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WHAT IS A TRANSFERABLE RECORD AND WHO CARES?

Jane K. Winn[*]

MICHAEL MEURER:

Our next speaker is Jane Kaufman Winn, Professor at Southern Methodist University School of Law. She has written extensively on the law of the electronic commerce, including a leading treatise in the field. She is a Board member of CALI. She co-directs SMU Center for Pacific Rim Legal Studies and is the Associate Editor of the International Lawyer. Now she is going to speak about electronic negotiated instruments.

JANE K. WINN:

A transferable record is an electronic equivalent of a negotiable instrument or document.[1] The term "transferable record" was coined in the drafting of the

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[1] An instrument is for the payment of money; a document controls title to goods. *See* U.C.C. §§ 3-104; 1-201(15). Although the UETA transferable record provision authorizes the creation of electronic documents, such as a bill of lading issued in connection with a letter of credit transaction, there do not yet appear to be significant efforts underway in the shipping industry to take advantage of this provision. *See* Chester D. Hopper, *Carriage of Goods and Charter Parties*, 73 TUL. L. REV. 1697, 1729-30 (1999) (discussing attempted development of electronic bills of lading in shipping). This paper will focus on electronic promissory notes, for which there is considerable market activity now taking place in the form of pilot projects. *See* Christopher B. Woods, *Determining Repugnancy in an*

Uniform Electronic Transaction Act (UETA)[2] and carried over to the federal Electronic Signatures in Global and National Commerce Act (E-Sign).[3] The transferable record provisions were included in these statutes largely in response to the inability of secondary mortgage markets under existing law to eliminate paper promissory notes from the real estate lending process and adopt wholly electronic alternatives. These provisions track the electronic chattel paper provisions included in the 1998 revisions to Uniform Commercial Code Article 9, which will permit lenders who take security interests in goods to enjoy the same benefits mortgage lenders were seeking.[4] The transferable record provisions now in effect in federal law and in the more than twenty states that have passed UETA should permit the reengineering of the business processes now used in real estate lending and equipment financing of a magnitude not seen in decades. In the 1970s, the development of secondary markets for real estate mortgages transformed markets in which loans were originated. Within the next few years, the routine use of electronic real estate closings should finally permit end-to-end electronic processing of real estate lending transactions, from the origination of mortgage notes through the securitization process to the final placement of pass-through certificates with the investing public. If the use of electronic promissory notes in real estate markets is a success, other types of financing transactions may follow suit. Similar developments are likely to take place in the equipment financing market after the electronic chattel paper provisions of revised Article 9 take effect on July 1, 2001.[5]

E-Sign and UETA are intended to remove unnecessary obstacles to the use of electronic media in commercial transactions. The core provisions of each statute provide that merely because a contract or signature is executed in electronic form, it cannot for that reason alone be denied enforcement.[6] These provisions authorize parties and courts to focus on the facts of the transactions in applying existing contract law doctrines to electronic contracts.[7] In addition to these generic enabling provisions aimed at commercial transactions generally, each statute includes a section designed to bring negotiable

Electronic Age: Transactions Under Writing and Signature Legislation, 52 OKLA. L. REV. 411, 453 (1999). *See generally* James A. Newell & Michael R. Gordon, *Electronic Commerce and Negotiable Instruments (Electronic Promissory Notes)*, 31 IDAHO L. REV. 819, 826-34 (1995) (discussing the conversion of paper-based documentation to electronic form in commercial transactions).

2 *See* UNIF. ELECTRONIC TRANSACTION ACT (1999) [hereinafter UETA].

3 *See* Electronic Signatures in Global and National Commerce Act, 15 U.S.C.S. § 7001 (Supp. 2001).

4 *See* REV. U.C.C. §§ 9-105, 9-203, 9-208, 9-310, 9-314, 9-317.

5 *See id.*

6 *See* 15 U.S.C.S. § 7001; UETA § 7.

7 *See* 15 U.S.C.S. § 7001(b)(1); UETA § 3(d).

instruments into the world of electronic commerce.[8]

Industries that today rely heavily on negotiable instruments, such as the real property mortgage market, needed more than just the general enabling provisions of E-Sign and UETA in order to make the switch from paper to electronic media. Negotiability is a special characteristic of some promissory notes that is established by adherence to the arcane and technical rules contained in UCC Article 3.[9] In order for a promissory note to qualify as a negotiable note, it must meet a long list of formal requirements, including the use of certain magic words, such as "pay to the order of," and the use of paper.[10] While these formalisms may seem to many to be increasingly out of touch with the realities of modern credit markets, within certain financial markets, lenders find the benefits still outweigh the costs of complying with apparently archaic rules.

Negotiability was once one of the primary foundations of commercial law because a holder-in-due course (HDC) of an instrument enjoyed special privileges and it also provided a simple, effective title transfer system. HDC doctrine is one example of the general commercial law principle of good faith purchase which applies in many types of commercial transactions. A good faith purchaser receives good title to a negotiable instrument even if the vendor had less than good title, and any party to an earlier dispute involving the negotiable instrument will only have recourse against the vendor, not against the good faith purchaser.[11] Negotiability has declined in importance both because good faith purchase rules are generally no longer as important as they once were in commercial transactions, and business information systems today are less likely to rely on possession of pieces of paper as a system of tracking ownership of assets. Residential real estate mortgage markets and secured equipment financing markets where loans are often destined for placement in securitization pools are exceptions to this general rule. Lenders in these markets fought hard for statutory recognition of electronic analogs to the paper assets they store in vaults today.

The transferable record provisions in E-Sign and UETA establish "control" as the electronic analog to possession that can be used to determine whether a transferor has good title to the electronic note.[12] This in turn makes HDC status possible for a transferee of an electronic promissory note. While these issues of negotiable instruments law are resolved in E-Sign and UETA, a host of other Article 3 issues remain unresolved. These include what modifications, if any, need to be made in the liability of indorsers or in the content of transfer and presentment warranties in light of the elimination of the paper negotiable instrument and its replacement by an electronic record. The transferable record

[8] *See* 15 U.S.C.S. § 7021; UETA §16.

[9] *See* 4 W. HAWKLAND & L. LAWRENCE, U.C.C. SERIES § 3-104:1 (2000).

[10] *See* U.C.C. § 3-104.

[11] *See* U.C.C. §§ 3-305, 3-306.

[12] *See* 15 U.S.C.S. § 7021; UETA § 16.

provision in E-Sign is nearly identical to the equivalent provision in UETA.[13] The most important difference between the two sections is that the E-Sign provision is more narrowly drawn, referring only to promissory notes secured by real property, whereas the UETA provision refers to promissory notes and documents without limitation. A transferable record can only be created if the obligor expressly agrees to execute a negotiable instrument in electronic form, so the conversion of existing paper notes into electronic form is not authorized by these statutes.[14]

Many of the rights and obligations of parties liable on negotiable instruments or those of transferees of instruments defined under the current Article 3 for transactions in paper instruments are not addressed in either statute and will need to be resolved at some point in the future. A drafting committee has been convened by the National Conference of Commissioners on Uniform State Laws (NCCUSL) to make revisions to Article 3, but the recognition of electronic negotiable instruments is outside the scope of the drafting committee's mandate.[15] Attempting to draft a complete electronic negotiable instrument law at this time was deemed premature and improvident, before marketplace acceptance of the concept has been conclusively demonstrated and in the face of possible opposition from financial market regulators and consumer advocates.[16]

Some bank regulators have expressed skepticism and even hostility to the idea of granting legal recognition to electronic negotiable instruments for several reasons.[17] Some bank regulators doubt the actual demand for such a financial asset, believing that the lack of experimentation to date in real estate or equipment financing markets may be evidence of lack of interest among lenders in such an option. While this interpretation of the lack of attempts to market electronic negotiable instruments up to the present is plausible, it may underestimate the pressures lenders targeting assets at securitization markets face to deliver guarantees of good title. Without the kind of statutory recognition UETA and E-Sign provide, purchasers of electronic negotiable instruments would face uncertainty in claiming title to assets that would be enforceable even against a bankruptcy trustee or levying creditor. Another concern of bank regulators is based on fears that electronic negotiable instruments might instead be too popular, and lead to the creation of new financial markets that are not clearly subject to existing regulations.[18]

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[13] *Compare* 15 U.S.C.S. § 7021, *with* UETA § 16.

[14] This is in contrast to the electronic chattel paper provisions of Article 9, which do anticipate secured parties may convert paper assets to electronic form. *See* U.C.C. § 9-105.

[15] *See* Robert A. Wittie & Jane K. Winn, *Electronic Records and Signatures under the Federal E-sign Legislation and the UETA*, 56 BUS. LAW. 293, 312 n.97 (2000).

[16] *See id*. at 312.

[17] *See id*; Woods, *supra* note 1, at 450.

[18] *See* Letter from Stephanie H. Heller, et al., Fed'l Reserve Bank of N.Y., to Drafting Committee of the Uniform Electronic Transactions Act (Feb. 1, 1999), *available at*

Electronic negotiable instruments, such as electronic checks, might fall into a regulatory void somewhere between the regulation of the paper-based check processing system and the wholly electronic world of electronic funds transfers. Without any experience to predict the risks of loss and hence no adequate basis for developing new regulations, bank regulators balked at the notion of authorizing electronic checks. As a result, the transferable record provisions of both UETA and E-Sign do not extend to checks.[19]

Some consumer advocates are opposed to the notion of an electronic negotiable instrument due to similar concerns that it may be too popular with the wrong sort of lenders and that existing consumer protection laws may not provide less sophisticated borrowers with enough protection from predatory lenders improperly exploiting the novelty of the concept.[20] Consumer advocates once fought against the application of HDC rules to consumer transactions as they often left consumers without any recourse against vendors of shoddy goods and services or fraudsters. In 1974, the FTC responded to these concerns by making it an unfair trade practice to ask a consumer to sign a negotiable instrument that does not preserve the consumer's right to assert any claims or defenses arising out the transaction for which the instrument was issued against subsequent transferees.[21] Although the FTC HDC Rule has dramatically diminished the relevance of the HDC doctrine in many consumer transactions, the ability of transferees to acquire HDC status still remains an important factor contributing to the use of negotiable instruments in commercial transactions and in consumer transactions outside the scope of the HDC Rule, such as real property mortgage notes. The limitation of the scope of the E-Sign transferable record provision to notes secured by real property was due in part to concerns of consumer advocates that too broad a transferable record provision might permit unscrupulous merchants and finance companies to revive old scams in new electronic forms, at least until the FTC has a chance to revise the HDC Rule to cover transferable records.[22]

Most modern information systems no longer rely on the use of physical tokens, such as paper negotiable instruments, to track of ownership of assets. More modern systems for tracking rights in assets include: UCC filing offices, which are a form of registry; registries maintained by issuers or registration agents, which are used by the U.S. Treasury and mutual fund issuers to track ownership of the financial assets they issue; motor vehicle title registration systems, which rely on a combination of a paper document of title and an entry in a central registry to track ownership of motor vehicles; and customer

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<http://www.webcom.com/legaled/ETAForum/docs/frbny.pdf>.

19 *See* Wittie & Winn, *supra* note 15, at 312.

20 *See* John D. Muller, *Selected Developments in the Law of Cyberspace Payments*, 54 BUS. LAW. 403, 418-26 (1998).

21 16 C.F.R. § 433.2 (2000).

22 15 U.S.C.A. § 7021 (2000); 146 CONG REC. S5287-88 (daily ed. Jun 16, 2000); 146 CONG. REC. H4355-56 (daily ed. June 14, 2000).

account systems maintained by regulated financial intermediaries, which are used by issuers to track ownership of financial assets such as most bonds and stocks issued by corporations as well as money in bank accounts. In some markets, however, the traditional concept of negotiability remains essential to the administration of transactions. These include the equipment financing market and the secondary market for residential real property mortgages. For industries which today must keep track of tens of millions of pieces of paper, the transferable record provisions of E-Sign and UETA will facilitate the use of more efficient electronic systems.

The cumbersome administrative processes used to keep track of financial assets issued in paper form that constitute the value held in securitization pools is in marked contrast with the very efficient administrative systems used to keep track of the financial assets created to sell shares of those pools to the public. In the United States, mutual funds and similar assets, such as rights in securitization pools, are normally administered in wholly electronic form, and paper share or pass-through certificates are not available even if investors wish to have them.[23] The conversion of these assets from paper to electronic form took place during the 1970s and 1980s. The rights of investors holding electronic shares or certificates is governed by UCC Article 8.[24] Both the 1978 and 1994 versions of Article 8 recognize "uncertificated securities" as a wholly electronic form of financial asset.[25] In the 1994 revised Article 8, a new form of commercial property represented by an electronic account entry, the "securities entitlement," was recognized.[26] In theory, the problem of converting paper negotiable instruments to electronic form might have been resolved if the real estate and equipment financing industries had cooperated to create new electronic alternatives within the framework of the revised Article 8. Since 1994, however, there has apparently been no move by participants in these markets to adopt such a scheme. While guessing why the dog did not bark is always a problematic undertaking, it seems likely that cost of reengineering current industry practices based on storing pieces of paper to completely innovative and untested industry practices based on the experience of the mutual fund industry might have seemed prohibitive.

Today, the administration of transactions in markets for real estate mortgages or equipment financing loans still requires someone somewhere to

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[23] Jane K. Winn, *Electronic Chattel Paper Under Revised Article 9: Updating the Concept of Embodied Rights for Electronic Commerce*, 74 CHI.-KENT L. REV. 1055, 1072 (1999).

[24] *See generally* U.C.C. art. 8, pt. 5; Larry T. Garvin, *The Changed (And Changing?) Uniform Commercial Code*, 26 FLA. ST. L. REV. 285, 317-20 (1999) (describing the concept of the "virtual stock certificate" in electronic commerce).

[25] *See* U.C.C. § 8-102(a)(9), (18) (defining financial assets and uncertificated securites under Article 8); Garvin *supra* note 24, at 313-20 (providing background on Article 8 and uncertificated securities in electronic commerce).

[26] *See* U.C.C. § 8-501; Garvin, *supra* note 24, at 318-20 (explaining the securities entitlement with electronic account entries).

keep track of each note or loan agreement. These industries have adopted many significant electronic commerce technologies in an effort to improve efficiency, such as the use of bar coding to track the location of particular assets more accurately.[27] The problem is that such incremental changes in administrative processes have not really made these markets significantly more efficient. Trillions of dollars of financial assets are still stored in filing cabinets. Some significant percentage of those assets go missing on a regular basis, notwithstanding the use of modern filing and storage technology. Until the assets can be converted from paper to electronic form, it is unlikely that there will be dramatic efficiency gains in the handling of these assets.

The reason that some financial markets, such as markets for mutual fund shares, have been able to become paperless, while others, such as markets for real estate mortgage and equipment financing, have not, is in some large part a reflection of the different legal regimes for determining good title to those assets. By the time investments in stocks, bonds, and mutual funds shares were converted to electronic form, securities markets had already moved to administrative systems based in part on registration of ownership and did not rely on the simple possession of a certificate to establish good title. A transfer of an investment in securities was accomplished by both the surrender of the existing certificate and by the revision of the records of the issuer or a transfer agent. The recognition of uncertificated securities merely required the elimination of the paper and the designation of the records maintained by the issuer or transfer agent as dispositive of the question of title.[28] There is no generally accepted equivalent at present of the investment securities transfer agent in real estate mortgaging and equipment leasing whose functions could be extended incrementally to permit the elimination of paper documents as evidence of ownership. The administrative systems used in real estate and equipment financing markets that guarantee that questions of title can be answered reliably are still focused simply on managing possession of paper records.

Possession of a negotiable instrument is usually essential to establishing ownership of the instrument and is also essential to establishing HDC status. No one can possess a unique electronic record in the same way that a piece of paper can be possessed, which might seem to prove that an electronic negotiable instrument cannot exist. But the concept of possession is important in negotiable instruments law not because tangible tokens are per se valuable, but because only one person can be in possession of a tangible object at one time. In order to recognize an electronic record as a token of ownership, a computer system does not need to create a physically unique electronic record.

[27] *See, e.g.,* Newell, *supra* note 1, at 824-29 (discussing current practices and possible uses of electronic commerce technologies in the real estate mortgage industry).

[28] Jane K. Winn, *Couriers without Luggage: Negotiable Instruments and Digital Signatures*, 49 S.C. L. REV. 739, 750-51 (1998) (discussing the rise of electronic record keeping, as with uncertificated securities, over paper-based systems).

If a computer system can so restrict the ability of users to claim to be owners such that there can never be more than one person at any time that can be identified as the owner of the transferable record, then the computer system has reproduced the relevant characteristic of a physical negotiable instrument.

The transferable record provisions refer to the ability of a computer system to distinguish the "authoritative copy," control over which establishes ownership, from all other copies of the transferable record.[29] An authoritative copy is "authoritative" because it identifies a unique party as the legal owner, who alone has the authority to make changes to the record or to transfer ownership of it.[30] It is a "copy" because in the digital world, information will inevitably be copied over and over as it is processed within a computer system. A transferable record control system must provide a way to distinguish between the authoritative copy and all other copies. As a practical matter, the only way to accomplish this will be through the implementation of sophisticated security procedures. So long as the system recognizes only one copy, safeguarded by rigorous security procedures, the statutory standard will be met. Other copies of the transferable record have no particular legal significance and would therefore require no particular security procedures. For example, the employees of a mortgage servicing company might be allowed to view freely "read only" copies of an electronic promissory note to check its terms, but only the party "in control" of the note should be able to transfer ownership of it.

Few computer systems in use today provide the rigorous security procedures necessary to meet the requirements of the transferable record control provisions in E-Sign and UETA. Computer systems can be designed and built today that are capable of so restricting access to resources stored in the computer, but they are normally much more expensive to create and difficult to maintain than the kind of computer systems used for other business information processing purposes. These highly secure computer systems rely on principles of information system security developed by U.S. government security experts during the Cold War. Such sophisticated security technologies rely on combinations of encryption technology, access controls, and other security devices that are not yet widely used in business computer systems.[31] The transferable record provisions are technology neutral, however, and a competitive marketplace should quickly develop among providers of such services.

The transferable record control requirements of E-Sign and UETA may strike many lawyers and IT professionals as odd, or even incomprehensible.

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[29] Electronic Signatures in Global and National Commerce Act, 15 U.S.C.S. § 7021 (Supp. 2001).

[30] *See id.* § 7021(c).

[31] *See* Michael Lee, et al., *Electronic Commerce, Hackers, and the Seach for Legitimacy: A Regulatory Approach*, 14 BERKELEY TECH. L.J. 839, 850-55 (1999) (reviewing encryption technology, access controls, and other security measures).

Most modern business information systems do not try to create a new mechanism approximating possession of a piece of paper as a system for tracking ownership, choosing instead to rely on customer account or registry systems. IT professionals familiar with conventional computer security principles might believe that the use of a sophisticated computer security technology such as digital signature technology might be adequate to meet the transferable record control requirements, but this is not correct. In effect, digital signature technology can confirm "chain of title" but cannot alone provide the equivalent of possession of a tangible object. Digital signatures can guarantee the authenticity of signatures and the integrity of the contents of a transferable record, but unless combined with strong access controls, would not be sufficient to produce an "authoritative copy" of the transferable record.

Will a market develop for transferable records? At this point, it seems quite possible, and even highly likely. A long term trend in financial markets is the disintermediation of regulated financial intermediaries by unregulated or less stringently regulated competitors that are able to reach millions of borrowers and lenders through public markets. Securitization was an obvious manifestation of that trend beginning in 1970s that accelerated in the 1980s and 1990s. The ability of non-bank financial service providers to compete with banks in ever more markets was due in some part to the development of more sophisticated information processing systems in financial markets that could accurately track fractional shares of huge pools of assets. Transferable record provisions will permit the upstream markets where the assets in the pools originate to switch from paper to electronic processes and achieve huge efficiencies as a result. Lower cost of originating wholly electronic loans should give non-bank lenders a significant competitive advantage.

It is unclear whether the same economic considerations that apply in lending markets will drive the development of new payment systems based on electronic negotiable instruments such as checks, however. If bank accounting systems can transfer funds, which are perhaps the most fungible assets that exist, reliably and with negligible costs, it may be difficult to persuade payment industry players that new investment in the enhanced computer security necessary to create electronic negotiable instruments can be justified. Loans, and especially loans secured by unique pieces of real or personal property, remain distinct assets throughout their economic life. Should a default trigger enforcement action by a lender, the ability to identify and claim a unique piece of collateral is an essential determinant of the value of a secured loan. The investment in the advanced computer systems required to create the "authoritative copy" required to have a transferable record might be much easier to justify if it guarantees that foreclosure on that collateral remains possible. A claim for a sum of money can be satisfied by a credit transfer from any source, so the effort of preserving the record of a particular payment instruction such as an electronic one as a durable, unique computer record may be hard to justify.

By creating a new legal form, the transferable record, lawmakers have opened the door to the use of electronic negotiable instruments. This should provide an opportunity to industries such as the real estate mortgage and equipment financing industries that until now have resisted the use of electronic media. The business risk created by the uncertain legal status of electronic negotiable instruments has been eliminated for the real estate industry by E-Sign and for other industries in states that have enacted UETA. What now remains is a challenge for IT professionals who will have to design and implement systems that meet the statutory standard for control of transferable records and for the lawyers called upon to advise clients whether a particular system meets the statutory standard.

MICHAEL MEURER:

You've doubled my stock of knowledge in the field. I thank you for that.