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E-Signatures Can Help with Remote Sales but Can Create Problems for Dealers and Their Finance Sources

May 1, 2020 | Robert F. Gage

Auto dealerships are one of many businesses reeling from the impact of the COVID-19 pandemic. Even where dealers are deemed an essential business and allowed to operate, buyers are avoiding the showroom.

Many dealers are thinking about ways to sell remotely, using the Internet and other technologies to complete sales or leases to consumers without requiring travel to the dealership.

Because these "remote" transactions create a host of potential legal issues for dealers to consider, we can't fully explore them in the space of one article. Instead, I want to talk about one of the challenges a dealer must address when getting contracts signed remotely.

Electronic signatures ("e-signatures") are a good option, and a quick Internet search reveals that there are plenty of cheap e-signature tools that are pretty easy to use. You can take a paper contract, scan or otherwise upload it to create an electronic record, and then send it off to be electronically signed in just a few simple steps.

But these are generic e-signature tools, designed for a wide range of transactions. They are not tailored for auto transactions, the majority of which involve some form of financing. Using one of these generic tools creates potential problems for finance sources, which means dealers must be careful when choosing an e-signature tool.

To understand one reason why, look to Article 9 of the Uniform Commercial Code. Every state has enacted Article 9, which establishes fairly uniform rules for secured transactions. Most auto financing takes the form of a retail installment contract or lease contract originated by the dealer that is then assigned to a finance source.

Article 9 refers to these kinds of contracts as "chattel paper." The assignment of chattel paper from the dealer to the finance source creates a "secured transaction" that is subject to the rules of Article 9. This is true whether the assignment is an outright sale of the chattel paper to a finance source or a pledge of the chattel paper as security for a loan to the dealer. In either case, the assigned chattel paper is "collateral" under Article 9, the dealer assigning the chattel paper is the "debtor," and the finance source is the "secured party."

Article 9 provides rules that govern how a secured party can protect its claim to collateral against a lien creditor or bankruptcy trustee-a concept known as "perfection." Article 9 also prescribes rules for determining a secured party's claim to collateral relative to the claims of other secured parties-a concept known as "priority."

There are three ways to perfect a security interest in chattel paper. One is by filing a financing statement. A second method, available for tangible chattel paper (i.e., chattel paper recorded on paper), is possession. A third method, used for electronic chattel paper, is known as "control." What constitutes control is a complex topic. All you really need to know is that, as applied to electronic chattel paper, "control" is typically achieved using computer hardware and software combined with protocols designed to reliably establish that the electronic chattel paper has been assigned to a specific secured party.

The method of perfection one uses can have an impact on the priority of one's claim to collateral.

Historically, finance sources would typically perfect their security interests in chattel paper by taking possession of the original copy of the chattel paper with the customer's wet-ink signature on it.

As electronic chattel paper has become more common, finance sources have begun to accept electronic chattel paper, provided they can take assignment of it under circumstances that will afford them with control under Article 9. Most finance sources prefer possession or control over filing as the method of perfection. Under the right conditions, possession of tangible chattel paper and control of electronic chattel paper will afford a finance source with priority over a secured creditor that perfected merely by filing, such as the dealer's floor plan provider. A finance source that merely perfects its interest in chattel paper by filing could find that its security interest is subordinate to that of a secured creditor that perfected by a prior filing.

Now let's consider a hypothetical involving a dealer who wants to use a generic e-signature tool to complete a retail installment sale. The dealer takes its paper contract form and scans or uploads it into the tool. This begins a workflow that involves an email prompting the customer to review the contract and sign electronically. The dealer gets notification of the customer's signature, which prompts the dealer to sign electronically. The signature process is complete, and the contract is saved in an electronic file that can be downloaded and/or printed.

Now our dealer wants to assign this contract to a sales finance company that typically perfects by taking possession of an original contract with a wet-ink signature. Our dealer doesn't have a wet-signed original. Instead, the dealer proposes to provide its finance source with an electronic file containing the e-signed contract. But this is electronic chattel paper, and this sales finance company relies on perfection by possession. It lacks a system for maintaining control of electronic chattel paper. As a result, the dealer's transmission of the electronic file has no effect under Article 9. This leaves the sales finance company without the ability to achieve the priority status it desires and, unless it is willing to file a financing statement, entirely unperfected.

Perhaps the dealer instead decides to print a paper copy of the e-signed contract and sends that to the sales finance company. This will also fail to satisfy the sales finance company. Our e-signed contract is still electronic chattel paper. Now the sales finance company simply has a paper copy of electronic chattel paper. The need for control is not eliminated merely by printing a paper copy.

E-signature solutions designed specifically for auto finance often allow for the conversion of electronic chattel paper into tangible chattel paper-a process commonly known as "papering out." That conversion process typically requires special controls built into the e-signature solution and some form of agreement among the parties as to the effect of the conversion. Generic e-signature tools are unlikely to allow for the conversion of electronic chattel paper into tangible chattel paper.

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