SECURED FINANCE TRENDS

Perfection of Security Interests in Electronic Bills of Lading Under the UCC

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In an increasingly paperless world, electronic bills of lading are garnering attention as an industry choice for cross-border commercial and shipping transactions. This article provides an overview of the legal framework prescribed by Articles 7 and 9 of the Uniform Commercial Code for a secured lender seeking to perfect its security interest in electronic bills of lading.

Bills of lading have a long history in commercial transactions, dating back as early as the eighteenth century.[1] Among the numerous pieces of paper that accompany shipments (certificates of origin, letters of credit and others), bills of lading are arguably the most important, as they serve several significant purposes: (1) they evidence the carriage agreement between shipper and carrier, (2) they serve as a receipt for the goods (including confirmation that the goods have been shipped on board the carrier at a named port for delivery to a named destination) and (3) a negotiable document of title evidences constructive possession of the subject goods.[2]

Electronic bills of lading ("EBOLs") are garnering increasing attention as an industry choice for cross-border commercial and shipping transactions. Compared to "tangible" bills of lading, EBOLs provide greater security, efficiency, convenience and the cost-effectiveness of utilizing an electronic medium.[3] With tangible bills of lading, there is greater time and money spent passing the physical bill of lading from party to party (which also increases the possibility of misplacement and delay), and there are greater concerns for human error and fraud since the paper can be more easily forged or mishandled. In contrast, EBOLs are generally shared and used on secure electronic systems, where access is more readily monitored and controlled. Yet authorized parties can access them almost instantaneously from any part of the world. Recent global events, such as the COVID-19 pandemic, have also encouraged industries to transition to paper-less methods to conduct business, including the use of EBOLs.

In 2014, New York State adopted, with limited modifications, the 2003 model version of Article 7 of the Uniform Commercial Code ("Model Article 7"),[4] which seeks to facilitate the use of electronic documents of title, including EBOLs, in commercial financing transactions, by including a mechanism for "control" of EBOLs.[5] EBOLs were explicitly included in the definition of "document of title" in the New York Uniform Commercial Code ("NY UCC"): "[t]he term includes bills of lading" and "an electronic document of title means a document of title evidenced by a record consisting of information stored in an electronic medium."[6]

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Perfection and enforceability of a lender's security interest in EBOLs are governed by Articles 7 and 9 of the NY UCC. Under Section 9-314 of the NY UCC, a security interest in EBOLs may be perfected by the secured party obtaining control under Section 7-106 of the NY UCC and such secured party remains perfected by control only while the secured party retains control.[7] In addition, if an EBOL is negotiable[8] under Section 7-104 of the NY UCC, perfection may be achieved by filing a UCC-1 financing statement against the debtor.[9] Establishing control is a method by which a secured party may both perfect and enforce its security interest in negotiable and non-negotiable EBOLs.[10]

The mechanism of establishing "control" with respect to EBOLs is governed by NY UCC §7-106, which provides as follows:

(a) A person has control of an electronic document of title if a system employed for evidencing the transfer of interests in the electronic document reliably establishes that person as the person to which the electronic document was issued or transferred.

(b) A system satisfies subsection (a), and a person is deemed to have control of an electronic document of title, if the document is created, stored and assigned in such a manner

that:

(1) a single authoritative copy of the document exists which is unique, identifiable, and, except as otherwise provided in paragraphs (4), (5), and (6), unalterable;

(2) the authoritative copy identifies the person asserting control as:

(A) the person to which the document was issued; or

(B) if the authoritative copy indicates that the document has been transferred, the person to which the document was most recently transferred;

(3) the authoritative copy is communicated to and maintained by the person asserting control or its designated custodian;

(4) copies or amendments that add or change an identified assignee of the authoritative copy can be made only with the consent of the person asserting control;

(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 amendment of the authoritative copy is readily identifiable as authorized or unauthorized."[11]

Thus, the general rule set forth in subsection (a) of NY UCC §7-106 requires the secured party to demonstrate, at any point in time, that the secured party is the person entitled to the electronic document.[12] The Official Comment to UCC §7-106 gives an example wherein a carrier could issue an EBOL by having the required information in a database or computer system that is encrypted and accessible by a password, and this requirement could be satisfied if such computer system identities the person as the person to which the EBOL was issued or transferred.[13] Specifically, the identification may be by virtue of password or other encryption methods. Though the foregoing example is given, notably, the Official Comment states that "[t]his Article leaves to the market place the development of sufficient technologies and business practices that will meet the [foregoing] test."[14]

While subsection (a) of NY UCC §7-106 establishes the general rule for "control" of an EBOL, subsection (b) provides a "safe harbor test" that creates one avenue by which the general test in subsection (a) can be satisfied.[15] To the meet the test under subsection (b), a party should be able to identify the single authoritative copy which is unique and identifiable as the authoritative copy; provided, however, the authoritative copy is permitted to be moved or copied from its original location so long as it remains at all times the authoritative copy.[16] These parameters in subsection (b) are not further elaborated in the Official Comment, but the drafters do point out that the parties may not contract to establish that "control" of the EBOL exists.[17] Rather, the test for control is a factual test that depends upon whether the general test in subsection (a) or the safe harbor in subsection (b) is satisfied.[18]

It is important to note that an EBOL may be reissued in a tangible form. A secured party that is perfected by control in an EBOL should file as to the EBOL that is negotiable before relinquishing control in order to maintain continuous perfection in such EBOL upon its conversion to a tangible bill of lading.[19] Reissuance in an alternative medium is different than simply printing out an EBOL. Printing out a copy of an EBOL does not convert the document into a tangible bill of lading; Section 7-105 of the NY UCC requires the issuer of the EBOL and the person entitled to the EBOL fulfill certain requirements to effectuate the conversion.

Interestingly, the Official Comment from 2003 acknowledges that third-party registry systems are "just beginning to develop" and that there are challenges to envisioning rules regulating such systems that are still developing or may not even be in existence yet.[20] For example, the drafters make a distinction between "closed" systems and "open" systems.[21] Closed systems, which appear to be the predominate type of such systems to date, are systems in which all participants are required to sign on to a master agreement, which provides for rights as against the registry system as well as rights among the members/users. The drafters contemplated that the control mechanism in NY UCC §7-106 would provide a method for the participants in the closed system to achieve the benefits of obtaining control allowed by Article 7 of the NY UCC. Conversely, in an open system, parties expecting to obtain rights through an EBOL may not be a party to a master agreement.[23]

One "closed" system explored by the authors and available today is designed so that multiple interested parties can exchange documents and information and hold copies of documents and information in their online account; however, only one party is granted functional capacity and features in their account to transfer or amend (or in the case of amendments requested through the system by other parties, to approve such requests to amend) the "original" EBOL. Only such "controlling party" holds the "original" watermarked version of the EBOL and all other parties view a version that has a "copy" watermark. The "controlling" party can transfer control to another member of the closed system, which is routinely done in the case of banks issuing letters of credit (i.e., the issuing bank would transfer the EBOL on the system to the buyer once the buyer, as applicant under the letter of credit, reimburses the issuing bank for its payment to the beneficiary).

While there is a great deal of interest in the digitization of bills of lading, there have been challenges in building one uniform system on an international level.[24] For one, there are several different closed systems that have been available and evolving in the market in the past decade, the Bolero Project and essDocs being two examples of such systems.[25] Some interested parties may hesitate to wholeheartedly adopt the electronic approach given there is not yet an international legal framework which governs use and enforcement of rights under EBOLs seamlessly across different foreign jurisdictions.

Also, from a practical and business perspective, each of the service providers compete for and target different subsections of clients and need to be acceptable to, and address the requirements of, different parties involved in the process, such as bankers, secured lenders, carriers/freight forwarders, sellers and buyers.[26]

As the market and technology evolve, it is hoped that Article 7 of the UCC will continue to provide a legal framework for secured lenders to perfect their security interests in EBOLs.[27] However, due to the ever-changing landscape of bill of lading digitization, it is not yet entirely clear how the prescribed rules will be applied in all instances in the real world. Further, application of UCC §7-106 in secured lending transactions has not yet, to our knowledge, been tested in the courts. Judicial application of Article 7 of the UCC will surely help us develop a better understanding of how market participants may utilize Article 7 with greater confidence.

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1 David A. Bury, *Electronic Bills of Lading: A Never-Ending Story?*, 41 Tul. Mar. L.J. 197, 201-202 (2016).

2 Eleanor Wragg, *How the electronic bill of lading became a battleground for trade digitization*, GLOBAL TRADE REVIEW (Dec. 07, 2021), https://www.gtreview.com/magazine/volume-19-issue-3/electronic-bill-lading-became-battleground-trade-digitisation/; CLYDE & CO FOR THE INTERNATIONAL CHAMBER OF COMMERCE, THE LEGAL STATUS OF ELECTRONIC BILLS OF LADING: A REPORT FOR THE ICC BANKING COMMISSION 8 (2018).

3 Bury, *supra* note 1, at 210-212.

4 U.C.C. ARTICLE 7, DOCUMENTS OF TITLE (2003).

5 G. Ray Warner, Rejoice In New York's Revised UCC, But Beware Traps, LAW360 (February 18, 2015), https://www.law360.com/articles/621303/rejoice-in-new-york-s-revised-ucc-but-beware-traps.

6 N.Y. U.C.C. LAW § 1-201(16) (McKinney 2014).

7 N.Y. U.C.C. LAW § 9-314(A)-(B) (McKinney 2014).

8 Under Section NY UCC §7-104, an EBOL is negotiable if, by its terms, the goods are to be delivered to bearer or to the order of a named person; any EBOL that does not meet the foregoing description (or which, at the time it is issued, contains a conspicuous legend stating that it is non-negotiable) is non-negotiable. N.Y. U.C.C. LAW § 7-104 (McKinney 2014).

9 Perfection by filing a UCC-1 financing statement is generally subordinate to perfection by control. N.Y. U.C.C. LAW §9-312(A) (McKinney 2014).

10 N.Y. U.C.C. LAW §9-203(B) (McKinney 2014).

11 N.Y. U.C.C. LAW §7-106 (McKinney 2014).

12 U.C.C. §7-106 OFFICIAL COMMENT #3 (2003).

13 *Id*.

14 *Id*.

15 U.C.C. §7-106 OFFICIAL COMMENT #4 (2003).

16 *Id*.

17 *Id*.

18 *Id*.

19 U.C.C. §9-314 OFFICIAL COMMENT #2 (2003); N.Y. U.C.C. LAW §7-105 (McKinney 2014). A party may perfect its security interest in goods covered by EBOLs that are negotiable by perfecting a security interest in the EBOLs. N.Y. U.C.C. LAW §9-312(C) (McKinney 2014). In contrast, to perfect in goods covered by EBOLs that are non-negotiable, a secured party must perfect its security interest in the covered goods themselves. N.Y. U.C.C. LAW §9-312(D) (McKinney 2014).

20 U.C.C. §7-106 OFFICIAL COMMENT #5 (2003).

21 *Id*.

22 *Id*.

23 *Id*.

24 Wragg, supra note 2.

25 *Id*.

26 *Id*.

27 As of September 30, 2023, all fifty states and Washington, D.C. have adopted some form of Model Article 7. Uniform Law Commission, *UCC Article 7, Documents of Title*, UNIFORM LAW COMMISSION, https://www.uniformlaws.org/committees/community-home?communitykey=9893636e-0046-498a-8ed9-3d57c192489a#LegBillTrackingAnchor (last visited Nov. 21, 2023).