

# THE TRANSACTIONAL LAWYER

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## SUBORDINATION RULING CREATES UNWARRANTED AND UNAVOIDABLE RISKS

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A recent decision of the Bankruptcy Appellate Panel in *In re Elieff*,<sup>1</sup> a case interpreting § 510(b) of the Bankruptcy Code, creates a significant impediment to ordinary transactions for no legitimate reason. Transactional lawyers need to be aware of the decision and its implications, so that they can properly advise their clients. This article begins by explaining § 510(b). It then analyzes the BAP’s decision and its implications. It concludes by offering a bit of advice.

### BANKRUPTCY CODE § 510(b)

Section 510(b) is reasonably short. The critical portions provide as follows:

a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, [or] for damages arising from the purchase or sale of such a security, . . . shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security . . . .

The principal goal of § 510(b) is to prevent shareholder claimants from elevating their interests from the level of equity to general creditor claims.<sup>2</sup> It is based on two related premises. First, shareholders and creditors have dissimilar risks and

expectations. Specifically, shareholders accept more risk than creditors in return for the potential for higher gain: the right to share in the profits of a business.<sup>3</sup> Second, when deciding whether to extend credit, creditors often rely on the financial cushion that equity investors provide.<sup>4</sup>

The prototypical case involving a § 510(b) claim would be one for securities fraud in connection with the debtor’s issuance and sale of equity securities in the debtor. In such a case, the claimant never expected to be on par with creditors of the debtor.<sup>5</sup> Other fact patterns also present relatively easy cases under § 510(b), in the sense that subordination serves the underlying purposes of the rule. For example, an equity security holder’s claim against the debtor for breach of a contract to redeem an equity security in the debtor is subject to subordination.<sup>6</sup>

### THE ELIEFF DECISION

In *Elieff*, two individuals – Kurtin and Elieff – who together owned and operated several real estate investment and development projects, settled a series of disputes. Pursuant to the settlement agreement, Kurtin transferred his interests in several entities to Elieff, and in return Kurtin was to receive a total of \$48.8 million, to be paid in four unequal installments. Elieff and the entities were jointly and severally liable for the first payment. Only the entities were liable for the remainder of the payments. However, the agreement prohibited Elieff from taking distributions from any of the entities to the extent that such distributions would prevent satisfaction of the obligation to Kurtin.

The final two payments were not made and Kurtin obtained a \$33.9 million judgment against Elieff for breach of the settlement agreement, based on Elieff’s diversion of assets from the entities. With the judgment, Kurtin obtained a judgment lien on Elieff’s real property. In Elieff’s bankruptcy case, the trustee sought to subordinate Kurtin’s claim under § 510(b). The bankruptcy court treated Kurtin’s claim as “arising from” the transfer of Kurtin’s interests in the various entities, and subordinated it. Following a request for clarification by both parties, the court ruled that Kurtin’s lien was subsumed within the term “claim.” As a result, Kurtin’s judgment lien was subordinated to the same extent that his claim was subordinated.

The BAP affirmed. In doing so, the court first ruled that Kurtin’s claim “arises from” a purchase or sale of securities because it shared a nexus or causal relationship with such a

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A Summary of the 2022 Amendments to the Uniform Commercial Code		
Subject	Sections Amended or Added	Change Made
Controllable Electronic Records – Definition	§§ 12-102(a)(1), 12-105	Defines a controllable electronic record (“CER”) as a record in electronic form that is susceptible to a specified method of control. Note, it is imperative to distinguish between a <i>record</i> (i.e., the CER itself) and any <i>rights evidenced</i> by the record. Some CERs (e.g., cryptocurrencies and non-fungible tokens) have intrinsic value in the sense that people are willing to pay for the CER itself. Other CERs evidence ownership of a tangible or intangible asset or right, and ownership of that asset or right might or might not be transferred when the CER is transferred.
Controllable Electronic Records – Transfer of Rights Generally	§ 12-104(c), (d)	Provides that a purchaser of a CER acquires all rights in the CER that the transferor had or had power to transfer. In most cases, whether a transfer of a CER transfers rights to property represented by the CER is left to law outside the UCC.
Controllable Electronic Records – Choice of Law	§§ 1-301(c)(9), 9-306B, 12-107(c), (d)	Provides that perfection by control and priority are governed by the law of the CER’s jurisdiction. A waterfall of rules is provided to determine what the CER’s jurisdiction is: (i) the jurisdiction expressly designated as the CER’s jurisdiction in the record; (ii) the jurisdiction expressly designated as the CER’s jurisdiction in the rules of the system in which the record is recorded; (iii) the jurisdiction whose law is selected to govern in the CER; (iv) the jurisdiction whose law is selected to govern the rules of the system; (v) the District of Columbia.  Perfection by filing is governed by the law of the jurisdiction where the debtor is located.
Controllable Electronic Records – Perfection	§§ 9-107A(a), 9-312(a), 9-314(a), (b), 12-105	Provides that a security interest in a CER may be perfected by filing or control. To have control of a CER, a person must have: <ul style="list-style-type: none"> <li>• The power to avail itself of substantially all the benefit from the record;</li> <li>• The exclusive power to prevent others from availing themselves of substantially all the benefit from the record;</li> <li>• The exclusive power to transfer control of the record; and</li> <li>• The ability readily to identify itself (by name, number, cryptographic key, account number, or otherwise) as the person having these powers.</li> </ul>
Controllable Electronic Records – Priority	§§ 9-326A, 12-102(a)(2), (4), 12-104(e), (f), (g), (h)	Provides that a security interest perfected by control has priority over a security interest held by a secured party that does not have control.  Provides that a “qualifying purchaser” (which can include a secured party) takes free of a claim of a property right in the CER. To be a qualifying purchaser, a purchaser must obtain control of the CER for value, in good faith, and without notice of a claim of a property right in the CER. The filing of a financing statement is not notice of a claim of a property right in a CER.
Controllable Accounts & Controllable Payment Intangibles – Definitions	§ 9-102(a)(27A), (27B)	Creates two new classifications of collateral, defined respectively as: (i) an account evidenced by a CER; and (ii) a payment intangible evidenced by a CER. Hence, controllable accounts are a subset of accounts (not of CERs) and controllable payment intangibles are a subset of payment intangibles (not of CERs).

A Summary of the 2022 Amendments to the Uniform Commercial Code		
Subject	Sections Amended or Added	Change Made
Controllable Accounts & Controllable Payment Intangibles – Transfer of Rights Generally	§ 12-104(a), (d)	Provides that the transfer of a CER evidencing a controllable account or controllable payment intangible transfers with it the underlying account or payment intangible. As noted above, transfers of other CERs do not necessarily have this effect; whether a transferee of other CERs acquires the property represented by the CERs is left to law outside the UCC.
Controllable Accounts & Controllable Payment Intangibles – Choice of Law	§§ 9-306B, 12-107(b), (c), (d)	Same as for CERs, except that: (i) the agreement with the account debtor may specify what jurisdiction law governs; and (ii) automatic perfection for a sale of controllable payment intangibles is governed by the law of the jurisdiction where the debtor is located.
Controllable Accounts & Controllable Payment Intangibles – Perfection	§§ 9-107A(b), 9-312(a), 9-314(a), (b), 12-105	Same as for CERs, except that there is automatic perfection for a sale of controllable payment intangibles.
Controllable Accounts & Controllable Payment Intangibles – Priority	§§ 9-326A, 12-102(a)(2), (4), 12-104(e), (f), (g), (h)	Same as for CERs.
Chattel Paper – Definition	§ 9-102(a)(3), (11), (31), (47), (79)	<p>Redefines chattel paper more accurately as a right to payment, rather than as a collection of writings or records.</p> <p>Eliminates the defined terms “electronic chattel paper” and “tangible chattel paper.”</p> <p>Clarifies that if the account debtor’s monetary obligation covers not only a lease of goods but also other property and services relating to the leased goods, then chattel paper is created only if the predominant purpose of the transaction is to create a lease of goods.</p> <p>Alters the relationship between instruments and chattel paper. The definition of “instrument” now excludes “writings that evidence chattel paper.” As a result, a receivable cannot be both an instrument and chattel paper. Instead, the term chattel paper now takes precedence.</p>
Chattel Paper – Choice of Law	§ 9-306A	<p>Provides that if chattel paper is evidenced by authoritative electronic records or by both authoritative electronic records and authoritative tangible records, the law of the chattel paper’s jurisdiction governs: (i) perfection by control and possession; and (ii) priority. A waterfall of rules is provided to determine what the chattel paper’s jurisdiction is: (i) the jurisdiction expressly designated as the chattel paper’s jurisdiction in the record; (ii) the jurisdiction expressly designated as the chattel paper’s jurisdiction in the rules of the system in which the record is recorded; (iii) the jurisdiction whose law is selected to govern in the chattel paper; (iv) the jurisdiction whose law is selected to govern the rules of the system; (v) the debtor’s location.</p> <p>For chattel paper evidenced only by authoritative tangible copies, perfection by possession and priority are governed by the law of the location of the authoritative tangible copies.</p> <p>For all types of chattel paper, perfection by filing continues to be governed by the law of the jurisdiction where the debtor is located.</p>

<b>A Summary of the 2022 Amendments to the Uniform Commercial Code</b>		
<b>Subject</b>	<b>Sections Amended or Added</b>	<b>Change Made</b>
Chattel Paper – Perfection	§§ 9-105, 9-314A	<p>Replaces the separate rules for perfection by possession of tangible chattel paper and perfection by control of electronic chattel paper with a single rule under which a security interest in chattel paper can be perfected by taking possession of all the authoritative tangible copies and obtaining control of all the authoritative electronic copies. This avoids the problems that can arise when: (i) there are both authoritative tangible records that evidence the right to payment and authoritative electronic records that evidence the right to payment; or (ii) tangible chattel paper is converted to electronic chattel paper, or vice-versa.</p> <p>Modifies the safe harbor for control to be consistent with control of CERs under § 12-105. It differs from the general rule discussed above, which is based on a “single authoritative copy” of an electronic record or records, and hence is unavailable when the chattel paper is maintained on a blockchain or other distributed ledger. To obtain control under the safe harbor: (i) a person must be able to identify each electronic copy as authoritative or non-authoritative; (ii) the chattel paper, a record associated with the chattel paper, or the system in which the chattel paper is recorded enables the person to identify itself as the person to which each authoritative electronic copy has been assigned; and (iii) the person must have the exclusive powers to: (A) prevent others from adding or changing an identified assignee of each authoritative electronic copy; and (B) to transfer control of each authoritative copy. If it is established that a person has those powers, subsection (f) provides a presumption of exclusivity.</p> <p>Perfection by filing remains available.</p>
Chattel Paper – Priority	§ 9-330	<p>Consistent with the new unitary rule for perfection of a security interest in chattel paper by possession and control of all authoritative records evidencing the chattel paper, provides that a purchaser’s priority over a perfected security interest applies only if the purchaser takes possession of each authoritative tangible record and obtains control of each authoritative electronic record.</p>
Commercial Tort Claims – Attachment	§ 9-204(c)	<p>Clarifies and makes explicit that subsection (b) does not prevent a security interest from attaching to commercial tort claims as proceeds of other collateral or, through an after-acquired property clause, to proceeds of commercial tort claims. This clarification corrects and rejects two lines of cases erroneously ruling to the contrary.</p>
Instruments – Temporary Perfection	§§ 9-102(a)(47), 9-312(g)	<p>Because the definition of “instrument” now excludes “writings that evidence chattel paper,” § 9-312(g) (which itself is not amended) no longer applies to maintain perfection for 20 days if a promissory note (or other writing) that evidences chattel paper is returned to the debtor for collection or some other legitimate reason.</p>

A Summary of the 2022 Amendments to the Uniform Commercial Code		
Subject	Sections Amended or Added	Change Made
Money – Definition	§ 1-201(b)(24), 9-102(a)(31A), (54A), (79A)	Expands the Article 1 definition to include “electronic money,” but also limits the term so that it does not include an electronic record that is a medium of exchange recorded and transferable in a system that existed and operated before the medium of exchange was authorized or adopted by a government. Hence, a government electronic currency can be money but privately created cryptocurrencies, such as bitcoin and ethereum, are not money.
Money – Perfection	§§ 9-105A, 9-312(b)(4), 9-314(a), (b)	Provides that a security interest in electronic money as original collateral can be perfected only by control. Control of electronic money is defined consistently with control of a CER (discussed above).
Money – Priority	§§ 9-332(b), 12-102(a)(1).	Provides that a transferee of electronic money takes free of a security interest if the transferee obtains control of the money without acting in collusion with the debtor in violating the rights of the secured party. Electronic money is excluded from the definition of “controllable electronic record,” and therefore Article 12 does not apply to electronic money. Consequently, there is no rule providing for transferees to take free of a claim of ownership other than a security interest.
Electronic Documents of Title – Perfection by Control	§ 7-106(c), (f)	Creates a new safe harbor for control modeled on control of CERs under § 12-105. It differs from the safe harbor in subsection (b), which is based on a “single authoritative copy” of an electronic document of title and hence is unavailable when the document is maintained on a blockchain or other distributed ledger. To obtain control: (i) a person must be able to identify each electronic copy as authoritative or non-authoritative; (ii) the document, a record associated with the document, or the system in which the document is recorded enables the person to identify itself as the person to which each authoritative electronic copy has been issued or transferred; and (iii) the person must have the exclusive powers to: (A) prevent others from adding or changing an identified person to which each authoritative electronic copy has been issued or transferred; and (B) to transfer control of each authoritative copy. If it is established that a person has received those powers, subsection (f) provides a presumption of exclusivity.
Control through Another Person – Permitted	§§ 7-106(g), 8-106(d)(3), 9-104(a)(4), 9-105(g), 9-105A(e), 9-107A(a), (b), 12-105(e)	Permits a person/purchaser/secured party to have control of electronic documents, security entitlements, deposit accounts, chattel paper, electronic money, controllable accounts, controllable payment intangibles, and CERs if someone else with control, other than the transferor, acknowledges that it has control on behalf of the person.
Control through Another Person – No Duty to Acknowledge	§§ 7-106(h), 8-106(h), 9-107B(a), 12-105(f)	Provides that a person who has control of an electronic document, security entitlement, deposit account, chattel paper, electronic money, or CER is not required to acknowledge that it has or will obtain control on behalf of another person. It is unclear if this rule applies to controllable accounts or controllable payment intangibles.

A Summary of the 2022 Amendments to the Uniform Commercial Code		
Subject	Sections Amended or Added	Change Made
Control through Another Person – Duties	§§ 7-106(i), 8-106(i), 9-107B(b), 12-105(g)	Provides that a person who agrees to have control of an electronic document, security entitlement, deposit account, chattel paper, electronic money, or CER on behalf of someone else has no duties other than those agreed to or created under law outside the UCC. It is unclear if this rule applies to controllable accounts or controllable payment intangibles.
Shared Control	§§ 7-106(d)(2), (e), 9-105(d)(2), (e), 9-105A(b)(2), (c), 12-105(b)(2), (c)	Allows for control of electronic documents, chattel paper, electronic money, controllable accounts, controllable payment intangibles, and CERs to be shared, thereby authorizing multi-signature agreements. However, if Party A can exercise a control power only with the cooperation of Party B but Party B either can exercise the control power without Party A or is the transferor, then Party A does not have control.
Secured Party's Duties – Relinquish Control	§ 9-208(b)(3), (6), (7), (8)	Provides that when there is no outstanding secured obligation and no commitment to make advances, the secured party (other than a buyer of a controllable account or controllable payment intangible) having control of an electronic record evidencing chattel paper, an electronic document, electronic money, or a CER must, within 10 days after receiving the debtor's demand therefor, transfer control to the debtor or a person designated by the debtor.
Secured Party's Duties – Unknown Debtors & Obligors	§§ 9-605(b), 9-628(f)	Provides an exception to the general rule that a secured party does not owe a duty to and does not incur liability to a debtor or obligor unless the secured party knows that person is a debtor or obligor and how to contact that person. Under the exception, a secured party owes a duty to such a person if, at the later of the time the security interest attaches to a CER, controllable account, or controllable payment intangible or the time the secured party obtains control of such collateral, the secured party knows that the name or address of the person is not provided by the collateral, a record attached to or logically associated with the collateral, or the system in which the collateral is recorded. The exception reflects the policy that a secured party should not be free to avoid statutory duties if it knows at the outset of the transaction that it will not have the information necessary to fulfill those duties.
Assignor & Assignee	§ 9-102(a)(7A), (7B)	Codifies PEB Commentary No. 21 (March 11, 2020) by: (i) defining "assignee" to include both a secured party with a security interest that secures an obligation and a buyer of an account, chattel paper, payment intangible, or promissory note; and (ii) defining "assignor" as the counter-party in such transactions. This overrules judicial decisions interpreting too narrowly those terms in Part 4 of Article 9.
Buyers and Lessees of Goods Take Free of Future Advances	§ 9-323(b), (d)	Expands the rules that allow buyers and lessees of goods to take free of some future advances to cover buyers in ordinary course of business and lessees in ordinary course of business. Such buyers and lessee take free of most security interests entirely, but when they do not (because, for example, the security interest was not created by the seller or lessor), they should nevertheless take free of advances made without knowledge of the sale or lease or more than 45 days after that transaction.

A Summary of the 2022 Amendments to the Uniform Commercial Code		
Subject	Sections Amended or Added	Change Made
Conspicuousness	§ 1-201(b)(10)	Removes the “safe harbor” for contrasting type, which was inconsistent with the general rule. An extensive new comment provides further guidance. Relevant primarily to disclaimers of implied warranties under Articles 2 and 2A.
Scope of Article 2	§§ 2-102, 2-106(5),	Codifies a two-tiered test for the scope of Article 2 that combines the widely used predominant purpose test with the less widely used bifurcation approach. If the sale-of-goods aspects of a hybrid transaction predominate, then Article 2 applies. If the other aspects of the transaction ( <i>i.e.</i> , services, real property, software or other intangible property, or even a lease of other goods) predominate, then the provisions of Article 2 that relate primarily to the goods, but not to the transaction as a whole, apply.
Scope of Article 2A	§§ 2A-102, 2A-103(1)(h.1)	Codifies a two-tiered test for the scope of Article 2A. If the lease-of-goods aspects of a hybrid transaction predominate, then Article 2A applies. If the other aspects of the transaction ( <i>i.e.</i> , services, real property, software or other intangible property, or even a sale of other goods) predominate, then the provisions of Article 2A that relate primarily to the goods, but not to the transaction as a whole, apply.
Negotiable Instruments	§ 3-104(a)	Clarifies that neither a choice-of-law clause nor a choice-of-forum clause prevents a writing from being a negotiable instrument.
Remote Deposit Capture	§§ 3-105, 3-604	Clarifies that: (i) an instrument is “issued” if a drawer sends an image of and information describing an item but never delivers the item; and (ii) destruction of the writing in such a process does not discharge the obligation of a person to pay a check.
Payment Orders	§ 4A-104	Clarifies when an instruction sent pursuant to a so-called “smart contract” constitutes a payment order.
Security Procedures	§§ 4A-201, 4A-202	Clarifies that: (i) a security procedure in connection with a payment order for a funds transfer may impose obligations on the receiving bank, the customer, or both; (ii) a security procedure may require the use of symbols, sounds, or biometrics; and (iii) a requirement that a payment order be sent from a known email address, IP address, or phone number is not by itself a security procedure.



A Summary of the 2022 Amendments to the Uniform Commercial Code		
Subject	Sections Amended or Added	Change Made
Medium Neutrality – Sign & Authenticate	§§ 1-201(b)(37), 1-306 5-104, 5-116(a), 7-102(a)(11), 9-102(a)(4)(A), (7), (66), 9-104(a)(2), 9-203(b)(3)(A), 9-208(b)(1), (4), (5), 9-209(b), 9-210(a)(2), (3), (4), (c), (d), (e), 9-312(e), 9-313(c)(1), (2), 9-324(b)(2), (d)(2), 9-334(f)(1), 9-341, 9-404(a)(2), 9-406(a), 9-509(a), 9-513(b)(2), (c), 9-608(a)(1)(C), 9-611(a)(1), (b), (c)(3), (e)(2), 9-615(a)(3)(A), (4), 9-616(a)(2), 9-619(a), 9-620(a)(2), (b)(1), (c)(1), (2), (f)(2), 9-621(a)(1), 9-624(a), (b), (c)	Modifies the definition of “sign” to apply to both tangible and electronic records. References to “authenticate” and “authenticated” are replaced with “sign” and “signed.”
Medium Neutrality – Writing & Record	§§ 2-201(1), (2), 2-202, 2-203, 2-205, 2-209, 2A-107, 2A-201(1)(b), (2), (5)(a), 2A-202, 2A-203, 2A-205, 2A-208, 4A-103(1), 4A-202(b), (c), 4A-203(a)(1), 4A-207(c)(2), 4A-208(b)(2), 4A-210(a), 4A-211(a), 4A-305(c), (d), 7-102(a)(10), 8-102(a)(6), 9-616(a)(1), (b)(1)(A), (c)	Most references to “writing” and “written” are replaced with references to “record” and “in a record.”



Recent State Legislation Amending the State's Version of the UCC				
State	Legislation	Description	Date Enacted	Effective Date
Arkansas	<a href="#">2021 Ark. Laws Act 1078</a>	Added Chapter 11 to the state's commercial code. Modeled on selected provisions of a draft version of UCC Article 12 produced by the Committee on the UCC and Emerging Technologies, the act defines "virtual currency" and provides that a good faith purchaser that acquires control of virtual currency takes free of any adverse claim.	4/30/21	7/28/21
Idaho	<a href="#">2022 Idaho Laws ch. 284</a>	Enacted the "Digital Assets Act," which, among other things: (i) defines digital assets to include virtual currency; (ii) provides that a security interest in virtual currency perfected by possession or control has priority over a security interest not perfected by possession or control; and (iii) provides that a good faith purchaser takes free of a claim of a property right to the currency.	3/28/22	7/1/22
Indiana	<a href="#">2022 Ind. Legis. Serv. P.L. 110-2022</a>	Amended the state's UCC Article 9 and added a new Chapter 11 to the state's UCC, modeled on a preliminary draft the amendments and new Article 12 produced by the Committee on the UCC and Emerging Technologies. The act addresses "controllable electronic records," "controllable accounts," and "controllable payment intangibles." It defines "control," and provides that a good faith purchaser that acquires control of such property takes free of any adverse claim.	3/15/22	7/1/22
Iowa	<a href="#">H. 2445</a>	Amended the state's UCC Article 9 and added a new Chapter 14 to the state's UCC, modeled on a preliminary draft the amendments and new Article 12 produced by the Committee on the UCC and Emerging Technologies. The act addresses "controllable electronic records," "controllable accounts," and "controllable payment intangibles." It defines "control," and provides that a good faith purchaser that acquires control of such property takes free of any adverse claim.	6/13/22	7/1/22
New Hampshire	<a href="#">2022 N.H. Laws ch. 281</a>	Amended the state's UCC to adopt the 2022 amendments, based on the draft presented at the 2022 ULC Annual Meeting.	6/28/22	1/1/23
Texas	<a href="#">2021 Tex. Sess. Law Serv. ch. 739</a>	Amended the state's UCC Article 9 and added Chapter 12 to the state's UCC. The act: (i) defines "virtual currency"; (ii) provides for a security interest in virtual currency to be perfected by "control," the definition of which is taken from a draft of UCC Article 12 produced by the Committee on the UCC and Emerging Technologies; and (iii) provides that a good faith purchaser that acquires control takes free of a claim of a property right to the currency.	6/15/21	9/1/21
Utah	<a href="#">2022 Utah Laws ch. 448</a>	Enacted the Digital Asset Management Act, which: (i) defines "digital assets"; (ii) defines "control" of a digital asset; and (iii) specifies that an owner may demonstrate ownership through control.	3/24/22	5/4/22

Recent State Legislation Amending the State’s Version of the UCC				
State	Legislation	Description	Date Enacted	Effective Date
Wyoming	<a href="#">2021 Wy. Laws ch. 91</a> & <a href="#">2020 Wy. Laws ch. 103</a>	Collectively, these laws provide that: (i) a security interest in virtual currency may be perfected by possession, which is defined as the ability to exclude others from the use of property, and includes use of a private key, a multi-signature arrangement exclusive to the secured party or a smart contract; (ii) a security interest in digital securities may be perfected by control; (iii) a security interest in virtual currency or digital securities perfected by possession or control, respectively, has priority over a security interest not perfected by possession or control; and (iv) a transferee of a digital asset takes free of any security interest perfected by filing two years after the transferee takes the digital asset for value and without actual notice of an adverse claim.	4/5/21 & 3/13/20	7/1/21 & 3/13/20

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