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Alert | Restructuring & Bankruptcy/ Blockchain & Digital Assets

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Proposed UCC Amendments to Article 12 Shed New Light on Transacting and Securing Interests in Digital Assets

Summary of Key Uniform Commercial Code (UCC) Amendments

- **Article 12**: A proposed new Article 12 of the UCC provides rules for transactions involving certain new types of digital assets, including cryptocurrency and non-fungible tokens. Under the proposed new Article 12, these intangible assets are called "controllable electronic records," or "CERs." To ensure that the UCC remains relevant, CERs are defined to include not only assets created using today's distributed ledger or "blockchain" technology but also any assets that may function similarly using future emerging technologies.
- **Article 9**. Conforming amendments to UCC Article 9 provide rules for perfection of security interests in CERs, facilitating the use of digital assets as collateral for financing transactions.

Background

As we know it, the emerging practice of transacting in digital assets has developed into a mainstream fragment of the financial market ecosystem. Yet regulators and market participants often find themselves wrangling over unsettled questions of law, including the appropriate characterization and treatment of digital assets, how to legally protect parties from adverse claims against digital assets transferred, and how to enforce security interests in digital assets against third parties (otherwise known as "perfection") under the UCC. Regulatory silence fared no better, as it allowed the tentative answers to these questions to remain uncertain and suppositions to endure untested, causing more confusion and discomfort in the commercial arena pertaining to digital assets.

In light of these concerns, the Uniform Law Commission (ULC) and the American Law Institute (ALI) appointed a joint committee ("Committee") in 2019 to review and amend the UCC provisions to address these concerns. The Committee approved proposed amendments ("UCC Amendments") to the UCC, providing clarity in the evolving, though obscure, market for the purchase, sale, and exchange of digital assets.

Controllable Electronic Records

To determine whether Article 12 applies to a particular asset, the asset must fall within the definition of "controllable electronic record," defined as a record that is stored in an electronic medium and that can be subjected to "control."[1] The lynchpin of Article 12 is thus the ability to *control* the digital asset.

The meaning of control varies, however, depending on the type of property involved.[2] Think of a bitcoin as the prototypical CER, for example. A bitcoin normally has a specific use or benefit that one person can enjoy (think, the power to "*spend*" a bitcoin) and at the same time exclude all others from enjoying (think, the power to include an "*unspent transaction output*" in the blockchain). Moreover, a person can transfer to another person the exclusive power to use, and exclusive power to transfer, a bitcoin (i.e., private keys). They can also show others that they have the power to use and transfer control of the bitcoin (i.e., settlement of bitcoin transactions using the corresponding public *and* private keys).

The above functions and characteristics of digital assets like bitcoin form the basis of Article 12's concept of control,[3] which requires that a person have:

- The power to enjoy "substantially all the benefit" of the CER (such as through use as a medium of exchange by spending or exchanging the CER for another CER);
- The "exclusive" power to prevent others from enjoying "substantially all the benefit" of the CER; and
- The exclusive power to transfer, or to cause another person to obtain, control of the CER.

Moreover, the person must be able readily to identify itself to a third party as the person having these powers. Identification can be made other than by name, such as by use of a cryptographic key or account number.[4]

Negotiability

The UCC Amendments also confer attributes of *negotiability* to CERs, meaning that Article 12 makes CERs capable of being transferred in a way that cuts off competing security interests and property claims in and to the CER. This is useful in the context of digital assets, largely when the system for transferring a particular CER is pseudonymous (think of the bitcoin blockchain and its guiding principle of anonymity), making it increasingly challenging to verify the identity of the transferor or, critically, the source of the

[1] UCC § 12-102(a)(1). Under the UCC, a "record" is information that is retrievable in "perceivable form." Thus, an encrypted record does not give a person the power to retrieve the record in "perceivable form."
[2] *See* e.g., UCC §§ 7-106 (electronic documents of title); 8-106 (four different types of investment property, each with a different definition of "control"); 9-104 (deposit accounts); 9-105 (electronic chattel paper); *see also* UCC § 9-105A (control of electronic money).
[3] UCC § 12-105(a).
[4] UCC § 12-105(a)(2).

transferor's title. Article 12, in making CERs negotiable, alleviates this concern by providing enhanced protections to innocent purchasers of CERS:

- Article 12 affords *purchasers* the protections of the "shelter-rule," under which purchasers of a CER acquire whatever right the transferor had or had the power to transfer.[5]
- Article 12 affords *qualifying purchasers*[6] —those who purchase CERs in good faith, for value and without notice–the protections of the "take-free-rule," under which qualifying purchasers (like "holders in due course" of negotiable instruments) acquire greater rights than their transferors had or had power to transfer.[7]

Tethering and Certain Rights to Payment

Some CERs may have inherent value only because the market treats them (the information) as having value. This would include Bitcoin, Ether, or Dogecoin. On the other hand, the inherent value of other CERs may lie in the underlying *rights* of the parties to the transaction and not in the actual electronic record (or information). In this context, distinguishing between a *record* and the *rights* that such record reflects is critical.

As a general rule, Article 12 applies to *records* and not to *rights* that records evidence. And as a general matter, law other than Article 12 determines what rights are evidenced by the CER, and whether a "take-free" rule applies to those other rights (besides the CER itself) upon a transfer of the CER. This deference to "other" law now includes Article 9 of the UCC.

Article 12 provides an exception to the general rule on payment rights evidenced by CERs, that provide that the obligor (or account debtor) agrees to pay the person who has control of the CER. These payment rights, called "controllable accounts" and "controllable payment intangibles," are subject to the following rules:

- If control of a CER that evidences a controllable account or controllable payment intangible is transferred, the controllable "account" or controllable "payment intangible" follows the CER;[8] and
- If the transferee is a "qualifying purchaser," the transferee benefits from the same "take-free" rule that applies to the CER.[9]

Article 9 – Secured Lending

Before the UCC Amendments, there was no effective way for lenders to perfect a security interest in digital assets except by filing a financing statement (pursuant to the notion that digital assets fell within the "general intangibles" bucket), and no way to ensure *a security lien's priority* position other than by agreement. The proposed amendments to Article 9 address security interests in CERs as well as those "controllable" accounts and payment intangibles that CERs evidence.

The normal rules for attachment will continue to apply to security interests in CERs, and a security interest in a CER, a controllable account, or a controllable payment intangible may still be perfected by

[5] UCC § 12-104(d).
[6] UCC § 12-102(a)(2). The definition of "qualifying purchaser" derived from UCC section 3-302(a)(2), which defines "holder in due course" of a negotiable instrument.
[7] UCC § 12-104(e).
[8] UCC § 12-104(f).
[9] UCC § 12-104(a).

the filing of a financing statement.[10] Article 9, however, now affords the following special uniform rules to security interests in CERs, controllable accounts and controllable payment intangibles:

- Perfection of a security interest in a CER, controllable account, or controllable payment intangible can now also be achieved by obtaining *control* of the CER.[11]
- A security interest in a CER, controllable account, or controllable payment intangible that is perfected by *control* has priority over a conflicting security interest perfected only by filing or by another method other than control.[12]
- The rights of secured parties that take free of competing property interests[13] or receive protections and benefits as qualifying purchasers are respected and equally applicable under Article 9.[14]

Final Remarks

Despite the desire for uniformity under the UCC, states like Wyoming, Idaho, and Kentucky already have sought to implement non-uniform amendments to their respective UCC to address digital assets. For states that ultimately adopt the Committee's uniform rules, however, the UCC Amendments make room for a "transition period" during which a lender's priority (established on the date of enactment) will be maintained to protect lenders who hold security interests in digital assets perfected under the prior rules. This provides a grace period during which the parties to a preexisting loan agreement can renegotiate terms as necessary and comply with provisions of the new law to ensure that their respective interests remain protected.

No states have adopted the proposed new Article 12 yet, but it may well be adopted widely in the next couple of years.

** This GT Alert summarizes in high-level fashion only select aspects of the proposed UCC Amendments and is not meant to be a comprehensive analysis of all revisions made to the UCC.*

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[10] Both "controllable accounts" and "controllable payment intangibles" are "monetary obligations," i.e., obligations to pay "money." Cryptocurrencies are not "money" as defined in section 1-201. Therefore, obligations to pay in cryptocurrency would not be included in "controllable accounts" and "controllable payment intangibles."
[11] "Control" of a CER is determined under UCC § 12-105.
[12] UCC § 9-326A.
[13] UCC § 12-104(e).
[14] UCC § 9-331.