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The Proposed 2022 Amendments to the Uniform Commercial Code: Digital Assets



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INTRODUCTION

Work is nearing completion on proposed amendments to the Uniform Commercial Code ("UCC") to address a limited set of transactions largely involving emerging technologies, such as virtual (non-fiat) currencies, distributed ledger technologies, and, to a limited extent, artificial intelligence. The principal amendments address so-called digital assets. The rules covering transfers of covered digital assets, including security interests in those assets, are carefully coordinated so that the transactions generate predictable and consistent results.

BACKGROUND

Since 2019, a Committee appointed by the American Law Institute and the Uniform Law Commission, the sponsoring organizations of the UCC, has been considering and formulating amendments to the UCC to address emerging technological developments. The Committee has included and worked with both lawyers experienced in UCC matters and lawyers whose practices concentrate on digital assets. The work of the Committee has benefitted enormously from the contributions of American Bar Association advisors and more than 300 observers from academia, trade groups, government agencies, law firms, private technology companies, and foreign participants from multinational law reform organizations or who are active in technology-related law reform efforts in their respective countries.

The Committee presented its initial draft of the amendments to the Uniform Law Commission at the Commission's annual meeting in July of 2021. The ALI Members Consultative Group ("MCG") met and discussed the draft in October 2021. A revised draft was considered and approved by the American Law Institute Council in January of 2022. The MCG will meet again and consider the latest draft late in April. The Council of the American Law Institute approved the amendments at the Council's meeting in January 2022. The Committee hopes to obtain approval of the members of the American Law Institute at the Institute's Annual Meeting in May of 2022, and of the

Uniform Law Commission at the Commission's Annual Meeting in July of 2022. The amendments would then be offered for enactment by the states.

The following is a high-level summary of the current draft of the proposed amendments as they relate to certain digital assets.

EXECUTIVE SUMMARY

The proposed amendments respond to market concerns about the lack of definitive commercial law rules for transactions involving digital assets, especially relating to:

- a. negotiability for virtual (non-fiat) currencies,
- b. certain electronic payment rights,
- c. secured lending against virtual (non-fiat) currencies, and
- d. security interests in electronic (fiat) money, such as central bank digital currencies.

The proposed amendments address only state commercial law rules. They do not address the federal or state regulation or taxation of digital assets, regulation of money transmitters, or anti-money laundering laws. The amendments look to law outside of the UCC to answer many questions concerning digital assets.

The proposed amendments concern a class of digital assets—defined as “controllable electronic records” (“CERs”)—which would include certain virtual (non-fiat) currencies, non-fungible tokens, and digital assets in which specified payment rights are embedded. The amendments provide for a CER to be in effect negotiable, *i.e.*, capable of being transferred in such a way as to cut off competing property claims (including security interests) to the CER (a “take-free” rule).

The proposed amendments also provide for a security interest in a CER to be perfected by “control” (or by filing a financing statement) and for a security interest perfected by “control” to have priority over a security interest in the CER perfected only by the filing of a financing statement (or

another method other than “control”). There are also proposed amendments to address security interests in electronic money.

DEFINITION OF “CONTROLLABLE ELECTRONIC RECORD”

A “controllable electronic record” is a record in electronic form that is susceptible to “control.” For a person to have “control” of a CER, the person must have:

- the power to enjoy “substantially all the benefit” of the CER,
- the exclusive power to prevent others from enjoying “substantially all the benefit” of the CER, *and*
- the exclusive power to transfer 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 by a cryptographic key or account number. The exclusivity requirement is satisfied even if there is a sharing of these powers through a “multi-sig” or similar arrangement or if changes occur automatically as part of the protocol built into the system in which the CER is recorded.

The amendments include the following language:

A virtual (non-fiat) currency would be an example of a CER. If a person owns an electronic “wallet” that contains a virtual currency, the person would have control of the virtual currency if (a) the person may benefit from the use of the virtual currency as a medium of exchange by spending the virtual currency or exchanging the virtual currency for another virtual currency, (b) the person has the exclusive power to prevent others from doing so, and (c) the person has the exclusive power to transfer control of the virtual currency to another person.

If an electronic record is not susceptible to control, it is outside the scope of the proposed amendments. In addition, the definition of a CER excludes certain digital assets that might otherwise be considered to fall within the definition of that term. These assets are excluded because commercial law rules already exist and generally work well for these assets. They include electronic chattel paper, electronic documents, investment property, transferable records under the federal E-SIGN law or the Uniform Electronic Transactions Act ("UETA"), deposit accounts, and, to some extent, electronic money (discussed below).

Nothing in the proposed amendments, for example, disturbs transacting parties' current practices of using transferable records under E-SIGN. Nor do the proposed amendments affect transacting parties' ability, in effect, to "opt-in" to Article 8 of the UCC by arranging for a digital asset to be held with a securities intermediary as a financial asset credited to a securities account. Electronic money is treated separately under the proposed amendments, as described below.

RIGHTS OF A TRANSFEREE OF A CONTROLLABLE ELECTRONIC RECORD

Proposed Article 12 governs certain transfers of CERs. If a CER is purchased (which consists of a voluntary transaction, including obtaining a security interest in the CER), the purchaser acquires all rights in the CER that the transferor had. In addition, if the purchaser is a "qualifying purchaser," the purchaser benefits from the "take-free" rule, *i.e.*, the purchaser acquires the CER free from competing property claims to the CER. A "qualifying purchaser" is a purchaser who obtains control of a CER for value, in good faith, and without notice of a property claim to the CER. As with negotiable instruments and investment property, the filing of a financing statement in and of itself is not notice of a property claim to the CER.

This is summarized in the amendments as follows:

Consider again the example of a person in control of a virtual (non-fiat) currency. If the person transfers control to another person, the transferee obtains whatever rights in the virtual currency that the transferor had. If the transferee is a "qualifying purchaser" of the virtual currency, the transferee also benefits from the "take-free" rule.

TETHERING AND CERTAIN PAYMENT RIGHTS

With one important exception described in the following paragraph, what rights are embodied in the CER, and whether the "take-free" rule applies to those other rights (in addition to the CER itself) upon a transfer of the CER, are all determined by law outside of the proposed amendments. For example, the proposed amendments do not affect copyright law as it relates to someone in control of a non-fungible token "tethered" to intellectual property. Other law would determine the effect of that "tethering." Similarly, if a CER purported to evidence an interest in real estate, whether the "take-free" rule applies to the interest in the real estate upon a transfer of control of the CER would be determined under other law, presumably the applicable real estate law.

There is one important exception: An "account" or "payment intangible," as those terms are already defined in Article 9 of the UCC, embodied in a CER is a "controllable account" or "controllable payment intangible" if the account debtor (the person obligated on the account or payment intangible) has agreed to pay the person in control of the CER. If control of a CER with an embedded controllable account or controllable payment intangible is transferred, the controllable account or controllable payment intangible travels with the CER, and the transferee may benefit from the same "take-free" rule that applies to the CER. The effect is to create what is functionally an electronic instrument even though the payment rights would continue to be classified as a "controllable account" or "controllable payment intangible." If the terms of the CER provide that the account debtor will not assert claims or defenses against the transferee of the CER (as and to the extent

permitted by UCC § 9-403 and subject to consumer laws), then the effect is to create the substantial equivalent of an electronic *negotiable* instrument. These provisions respond to market concerns in the trade finance area that commercial law rules are currently insufficient for electronic promissory notes and electronic bills of exchange.

Consider a buyer of goods who delivers to the buyer's seller a promissory note in payment for the goods. If the promissory note is in a writing, it might, if certain conditions are met, qualify as a negotiable instrument under Article 3 of the UCC, and potentially a holder of the promissory note could be a holder in due course of the negotiable instrument. But, if the promissory note is in electronic form and even if those conditions are met, Article 3 does not apply because the promissory note is not in a writing. Absent the promissory note qualifying as a "transferable record" under UETA, the rights of a transferee of the promissory note would be governed under normal contract rules and some rules under UCC Article 9. Under the proposed amendments, though, the promissory note (in electronic form) could be a CER. If the promissory note were a CER, the "take-free" rule would apply to a qualifying purchaser of the promissory note. If the buyer also agreed not to assert claims or defenses against a transferee of the promissory note, the electronic promissory note would, subject to applicable consumer laws, have negotiability characteristics similar to those of a negotiable instrument under Article 3.

SECURED LENDING

The provisions applicable to purchasers of CERs are carefully coordinated with corresponding changes to lending secured by security interests in CERs under Article 9 and are designed to preserve the availability of existing transaction patterns. Under the proposed amendments, there would be no need to change collateral descriptions in security agreements or collateral indications on financing statements. A CER is a "general intangible," a controllable

account is an "account," and a controllable payment intangible is a "payment intangible," as those terms are already defined in Article 9 of the UCC. The normal rules for attachment would continue to apply, and a security interest in a CER, a controllable account, or a controllable payment intangible could still be perfected by the filing of a financing statement.

However, under the proposed amendments, a security interest in a CER, a controllable account, or a controllable payment intangible could also be perfected by the secured party obtaining "control" of the CER. A security interest in a CER, a controllable account, or a controllable payment intangible perfected by "control" would have priority over a security interest in the CER, controllable account, or controllable payment intangible perfected only by filing (or by another method other than control). Control would be defined as described above.

Another example may be helpful. SP-1 lends to Debtor, obtains a security interest in Debtor's accounts, payment intangibles, and other general intangibles, and perfects the security interest by the filing of a financing statement. SP-2 later lends to Debtor, obtains a security interest in a CER in which is embodied what is functionally an electronic promissory note payable to the person in control is embodied, and files a financing statement to perfect its security interest. SP-1's security interest has priority under the first to file or perfect priority rule of Article 9. If SP-2 obtains control of the CER, SP-2's security interest in the electronic promissory note is senior to SP-1's security interest in the electronic promissory note.

ACCOUNT DEBTOR DISCHARGE

Similar to current UCC Article 9 provisions for accounts and payment intangibles generally, an account debtor (the obligor on an account or payment intangible) receives a discharge by paying the person formerly in control until the account debtor receives a notification signed in writing or

electronically by the debtor or its secured party that the secured party has a security interest in the controllable account or controllable payment intangible and a payment instruction (often referred to a “deflection notification”) to pay the secured party as the person now in control. Following receipt of the deflection notification, the account debtor may obtain a discharge only by paying the secured party and may not obtain a discharge by paying the debtor.

Also, similar to current UCC Article 9, the debtor may ask for reasonable proof that the secured party is the person in control before paying the secured party. However, unlike under current Article 9, for a controllable account or controllable payment intangible the method of providing that reasonable proof must have been agreed to by the account debtor, presumably as part of the CER when it was created. Absent an agreed method of providing reasonable proof, the deflection notification is not effective, and the account debtor may obtain a discharge by continuing to pay the debtor.

As a practical matter, few account debtors question a deflection notification or ask for reasonable proof. However, if an account debtor does ask for reasonable proof, the relevant parties have the flexibility to develop for market acceptance methods for providing the reasonable proof.

ELECTRONIC MONEY

The current definition of “money” in the UCC is sufficient to include a virtual (fiat) currency authorized or adopted by a government, whether token-based or deposit account-based. The definition of “money” would be revised to exclude a medium of exchange in an electronic record (such as Bitcoin) that existed and operated as a medium of exchange before it was authorized or adopted as a medium of exchange by a government. However, a medium of exchange in an electronic record so excluded might still qualify as a CER.

Under current UCC Article 9, a security interest in money can be perfected only by possession. However, electronic money is not susceptible to possession. The proposed amendments provide that, if electronic money is credited to a deposit account (even one at a central bank), the normal deposit account perfection rules apply. Electronic money also would exclude money that cannot be subject to “control,” similar to control for a CER. If the electronic money is not credited to a deposit account, a security interest may be perfected by “control”. UCC § 9-332 would be amended generally to provide for a transferee of money, whether tangible or electronic, to take free of a security interest in the money. Otherwise, any “take-free” rule would be determined by the law governing the electronic money.

CHOICE OF LAW

The proposed amendments include substantially identical choice-of-law rules for the take-free rules for transferees of CERs and the perfection by control and priority of a security interest in a CER, controllable account, or controllable payment intangible perfected by control. Having the same rules promotes consistent results and predictability.

The amendments generally follow the choice-of-law approach taken in UCC Articles 8 and 9 for financial assets credited to a securities account at a securities intermediary. The application of take-free rules in connection with transfers of CERs and the perfection, effect of perfection or non-perfection, and priority of a security interest in a CER perfected by control would be determined by the law where the CER is deemed to be “located” – *i.e.*, the CER’s jurisdiction. For a CER that expressly provides its jurisdiction, perfection, other than by the filing of a financing statement, and priority are governed by the law of that jurisdiction. Otherwise the CER’s jurisdiction would be the jurisdiction whose law governs the system in which the CER is recorded. If no express provision is made in the CER or the system, the CER would be located in Washington, D.C. If Washington D.C. has not enacted the amendments, the substantive law rules of the Official Text of the

amendments would apply. However, in the case of perfection of a security interest by the filing of a financing statement, the normal debtor location rules would apply.

TRANSITION RULES

Transition rules are being developed. These rules will be designed to protect the expectations to parties to pre-amendments effective date transactions and to provide for sufficient time for parties to plan transactions post-amendments effective date.

The transition rules will likely not contain a uniform amendments effective date. for the amendments because some states appear ready to enact the amendments as early as possible. However, a uniform adjustment date is being considered. The adjustment date would give transacting parties a grace period to preserve priorities established on the effective date if the amendments would otherwise affect those priorities.

OTHER PROPOSED AMENDMENTS

The proposed amendments also contain some provisions relating to chattel paper, “bundled” transactions (involving as a single transaction for the sale or lease of goods, the licensing of software or information, and the provision of services), negotiable instruments, payment systems, letters of credit, documents of title, the meaning of “conspicuous,” and some miscellaneous amendments to the UCC. The amendments unrelated to CERs and electronic money are beyond the scope of this summary.

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