spends about the same to generate a $50,000 loan as a $500,000 loan, resulting in his bank emphasizing larger loans and de-emphasizing what he considers high-cost small loans.

Of course each bank operates with a unique set of costs, fee, and other revenue components and needs to customize the above analysis to mirror its own situation, developing a quantitative analysis of actual costs rather than relying on anecdotes. In many cases, banks will find their assessment points to negative or subpar returns from small business lending.

### Borrower Willingness to Work With AFs

A 2014 *Inc.* magazine article summarizes some of the key contrasts between banks and alternative lenders and the attractiveness of these companies (Table 3).

Whereas borrowers pay more for loans from alternative lenders, an increasing number are willing to do so for reasons of speed of decisionmaking, flexibility of loan structure, and availability of funds. One alternative lender, James Hobson, COO of OnDeck, in his presentation to this year's ELFA's Executive Roundtable, cited a 2014 Federal Reserve Bank of New York study stating that small businesses spend an average of 33 hours searching and applying for financing.[2]

In addition, the gap between the timing required for bank versus nonbank decisionmaking is often greater than that indicated above, with some banks requiring more than a month for a decision versus some alternative lenders that are able to make decisions in 24 to 48 hours or less.

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### Role of Technology and Digitally Enabled Lending

Without the effective and enhanced use of technology, alternative lending in its present form would not exist. The most

**Table 3.** Contrasts Between Banks and Alternative Finance Companies

| | **Banks** | **AFs** |
|---|---|---|
| Typical small business loan APR | 6%–8% | 20%–50% |
| Time to close loan | 2 to 3 weeks | 3 to 4 days |
| Approval rates | 19% | 64% |
| Average small business loan size | $350K | $85K |

*Source:* Inc. Magazine, "How Big Banks Compare to Alternative Lenders" http://www.inc.com/magazine/201405/alix-stuart/loans-big-banks-compared-to-alternative-lenders.html?cid=readmore.

productive AFs have moved from the manual underwriting that still occurs at many banks to automation of key business processes.

> Equipment finance companies have the opportunity to provide aggregators with their turndowns and/or join their lending groups to receive potential loan opportunities for their review.

Although an underwriter may also review a loan before funding, the AF's emphasis centers on building streamlined processes and limiting personal "touch." AFs also apply multiple and varied data points to each customer to assess and quantify risks and allow for risk-based pricing across the portfolio.

### Ready Access to Funding and Capital

Private equity firms have largely fueled the growth of alternative lenders. These investors believe that alternative lenders can capture substantial market share from the banks while generating returns that exceed what is available from many other investments, particularly in a low-rate environment.

AFs have multiple funding options beyond private equity, including bank loans (for example, CAN Capital recently secured a $650 million credit facility from a bank group led by Wells Fargo), securitizations (in 2014, OnDeck issued the first non-Small Business Administration direct business lending securitization), and IPOs (both Lending Cub and OnDeck went public in 2014 with implied valuations of $23.4 billion and $8.9 billion, respectively).

## TYPICAL BUSINESS MODELS

What are the typical business models? In its broadest context, alternative finance involves four business models:

**Reward-based.** This activity involves the Kickstarter model, whereby individuals fund creative projects, often with a "thank you" or acknowledgment as their only repayment. Investors receive no financial return.

**Donation-based.** This model primarily is used to fund charitable donations.

**Equity-based.** Targeted at accredited investors who can receive a stake in a company and build an ownership portfolio, this area remains under development, because the investment provisions of the 2012 Jumpstart Our Business Startups (JOBS) Act will not be in place until early 2016.

**Lending-based.** Lending activities provide the central focus for investors and AFs as well as the area in which a revenue growth opportunity may exist for the equipment finance industry. While lending-based activities continue to evolve, alternative finance companies work with traditional lenders in one or more of four primary ways: aggregator, marketplace lender, direct lender, and service provider.

### Aggregators

Companies such as Biz2Credit, Fundera, and Lendio in effect act as loan kiosks or brokers. Without putting their own equity at risk to make a loan, they offer a range of loans to end borrowers based on teaming up with lenders that operate with different risk appetites and product preferences. Fundera's loan product list includes SBA loans, term loans, equipment financing, lines of credit, invoice financing, short-term loans, merchant cash advances, and small business startup loans.

Typically, this process involves potential borrowers entering financial and business information online and then receiving tentative loan offers from one or more bank or nonbank lenders. For example, Biz2Credit's website states that borrowers can complete a loan profile within four minutes using a PC, tablet, or smartphone.

Aggregators provide value to borrowers by establishing a network of lenders with varied appetites related to risk and loan type, and they conduct an initial screen of applications to match up borrowers with their most likely lenders. Their goal is to move to close loans much quicker than banks. Fundera's website states that its quickest time to fund a loan was two hours.

Aggregators usually work with traditional lenders in two ways. First, they solicit referrals from lenders that are unable or unwilling to lend to certain businesses, based on industry, credit history, or other factors. Referral sources receive a fee for a closed transaction related to these turndowns and also maintain control over the relationship, potentially capturing deposits, cash management, and other business.

In addition, the aggregators are often interested in expanding their lending pool, adding more lenders to their mix to increase both the options available to borrowers and their likelihood of success. For example, today Biz2Credit operates with 1300+ bank and nonbank lenders.

Equipment finance companies have the opportunity to provide aggregators with their turndowns and/or join their lending groups to receive potential loan opportunities for their review.

### Marketplace Lenders

Like aggregators, marketplace lenders avoid credit-related losses by introducing institutional and individual investors to lending opportunities. Lending Club and Funding Circle are two of the largest players in this space. Funding Circle's website states

In effect, marketplace lenders act as asset managers, applying proprietary data analytics to assess loan applications and match borrowers with appropriate sophisticated investors.

that it provides "fast, affordable business loans for the millions of American small businesses who the banks have left behind." Investors in its loan securities can be asset managers, family offices, or other institutions as well as individuals interested in investing in the fractional loan marketplace. In effect, marketplace lenders act as asset managers, applying proprietary data analytics to assess loan applications and match borrowers with appropriate sophisticated investors.

Marketplace lenders solicit referrals from traditional lenders such as equipment finance companies and pay fees for closed transactions, while the referring lender maintains overall control of the relationship.

### Direct Lenders

Direct lenders risk their own capital or borrowed funds to provide small business loans, both originating and, typically, holding the transaction on their balance sheets. However, these companies vary in how they position themselves with borrowers based on loan size, risk appetite, and pricing, among other factors.

One direct lender, Fundation, focuses on term loans of up to $500,000 with rates starting at 7.99%. In contrast, while OnDeck offers term loans up to $250,000, its primary focus has been on smaller lines of credit lending, with rates usually ranging from 29.9% to 49% APR. However, most loans are paid off within a few months, with OnDeck automatically deducting weekly payments from a company's bank account.

Fundation's risk focus centers on companies that are at or approaching near-prime status, whereas companies such as OnDeck and merchant advance lenders tend to focus on subprime borrowers, accounting for their higher rates.

OnDeck's website cites its partnership agreements with BBVA Compass and First Tennessee as two examples of bank referral programs for which the banks receive fees while maintaining the overall small business relationship. In its earlier years, some of OnDeck's volume resulted from referral relationships with a number of leasing and equipment finance companies.

### Infrastructure and Platform Solutions

Alternative finance companies have invested heavily in technology related to streamlining the loan application process for the borrower, the internal movement of information within their shops, overall operational efficiency, and the quality and depth of the risk management process, among other areas.

Several AFs—Lending Club, Prosper, and OnDeck among them—are now offering their operational and risk management platforms to traditional lenders. Their focus centers on allowing lenders to leverage the AF's capabilities and the prior investments made by them to reduce the cost of making a loan and, thereby, increase profitability. In addition, the AF's risk management platforms and proprietary analysis can allow lenders to extend loans to selected companies that traditional lenders may have previously turned down.

Both Prosper and Lending Club have announced consumer focused lending partnerships with groups of community banks. In addition, Lending Club has teamed with Alibaba to finance manufacturers purchasing products in China through Alibaba. Similarly, Google and Lending Club joined to offer low-interest financing to Google partners, focusing on expanding the sales of Google-business expansion opportunities. These and other players are considering similar opportunities in the business space.

With its focus on SBA lending, SmartBiz provides platform solutions to Celtic Bank and the California Small Business Development Fund, among others. OnDeck offers turnkey solution to partners to offer working capital loans to current and new customers, including using its "streamlined underwriting and OnDeck score," pre-approving customers, "instant," 24-hour turnaround, and other features including the option to self-fund the loan or refer it to OnDeck.

At this point, only a handful of alternative finance companies are offering platform solutions, although more are in the process of doing so. Faced with increasing costs, traditional lenders, including small-ticker lessors, may benefit from at least assessing the capabilities these providers offer to determine the attractiveness of the third-party solution they offer.

As summarized above, numerous opportunities exist for equipment finance companies to cooperate with alternative finance players. Whether as aggregator, marketplace lender, direct lender, and/or platform provider, AFs are anxious to work with traditional lenders such as equipment finance companies.

These new entrants understand the origination potential that traditional players offer as well as the favorable reputation and networking ability they enjoy with most of their customer and prospect bases. They want to take advantage of those strengths to build origination volume.

Although the potential revenue opportunity of working with alternative finance companies may be significant, traditional lenders need to balance that opportunity against a number of risks, including reputation, execution, and compliance risks.

## RULES OF THE ROAD: SELECTING AN ALTERNATIVE FINANCE PARTNER

Given the number of alternative lending approaches now being offered to borrowers, the increasing number of AF players, and increasing demands on the time of traditional lenders, companies contemplating working with an AF should consider applying a brief qualifying checklist to each potential partner.

### Compliance Capabilities

Regulators are holding lenders to increasingly high standards related to transparency, privacy protection, and related areas. Sharing client information with others involves a compliance hurdle that can be difficult to overcome, particularly if an opportunity involves working with a high-rate lender. Banks are also sensitive to working with some AFs that emphasize collecting loans through account sweeps and offering multiple loans to the same borrower, potentially straining the borrower's ability to repay.

Given these sensitivities, the most appropriate partner has already built an internal compliance capability, established appropriate internal operating standards, and developed ongoing working relationships with various regulatory agencies.

### Turnkey Emphasis and Excellence in Execution

Most traditional lenders lack the time (and in some cases the staffing and sales capability) to exploit the revenue opportunity that AFs provide. AF partners should be able to contribute to and even lead the sales process to ensure that the AF's initiatives provide meaningful growth to the traditional lender's bottom line.

### Demonstrated Patience and Persistence in Marketing

Traditional lenders may take months to evaluate partners and determine their short list of candidates. AFs need to demonstrate their willingness to stick with the process and follow up; that intensity also serves as an indication of the likely intensity of their ongoing engagement with the company.

As straightforward and relatively simple as the above criteria are, traditional players will find that few AFs meet these hurdles.

## WHAT DOES THE FUTURE HOLD FOR ALTERNATIVE FINANCE COMPANIES?

Although both the number of these companies and how they compete will change, many alternative finance companies will remain part of the permanent financing landscape. AFs are currently focusing on a number of competitive issues:

- **Competition and cannibalization is increasing.** As noted, AFs focus on different risk and pricing segments within small businesses. Increasingly, lower cost AF players are competing against higher rate loan providers as borrower performance improves and lenders gain greater confidence from their risk-management analytics.
- **Rates are declining.** As a result of increased competition and new entrants, spreads are declining, although they still remain far above typical bank rates.
- **An increasing number of banks are entering the market.** In at least three cases (two regional banks and one top-10 bank), banks are actively developing approaches that compete directly in what has previously been the preserve of alternative finance companies. These banks are evaluating customer cash flow, bank statements, receivables, and other factors to provide loans to companies that had been considered unbankable. Some of these banks may offer their platforms to other banks, putting them in direct competition with some AF providers.
- **Origination and execution issues are emerging.** As more players enter the market, the ability to efficiently generate loan leads becomes a greater challenge. Both during our research for the Foundation report and subsequently, we have found many alternative finance companies struggling to generate sufficient volume. This issue has resulted in pushing many players to work cooperatively with traditional lenders.

> Sharing client information with others involves a compliance hurdle that can be difficult to overcome, particularly if an opportunity involves working with a high-rate lender.

- **Risk management and business models are going to be tested.** Alternative finance has begun to play a disruptive role with its emphasis on fast and convenient technology and processes. However, the AF risk-management approach differs from that used by most traditional lenders and, while arguably assessing an increased number of performance and risk factors, has yet to be tested during an economic down-cycle. In addition, AF's reliance on private equity firms and nondepository funding could put some players in a vulnerable

position when the economy contracts.

- **Consumer Financial Protection Bureau (CFPB) and other regulators may focus on AFs.** Until now the AF industry has operated with far fewer regulatory constraints than banks. However, this favorable circumstance is subject to change if the CFPB begins to consider some small businesses within its definition of consumer banking. Conversations with the heads of several bank-owned equipment finance companies indicate the CFPB may be in the process of doing so. Management at the top AF providers expects increased regulatory scrutiny and has hired experienced compliance personnel to address this area.

The above factors, among others, will likely lead to a shakeout within the industry. Those lenders that lack sufficient origination capabilities and the ability to scale up in size to increase efficiencies, and that fail to establish a defensible segmented niche may disappear while a few large alternative players continue to gain additional share.

## CAN EQUIPMENT AND ALTERNATIVE FINANCE COMPANIES WORK TOGETHER?

Multiple options exist for equipment finance companies to work with and take advantage of the capabilities that alternative finance companies offer, including these:

- **Obtain referrals from aggregators.** Companies such as Fundera and Biz-2Credit want to provide leads to lenders in order to expand their ability to meet borrower needs.
- **Provide leads for a referral fee to marketplace lenders or direct lenders.** Virtually all alternative finance companies express an interest in working with tradit`ional lenders to review their turndowns or analyze their customer base to determine additional potential lending opportunities.
- **Leverage platform solutions.** OnDeck, Lending Club, SmartBiz, and others offer their operational and risk management platforms to traditional lenders with the twin aims of increasing operating efficiencies and expanding potential lending within the current customer base.
- **Compete directly.** Many equipment finance companies possess the customer history and analytic capabilities to replicate the approaches used by some alternative lenders. However, the investment required in time, people, and technology will make this an uneconomic and unattractive initiative for most lenders.

The alternative finance industry continues to evolve, with expectations that it will continue to disrupt the traditional loan market. Given the expected growth of these companies and the potential economic and strategic value they can provide, equipment finance and leasing companies should assess their level of interest in working with these lenders as well as their most appropriate path for doing so.

### Endnotes

1. From presentation by Sam Graziano, CEO of Fundation, "Introduction to Alternative Lending," made to the Commercial Finance Association's Alternative & P2P Lending Forum 2015, March 19, 2015.

2. From presentation by James Hobson, COO of OnDeck, "Alternative Finance Solutions," made to the ELFA Executive Roundtable, March 17, 2015.

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# Special Considerations for Perfection Opinions Covering Electronic Chattel Paper as Collateral

By Margo H.K. Tank and R. David Whitaker

The equipment leasing industry is expanding its use of electronic records and signatures to document equipment leases. Inclusion of electronic chattel paper in a perfection opinion will require the attorney preparing the opinion to understand both the structure for establishing "control" under UCC Section 9–105 and the technology platform being used to manage the electronic chattel paper and to transfer control.

*Editor's note: This article is a companion piece to the March 2015 Foundation study by BuckleySandler titled* Digital Documents: Financing Paperless Transactions. *The study is available at www.leasefoundation.org.*

A recent study completed by the Equipment Leasing and Finance Foundation confirms that the equipment leasing industry is expanding its use of electronic records and signatures to document equipment leases.[1] As the use of electronic lease documentation grows, so does the desire of equipment lessors to offer those leases to lenders as collateral on the same footing with paper-based leases.[2] In turn, lenders taking electronic leases as collateral seek the same level of confidence concerning the existence of a first-priority, perfected security interest that is achieved when the lender takes delivery and physical possession of paper-based leases.

To facilitate these objectives, Revised Article 9 of the Uniform Commercial Code has adopted a specific structure for perfecting a first-priority security interest against equipment leases evidenced by electronic records.[3] Revised Article 9's special structure permits a secured party to perfect a first-priority security interest in leases evidenced by electronic records and signatures without requiring either physical possession of tangible lease documentation or the filing of a first-in-time financing statement.[4]

This new structure presents a challenge for legal counsel asked to issue a perfection opinion concerning the leases evidenced by electronic documentation, since Revised Article 9 replaces the customary reliance on physical delivery and possession of original paper lease documents with certain technology-based process requirements.[5] This article will discuss (1) the structure established by Revised Article 9 for establishing a first-priority security interest in leases evidenced by electronic documents, (2) special issues to consider when determining whether that structure has been met, and (3) sample language for perfection and priority opinions addressing equipment leases evidenced by electronic documents.[6]

## EQUIPMENT LEASE DOCUMENTS AS ELECTRONIC CHATTEL PAPER

Revised Article 9 defines "chattel paper," in pertinent part, as

> a record or records that evidence both a monetary obligation and a security interest in specific goods, … [or] a lease of specific goods. … In this paragraph, "monetary obligation" means a monetary obligation secured by the goods or owed under a lease of the goods.[7]

"Electronic chattel paper" is further defined as chattel paper evidenced by a record or records consisting of information stored in an electronic medium.[8] Therefore, by definition a lease of specific equipment evidenced by electronic records and signatures will be electronic chattel paper under Revised Article 9. It is possible to perfect a security interest in electronic chattel paper by filing a financing statement covering the electronic chattel paper.[9] However, just as with paper chattel paper (referred to in Revised Article 9 as "tangible chattel paper"), there is a structure available for taking a perfected security interest in electronic chattel paper that will have priority over a security interest perfected by filing.

Section 9–105 of Revised Article 9 (Section 9–105) supplants the former Article 9's notion of perfection by *possession* of the original of the tangible chattel paper with *control* of the authoritative copy of the

electronic chattel paper. Further, it sets the stage for creating liquidity in the market for electronic chattel paper by establishing the rights of a secured party in control vis-à-vis other parties holding a security interest in the electronic chattel paper.[10] Specifically, Revised Article 9 provides that:

(a) 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

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

(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.[11]

The term "purchaser" in Revised Article 9 includes a secured party taking a security interest in the chattel paper.[12] Therefore, if a secured party has "control" of electronic chattel paper, the secured party has a security interest in the electronic chattel paper that is perfected under Section 9–314 of Revised Article 9 and, under the circumstances outlined above, prior to earlier security interests in the chattel paper perfected by filing a financing statement.[13]

## CONTROL OF ELECTRONIC CHATTEL PAPER

The requirements for establishing control are set out in Section 9–105. Control of electronic chattel paper is intended to be the "functional equivalent" of possession of tangible chattel paper.[14]

Under the original version of Section 9–105 of Revised Article 9, 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 numbered clauses 4, 5, and 6 below, 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.[15]

Under the original terms of Section 9–105, it is necessary to satisfy all six of the above-listed requirements to have control of electronic chattel paper. Therefore, if a system does not meet all of the above-listed requirements, a secured party will not have "control" of electronic chattel paper under original Section 9–105.

However, the 2010 amendments to Revised Article 9,[16] which have been adopted by forty-seven states and the District of Columbia as of the date of this article, create a more permissive regimen for establishing control. Under the 2010 amendments, control is established "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."[17]

This new general rule substantially liberalizes the requirements for control described above. In states that have enacted the 2010 amendments those six requirements now serve as a safe harbor for meeting the general rule of control, but failing to satisfy all six requirements is not necessarily fatal to establishing control.[18]

> The requirements for establishing control are set out in UCC Section 9–105. Control of electronic chattel paper is intended to be the "functional equivalent" of possession of tangible chattel paper.

On the other hand, in those states that have not enacted the 2010 amendments as of this writing (including Oklahoma, and also New York and Missouri, both of which adopted some of the 2010 amendments but not those pertaining to Section 9–105), it is still necessary to satisfy all six requirements in order to establish control. Because the 2010 amendments have not been universally adopted by all jurisdictions, the discussion in this article assumes the six requirements are mandatory and not just a safe harbor.

Ownership and control are related to access rights and change dynamically as control is transferred within the eVault and pursuant to an internal record integrated into the eVault.

## EVALUATING A SYSTEM FOR ESTABLISHING CONTROL OF ELECTRONIC CHATTEL PAPER

Official Comment 4 to Section 9–105 of Revised Article 9 states the drafters' intention to leave to the marketplace the development of systems and procedures, through a combination of suitable technologies and business practices, for dealing with control of electronic chattel paper in a commercial context.[19]

Satisfying the requirements of UCC Section 9–105 entails more than the agreement of interested persons. In Official Comment 4, the drafters observe that "control" requires that it be "a physical impossibility (or sufficiently unlikely or implausible so as to approach practical impossibility) to add or change an identified assignee without the participation of the secured party (or its authorized representative). It would not be enough for the assignor merely to agree that it will not change the identified assignee without the assignee-secured party's consent."[20]

On the other hand, the drafters also observe that the standards applied to determine whether a party has control of electronic chattel paper should not be more stringent than those applied in the paper world to determine whether a party has possession of tangible chattel paper.[21]

The primary practical model that has emerged for establishing control pursuant to Section 9–105 is a "closed system" in which all parties seeking control have access to the authoritative copy of the electronic chattel paper on a single server platform and software system specifically designed to manage transfers of control and the integrity of the electronic chattel paper (often referred to in the industry as an "eVault").[22]

Ownership and control are related to access rights and change dynamically as control is transferred within the eVault and pursuant to an internal record integrated into the eVault.[23] As part of the process of preparing a perfection and priority opinion for electronic chattel paper being stored and transferred using an eVault, it is necessary to review and confirm that the eVault effectively meets the requirements of Section 9–105.

To do so, the eVault must successfully perform each of these four functions:

- Identifying the authoritative copy of the electronic chattel paper
- Establishing the location of the authoritative copy of the electronic chattel paper
- Identifying the current secured party in control
- Effecting a transfer of control from the debtor to a secured party, or from one secured party to another

An eVault is usually designed as a self-contained, secure environment. It leverages the fact that with electronic chattel paper it is control over access, and not physical location, that is of chief importance to meeting the requirements of Section 9–105. The authoritative copy of the electronic chattel paper is created and stored in the eVault, which is managed either by the secured party or its designated custodian. Every party requiring access, from the original owner creating the documentation and obtaining signatures to the ultimate secured party or purchaser, obtains access to the authoritative copy and the transfer functions via the eVault.

Access may be either direct or through a portal. The authoritative copy is stored in the eVault, and the eVault employs an internal ownership record or registry to keep track of the identity of the control party. Each subsequent secured party takes control by accepting a transfer of control initiated by the current party in control (beginning with the original owner of the electronic chattel paper), taking advantage of the transfer functions built into the eVault. The eVault also stores and protects the integrity of the authoritative copy.

In evaluating the eVault and its effectiveness, there are three key elements to bear in mind. The first key element is the requirement for an authoritative copy. The second key element is that there is a method for establishing the person in control of the authoritative copy. The third key element is that the authoritative copy must be distinguishable from other copies.

### Requirement for an Authoritative Copy

The emphasis on an authoritative copy reflects a reality of the electronic environment: there is really no such thing as a tangible original document that can be physically transferred from person to person. The transmission of an electronic document results in the creation of a new copy, not the physical transposition of the existing copy.[24] A copy, to qualify as the authoritative copy under Section 9–105, must meet three criteria: it must be unique, identifiable, and (except as otherwise provided) unalterable.[25]

*Unique*

The first criterion, that the authoritative copy be "unique," should be understood in its simple dictionary sense: that is, the authoritative copy must have a characteristic that distinguishes

it from other copies. That characteristic may be provided by technology or by process or agreement. For example, an authoritative copy stored within a secure information processing system may either be provided with a unique control number or be held in a specified server or other location. [26]

Essentially, the authoritative copy must be unalterable without detection, but that copy may be altered so long as the changes can be tracked and it can be determined whether the change was authorized.

*Identifiable*

As a practical matter, if a record is unique, almost by definition it is identifiable, so that the second criterion for an authoritative copy appears somewhat redundant. The most sensible interpretation of the identification rule is that the document management system being used, or the agreement of the parties, must explicitly define the authoritative copy in terms of its unique characteristic. In other words, an agreement or system rule or system function should specify, describe, or detect the unique feature that identifies the authoritative copy.

*Unalterable (with Exceptions)*

Finally, the third criterion for an authoritative copy is that the record must be unalterable, but this general rule is subject to three significant exceptions. First, the record may be altered to reflect a new, authorized control party of the record. Second, the record may be altered to reflect whether it is the authoritative copy. And finally, the record may be altered so long as the authorized copy reflects whether the revision is authorized or unauthorized.[27]

These exceptions are so extensive that as a practical matter they almost swallow the rule. Essentially, the authoritative copy must be unalterable without detection, but that copy may be altered so long as the changes can be tracked and it can be determined whether the change was authorized.[28]

### Identifying the Party in Control

The second key element in the evaluation of the eVault is that the authoritative copy must in some way be tied to a method for identifying the current party in control. This may be done by having evidence of the transfer of control integrated into the authoritative copy itself, or by having the authoritative copy logically associated with a methodology for tracking control, so that a person viewing the authoritative copy also is alerted and has access to the evidence of control.[29]

Transfers of control should be handled through a secure access process that requires authorization from the current person in control and acceptance from the person receiving control. The eVault should also generate and retain records evidencing the entire chain of control and all transfers.

### Distinguishing the Authoritative Copy

The third key element is the requirement that all copies of the authoritative copy must be readily identifiable as such and distinguishable from the authoritative copy. Section 9–105 does not specify a technological or process solution to this requirement, which makes possible multiple strategies for satisfying the requirement. For example, the requirement could presumably be met by storing the authoritative copy in a secure information processing system that automatically brands all copies as such.

As an alternative, the record itself could give notice of the location at which the authoritative copy is stored, so that by definition all copies stored at other locations are not the authoritative copy. As yet a third example, the record itself could provide for reference to a registry or system rules for determining the location of the authoritative copy, so that a person reviewing the record is on notice to check the registry or system rules to identify the authoritative copy.

## SAMPLE LANGUAGE FOR A PERFECTION OPINION

Once the eVault has been reviewed and determined to be effective, it will be desirable to place specific language in the opinion letter addressing certain specific elements of the review process as well as certain key assumptions concerning the eVault's ongoing management and operation. Whereas formats for perfection opinion letters vary, most include certain common elements relevant here: a list of documents reviewed, a statement of assumptions, and the statement of the opinion concerning perfection.[30]

For purposes of the following discussion and examples, it will be assumed that the opinion and documentation have defined the pledgor of the electronic chattel paper as the "debtor," the lender or purchaser as the "secured party," and the electronic chattel paper as the "collateral."[31]

Because most attorneys are not technologists, any review of the eVault is likely to be based on a system description of the eVault that has been provided to the attorney, together with a certification of the accuracy of the description from the debtor. In addition, it is likely that a third party is managing and operating the eVault both to effectuate transfers of control between, and act as the document custodian for, the debtor and the secured party. In that case, a copy of the agreement between the debtor and the document custodian, and between the

secured party and the document custodian, will also need to be reviewed to establish that the third party has agreed to act as the designated custodian of the authoritative copy for both parties.

Here are examples of the kind of language that might be added to the section of the opinion letter concerning reviewed documents[32]:

- Certificate of the Debtor dated <INSERT DATE> with respect to the description and functioning of the system for managing transfers of control and preservation of the authoritative copy of the Collateral (the "eVault") in accordance with <INSERT STATUTORY REFERENCE TO SECTION 9–105 UNDER CONTROLLING LAW>, and the system description attached thereto as Exhibit A (the "eVault Description").
- Agreement between the Debtor and <INSERT NAME OF DESIGNATED CUSTODIAN>, dated <INSERT DATE> (the "Debtor eVault Agreement"), with respect to the appointment of <INSERT NAME OF DESIGNATED CUSTODIAN> ("Document Custodian") as the Debtor's designated custodian in accordance with <INSERT STATUTORY REFERENCE TO SECTION 9–105 UNDER CONTROLLING LAW>.
- Agreement between the Secured Party and <INSERT NAME OF DESIGNATED CUSTODIAN>, dated <INSERT DATE> (the "Secured Party eVault Agreement"), with respect to the appointment of the Document Custodian as the Secured Party's designated custodian in accordance with <INSERT STATUTORY REFERENCE TO SECTION 9–105 UNDER CONTROLLING LAW>.

In addition, it will probably be desirable to establish certain assumptions concerning the ongoing performance of the document custodian and the functioning of the eVault. In particular, it will usually be necessary to assume that the eVault is functioning as anticipated and that the security controls in place to prevent unauthorized transfers of control are being correctly and consistently employed.

Here are examples of the kind of language that might be added to the section of the opinion letter concerning assumptions:

- The eVault Description is complete and accurate, and the eVault will at all times function as described in the eVault Description.
- The Debtor eVault Agreement and Secured Party eVault Agreement will remain in full force and effect and will not have been breached, until such time as the Debtor and Secured Party, respectively, no longer have any interest in the Collateral.[33]
- The authoritative copies of the Collateral, as that term is used in <INSERT STATUTORY REFERENCE TO SECTION 9–105 UNDER CONTROLLING LAW>, will be continuously maintained in the eVault.[34]
- Any transfer of control with respect to the Collateral from the Debtor to the Secured Party will be performed by a transfer of control within the eVault and will require the participation of a duly authorized representative of the Debtor to initiate the Transfer, and the participation of the Secured Party or a duly appointed authorized representative of the Purchaser is required in order to accept the transfer of control.
- The Document Custodian will establish, implement and maintain appropriate internal controls, business processes and security measures with respect to its administration and operation of the eVault so as to comply with the requirements of <INSERT STATUTORY REFERENCE TO SECTION 9–105 UNDER CONTROLLING LAW>.[35]

Finally, the opinion will need to address the question of perfection and priority (subject, of course, to the sections in the opinion letter on document review and assumptions). Here is an example of the language that might be added to the section of the opinion letter concerning perfection and priority:

- The security interest in the Collateral will be a perfected security interest upon completion of a transfer of control of the Collateral from the Debtor to the Secured Party in accordance with the procedures established by the eVault. The security interest in the Collateral perfected by the transfer of control will have priority over any other security interest in the Collateral.[36]

The opinion letter itself will likely need to include special terms addressing the additional documents reviewed, and assumptions made, as a precondition to the opinion concerning perfection and priority.

## CONCLUSION

The inclusion of electronic chattel paper in a perfection opinion will require the attorney preparing the opinion to understand both the structure for establishing "control" under Section 9–105, and the technology platform being used to provide the eVault. It will likely be necessary to review additional agreements concerning custody and management of the eVault as well.

Lastly, the opinion letter itself will likely need to include special terms addressing the additional documents reviewed, and assumptions made, as a precondition to the opinion concerning perfection and priority.

## Endnotes

1. BuckleySandler, *Digital Documents: Financing Paperless Transactions*, research study (Washington, DC: Equipment Leasing & Finance Foundation, 2015).

2. For a more detailed discussion of the law applicable to the use of electronic records and signatures in commerce, see Buckley, Kromer, Tank and Whitaker, *The Law of Electronic Signatures* (2014–2015 Edition, Thomson Reuters); See also the Standards and Procedures for electronic Records and Signatures ("SPeRS"), Version 3.0 (SPeRS Inc. 2015).

3. Revised Article 9 of the Uniform Commercial Code (2000 Revision), as promulgated by the Uniform Law Commission (hereafter "ULC"), and as amended, in certain states, by UCC Article 9 Revisions (2010), as promulgated by the ULC.

4. *See generally* Jane K. Winn, *Electronic Chattel Paper: Invitation Accepted*, 46 Gonzaga L. Rev. 407 (2010/11).

5. Legal counsel sometimes makes a distinction between issuing an opinion concerning perfection of the security interest, and issuing an opinion concerning the priority of the security interest. For purposes of this article, the authors assume that the opinion is intended to address both perfection and priority.

6. This article is presented for purposes of education and discussion. It is intended to be informational only and does not constitute legal advice regarding any specific situation, product or service.

7. Uniform Commercial Code (hereafter "UCC") § 9–102(a)(11).

8. UCC § 9–1
02(a)(31).

9. UCC § 9–312(a).

10. *See* UCC §§ 9–314(a) and (b); See also UCC § 9-105, Draft Rptr's Cmt. 2 (1998) ("Control is necessary to benefit for the special priority rule provided in Section 9-330. In descriptive terms, it provides that control of electronic chattel paper is the functional equivalent of "possession" of tangible chattel paper. . . [t]he draft leaves to the marketplace the development of systems and procedures for dealing with control of electronic chattel paper in a commercial context.").

11. *See* UCC §§ 9–330(a), (b) (emphasis added). The term "purchaser" includes a secured party taking a security interest in the chattel paper.

12. UCC §§ 1–201(29) and (30).

13. UCC § 9–314(a).

14. UCC Section 9–105, Official Comment 2.

15. UCC § 9–105.

16. UCC Article 9 Revisions (2010), as promulgated by the ULC.

17. UCC Article 9 Revisions (2010), § 9–105(a).

18. UCC Article 9 Revisions (2010), § 9–105(b).

19. UCC Section 9-105, Official Comment 4.

20. *Id.*

21. *Id.*

22. Certain eVault implementations also permit transfers of control and the authoritative copy of the electronic chattel paper from one eVault to another, subject to the same controls and procedures that apply for a transfer of control within a single eVault, and also providing for the de-certification of the former authoritative copy on the eVault relinquishing control.

23. A second model has also emerged, which uses an independent registry to record transfers of control and the location of the authoritative copy. This model has been adopted by the first residential mortgage industry for electronic mortgage notes that qualify as transferable records under Section 16 of the Uniform Electronic Transaction Act (hereafter "UETA"), but is not currently widely used with respect to electronic chattel paper.

24. As the Comment to section 12 of the UETA explains:

> *In an electronic medium, the concept of an original document is problematic*. For example, as one drafts a document on a computer the "original" is either on a disc or the hard drive to which the document has been initially saved. If one periodically saves the draft, the fact is that at times a document may be first saved to disc then to hard drive, and at others vice versa. In such a case the "original" may change from the information on the disc to the information on the hard drive. Indeed, it may be argued that the "original" exists solely in RAM and, in a sense, the original is destroyed when a "copy" is saved to a disc or to the hard drive.

UETA § 12 cmt. 2 (1999) (emphasis added).

25. UCC § 9-105(1)-(6).

26. Professor Jane Winn has observed:

> The issue is, therefore, not whether the electronic chattel paper record is absolutely unique in the sense that chattel paper represented by a piece of paper is a unique collection of atoms in the material world, because no electronic record used in an electronic business information system can be unique in that sense. Rather, the electronic chattel paper record must exist within a computer system which is designed to distinguish one special copy of the record as uniquely significant.

Jane Kaufman Winn, *Electronic Chattel Paper Under Revised Article 9: Updating The Concept Of Embodied Rights For Electronic Commerce*, 74 Chi.-Kent. L. Rev. 1055, 1061 (1999).

27. UCC § 9-105(4)–(6). Note that while Section 9–105 permits the record to be altered, so long as alterations can be identified as authorized or unauthorized, most eVaults are designed to prevent unauthorized alteration of the electronic records stored in the eVault.

28. It is also worth noting the following with respect to the rule on unalterability:

- The rule does not prohibit untracked or unmonitored changes prior to execution and issuance of the record. The record only becomes a transferable record when it is signed and issued. Pre-execution drafts may be revised or altered as necessary, with or without tracking of alterations.
- While it must be possible to determine whether alterations or revisions to the authoritative copy have been authorized, the statute does not define what constitutes an authorized change or who has to authorize the change. These issues are left to agreement or system rule.
- Revised Article 9 does not require the authoritative copy to be static over time. Hence, the rule that provides that the record may be altered to reflect its status as authoritative or nonauthoritative. The copy that qualifies as the authoritative copy at one time, during or after the transaction, need not be the same copy that qualifies as the authoritative copy at another time. All that is required is that, at any given moment, there is a single authoritative copy. So, for example, the authoritative copy may be transmitted from one location to another, which technically requires the reproduction of the authoritative copy at the place of receipt and destruction or decertification of the authoritative copy at the sending location.

29. Examples of methods that might be used to establish the linkage between the authoritative copy and control include:

- The authoritative copy of a transferable record is be created and stored in a secure electronic environment (transferable record device). Each transferable record device keeps track of the entity or entities controlling the authoritative copy of each transferable record stored on that device. The transferee takes control of a transferable record by becoming the identified party in control of the authoritative copy in accordance with a control-tracking scheme administered by the device.
- The authoritative copy of a transferable record on its face identifies a registry as the place to determine the current party in control. Owners of transferable records would register them with the identified registry. Thereafter, all transfers of control would occur under a secure transfer system operated as part of, or in conjunction with, the registry. The registry becomes the ultimate authority with regard to the question of who controls the transferable record.

30. *See*, for example, *The Collected Tri-Bar Legal Opinion Reports 1979–1998* (hereafter *"TriBar Reports"*), Section of Business Law, American Bar Association (1999).

31. It is also assumed that the opinion will include all the customary terms concerning document review and assumptions associated with chattel paper, other than those related to delivery and possession.

32. The sample language set out in this article is intended only as a series of examples — the actual language in the opinion would, of course, have to

be developed and drafted to take into account the specific circumstances of the transaction and all applicable law.

33. While it is conceivable that a breach by the debtor could impact control (such as by not complying with provisions of the agreement concerning assignment and protection of credentials for access to the eVault), it is more likely that a breach by the custodian would threaten control.

34. Note that the term "authoritative copy" is used in Section 9–105, but is not a defined term in Revised Article 9.

35. The eVault will need to be maintained in a way that ensures that the people and system processes used to create, secure, and transfer control of the authoritative copy remain reliable over time. A failure of reliability in any area could result in the failure of control under Section 9–105.

36. This statement of priority will, of course, be subject to all the additional limitations and exceptions concerning perfection and priority that are included in the opinion letter. See the *TriBar Reports* for examples.

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