



## TIPPING THE scales

# Blockchain: The Next Big Thing for Equipment Finance?

BY KEITH B. LETOURNEAU AND STEPHEN T. WHELAN

**Blockchain technology, an esoteric topic a few years ago,** has worked its way into the mainstream. Blank Rome's Keith Letourneau and Stephen Whelan provide an overview of this distributed ledger technology and discuss how it could be used in equipment, commercial and trade finance transactions.



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**T**wo years ago, most readers of this article probably had not heard of blockchain. Since then, the following events have occurred:

- The keynote speaker at the 2017 ELFA annual convention identified blockchain as one of the top five trends in equipment finance.
- In February 2018, the California legislature introduced a bill (A.2658), which would expand the definition of *electronic record* in the Electronic Records Act to include a signature that is secured through blockchain technology.
- Delaware amended its General Corporation Law to permit use of blockchain in maintaining corporate records.
- The Securities and Exchange Commission allowed *Overstock.com* to issue digital securities, using a proprietary blockchain.
- Several prestigious law schools began to offer courses on distributed ledger technology, including blockchain.

Blockchain, a type of distributed ledger technology (DLT), continues to grab headlines as it proliferates across industries and market sectors.<sup>1</sup> DLT promises

<sup>1</sup> Blockchain is the technology that underlies cryptocurrencies such as bitcoin and ether. While these cryptocurrencies and others have experienced a checkered existence, private or permissioned blockchain networks, addressed by this article, are not reliant upon cryptocurrencies for their viability.

to eliminate intermediaries, such as central clearing-houses, to facilitate transactions and the movement of goods. The essential elements of blockchain technology include computer terminal access (nodes) between each participant in the chain, the immutability of records logged into the system, a greater degree of security through the use of digital signatures and key-access software and transparency of transaction details by each participant having access to the complete ledger of real-time data. The use of smart contracts — digital computer protocols allowing the next transaction step to occur once predicate earlier steps are completed — also could amplify the utility of blockchain networks. We fully expect blockchain to reach into equipment financing transactions as the technology develops.

### How Does Blockchain Work?

Blockchain offers the potential for equipment finance transactions — especially among industry players who know and trust each other — to streamline transfer of ownership and security interests in equipment leases, loans and equipment finance agreements (EFA).

In a typical equipment lease transaction, the lessor would enter the lease — either hard copy or electronic chattel paper (ECP), it would not matter — with the lessee and would create a chain between those two parties. The same process would be used for loan or EFA contracts.

If the lessor sells or finances the contract, or receivables arising from it, then the purchaser or financier would be added to the chain. If the financing was part of an issuance of asset-backed securities (ABS) secured by hundreds of contracts, then ownership of the pool of contracts would be transferred to a special purpose entity (SPE). The SPE would pledge its ownership of the contracts and the receivables, and its interest in the equipment, to an indenture trustee or collateral agent. Both of these transfers and pledges would be added to the chain.

Some commentators have mused that blockchain is just another variant of an eVault, a service which

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provides custody of leases and loan agreements in electronic form. This is incorrect. Blockchain is a form of *distributed* ledger technology, whereas an eVault is a form of *centralized* ledger technology. Blockchain presents the possibility for equipment finance participants to bypass an eVault while maintaining and transferring electronic chattel paper.<sup>2</sup>

Other observers have remarked that blockchain could displace intermediaries such as indenture trustees and collateral agents. We disagree. When multiple parties are involved in an ABS financing, both the SPE and the investors — especially if there are tiered classes of senior and subordinate securities — will insist upon an independent trustee or agent, so the complex provisions of an indenture or credit agreement (particularly the exercise of remedies following an event of default) can be enforced by a dispassionate intermediary. As banking institutions are likely to be most familiar with financial technology, investors and originators are likely to welcome bank participation in blockchain transactions.

### Not Just For Equipment Finance

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In 2017, many companies and educational and governmental organizations created alliances to develop technological standards and proofs of concept to deploy blockchain technology in myriad fields. For example, Toyota Financial Services joined the R3 blockchain consortium to explore auto financing applications. This year, slow progress is moving markets toward greater implementation operationally, such as the joint venture of Maersk and IBM to digitize the carriage of container goods by sea. Incremental progress is being made across many industries and markets to implement blockchain solutions, but we are still at the onset of a promising new age.

The impact of blockchain technology in the trade-finance arena could prove profound in the years ahead. Blockchain solutions should enable much easier tracking of the lifecycle of documents linked to financial assets such as mortgages and secured loans, as well as the lifecycle of the asset itself.

By 2027, The World Economic Forum (WEF) projects transactions involving 10% of the world's gross domestic product will be stored using blockchain technology. For international transactions, the WEF believes DLT is well suited to eliminate trade and supply chain inefficiencies by providing faster credit risk assessment from the transaction history, minimizing human error in document checks, instantly verifying and reconciling records, automatically executing workflow steps using smart contracts and instantly and securely exchanging data at low cost. Bain projects DLT could reduce trade finance operating costs by 50% to 70%.

Blockchain technology should also serve to support *single-window* regulatory systems, enabling a company to submit all of its compliance documents through a single portal to comply with the requirements of

a country's various regulatory agencies. Single-window systems should serve to reduce the time and compliance costs associated with processing equipment transactions, especially those across international boundaries.

### Smart Contracts?

We are less sanguine that so-called smart contracts will gain a foothold, except perhaps in tracking payments and default notices for micro-ticket equipment deals.<sup>3</sup> We concur with one author who recently wrote that "it may be impossible...to envisage all the eventualities a smart contract might encounter in the real world [and] it's not at all clear that contract law abdi-

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cates responsibility in their [smart contracts] presence."<sup>4</sup> It is more likely that smart contracts would gain acceptance in commercial transactions, such as those involving an ocean bill of lading where the buyer makes payment to an overseas seller via a letter of credit.

Also noteworthy is California A.2658, which amended the definition of *contract* to include a "smart contract [which] means an event-driven program that runs on a distributed, decentralized, shared and replicated ledger that can take custody over, and instruct transfer of, assets on that ledger." Four other states reportedly have some form of blockchain legislation on the books.

Blockchain is not a solution to market forces and is not a panacea to the economic woes that ail economies, such as low growth, deficits and the lack of viable products, commodities or educated workers. Moreover, the technology is not fully developed or broadly implemented in any particular industry yet; we can expect years of overlap between existing systems and blockchain solutions before the dominant system(s) evolve.

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<sup>2</sup> However, it is unclear whether blockchain would satisfy the Uniform Commercial Code requirements for perfecting a security interest in ECP. Financiers would continue to follow the standard practice of filing financing statements to perfect "the old-fashioned way."

<sup>3</sup> See Bonanno, "Smart Contracts: The Future of Documentation & Collections," *Monitor*, (Jan/Feb 2018), 26-27.

<sup>4</sup> Hughes, "The Global Financial Services Industry and the Blockchain," 23 *Journal of Structured Finance* at 39 (Winter 2018).