Cassels

E-Signature and E-Vaulting – Traps in the New Environment

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The COVID-19 pandemic has accelerated the use of e-signatures in almost all aspects of life. This is particularly true in the vendor finance market where both commercial and consumer contracts are being executed electronically, often using DocuSign or like technology. Customers prefer this technology for its ease of use and simplicity. Finance companies prefer to use e-signature technology as it reduces the likelihood that signatures will be missed and it avoids uncollated documents. All in all, it is a win-win for both the customer and the vendor. The issue that arises as more contracts are executed electronically is how does the vendor then sell or securitize the finance contract that it entered into with the customer through electronic means.

There is no question that electronically executed finance contracts can be enforceable (see “Electronic Signatures in Commercial Transactions”). A finance contract can be signed in a variety of ways, including by way of example only, DocuSign or a similar technology, on an Apple iPad with a pencil signature, or signed in wet ink and then converted into PDF, scanned or photographed. At least two provinces in Canada now provide for a methodology that enables the vendor to allow its funder to take control of the electronic finance contracts to facilitate the financing of these contracts (these contracts pursuant to the *Personal Property Security Act* (Ontario) (PPSA), being “electronic chattel paper”) (see “Ontario Joins the 21st Century by Introducing Electronic Chattel Paper”). However, there is a disconnect between the method by which electronic chattel paper is executed and stored, and a funder’s ability to easily benefit from and apply the new electronic chattel paper rules that allow for taking control of electronic chattel paper.

To explain the process, it is best to use a real-world example:

An equipment dealer is selling an asset to a customer who wants to finance the acquisition by utilizing the vendor’s finance company.

1. **Scenario 1:** The vendor prepares the document package and sends it to the customer for signing by scanning or uploading the contract into a generic e-signature tool. The customer gets the electronic contract, applies its signature through the e-signature tool and returns it to the vendor. The vendor then signs the contract and stores the document in its corporate system.

It is clear in this scenario that the parties likely have an enforceable electronic contract, but, the concern will be whether this form of e-contract can benefit from the new PPSA regime of electronic chattel paper control, which has specific and exacting requirements to achieve control of electronic chattel paper similar to that found in the UCC.

2. **Scenario 2:** Another common practice is for the customer to electronically sign the document and then transmit the document by email. The finance company then prints and wet signs the document. The document is neither a full wet signature document, as both parties did not sign by wet signature, nor a full electronic document.

This scenario demonstrates the existence of a hybrid contract. These hybrid documents are causing concerns for funders which are not perfectly addressed by the PPSA regime for control of electronic chattel paper or possession of tangible chattel paper.

This article will try to explain the issue with electronic documents and hybrid contracts that we are starting to see arise in the Canadian market.

Perfection

Simply stated, in order for a funder to have a perfected security interest in any chattel paper, whether wet signature or electronic, it must perfect its interest by either (i) taking possession of the original “wet ink” chattel paper; (ii) taking control of the electronic chattel paper; or (iii) by registering its interest utilizing the Personal Property Registry System by filing a financing statement. Possession or control are always the preferred methods given the priority regime established by the PPSA. If the funder has possession or control, it knows (subject to narrow exceptions) that it has a first ranking security interest in the chattel paper.

Perfection by registration is also acceptable, but it may require the funder to obtain confirmation from third parties that such third party does not have a competing interest in the financed chattel paper. If a “wet-ink” original is utilized, then determining possession is typically straight forward. The vendor simply delivers the “wet-ink” original of the tangible chattel paper to the funder. Similarly, if the electronic chattel paper stored in a secured setting with the applicable controls as required under the PPSA (known as an e-vault) then likewise, the funder knows that it will control the electronic chattel paper within the meaning of the PPSA. The problem arises when a contract does not fall into either of these scenarios.

Electronic Documents and the Hybrid Contract

As noted above, electronic finance documents can be signed and stored in many ways. In our first scenario, the vendor had the document electronically signed by the customer but not in such a way that it can be placed in an e-vault. The method of the customer applying the signature may not conform to the methodology required for an e-vault. If the contract is signed by using a photograph of a wet signature, as opposed to DocuSign or similar technology, then it likely cannot be e-vaulted.

Further, if the storage method used by the vendor does not meet the criteria of an e-vault, then there is uncertainty as to whether control (within the meaning of the PPSA) took place. Complicating this is that the vendor may have established a proper storage methodology, but the funder has not. Each of these issues raise concern as to whether the funder has achieved perfection by control and whether it will be able to benefit from the applicable PPSA provision. As such, while execution of chattel paper electronically makes the origination of the same easier, until a proper e-vault is in place it may make securitization of those contracts more challenging if a funder intends to rely on control. Note that there are ways to "paper in" an electronic contract into an e-vault system or to "paper out" an electronic contract from an e-vault, but the requirements are typically rigid and unlikely to be satisfied simply by using the generic e-signature uses widely adopted in the market.

In our second scenario, the non-conforming issue is being referred to as a "hybrid contract": a contract which was partly executed electronically and partly by wet-ink. It is an enforceable contract but it does not meet all of the criteria in order to satisfy the control requirements under the PPSA. This is not strictly a Canadian concern as the same issue has been noted in the United States, a jurisdiction which has a much longer history of funding electronic chattel paper. A general practice appears to have evolved in the United States whereby a provision is added to the underlying lease stating that, despite the execution of the document by electronic means, the version of the hybrid contract that has the "wet ink" from the finance company will be viewed as original for the purpose of possession in the UCC. Inclusion of this provision in Canadian lease agreements offers a practical solution to the unique circumstances that hybrid contracts create, though until these provisions are tested by a Canadian court there will remain uncertainty as to if possession is achieved in hybrid chattel paper pursuant to the PPSA. Until then, we will still have to rely on registration, searches and waivers or obtaining possession of "wet ink" originals.
