



# Digital Assets as Collateral Under the Uniform Commercial Code

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In 2019, the American Law Institute ("ALI") and Uniform Law Commission ("ULC") began developing amendments to the Uniform Commercial Code ("UCC") to adapt to the changing landscape of transactions involving digital assets, which have experienced tremendous growth in the last decade. The proposed amendments were adopted by the ALI and ULC in summer 2022 and have since been adopted into law by various state governments, including Alabama, California, Colorado, Delaware, Hawaii, Indiana, Nevada, New Hampshire, New Mexico, North Dakota, and Washington.

The updated rules offer guidance for transactions involving virtual currencies, blockchain technology, artificial intelligence, and other similar technological advancements. These amendments extend across nearly all sections of the UCC and introduce a new Article 12 that defines "Controllable Electronic Records" ("CERs") as a particular type of digital asset. The new set of rules outlined in the amendments will govern transactions involving these novel technologies, while also clarifying the UCC's applicability to mixed transactions that involve both goods and services. Alongside these revisions, the amendments include some miscellaneous changes that offer clarifications that are not directly related to technological developments.

The Uniform Commercial Code's Article 12 and its accompanying amendments treat cryptocurrencies and certain digital assets as intangible assets that are easily negotiable, much like money. Additionally, a security interest in such assets can be perfected by way of control, much like a financial asset.

## **Controllable Electronic Records**

The introduction of controllable electronic records ("CERs") simplifies the process of securing first-priority security over certain digital assets through control. The central idea behind the proposed UCC Article 12 is the concept of a controllable electronic record, which is defined as a record stored in an electronic medium that is subject to control under Section 12-105. The definition specifically excludes certain types of collateral from the definition of CERs, such as "controllable accounts" and "controllable payment intangibles." CERs are merely records that may represent valuable personal property like Bitcoin, Ether, or nonfungible tokens ("NFTs").

Along with the new UCC Article 12, there are amendments to UCC Article 9 that classify new types of electronic assets, such as controllable accounts, controllable payment intangibles, and electronic money, among others. A controllable account is defined as an account that is evidenced by a controllable electronic record that obligates the account debtor to pay the person who has control of the CER under UCC Article 12-105. Similarly, a controllable payment intangible is a payment intangible that is evidenced by a controllable electronic record that obligates the account debtor to pay the person who has control of the CER under UCC Article 12-105. These concepts enable certain assets to be effectively "tethered" or attached to corresponding CERs. This is particularly important for digital assets like NFTs, which may not be valuable personal property in and of themselves but rather refer to some other underlying right or property.

The term "electronic money" pertains to money that is in an electronic form, which includes any digital currency that is supported by a government. However, the definition of "money" in UCC Article 1 has been revised to exclude any "electronic record that serves as a medium of exchange recorded or transferable in a system that existed and operated for the medium of exchange before the government authorized or adopted it." This exclusion ensures that cryptocurrencies that were made legal tender by a government before the amendments to the UCC, such as Bitcoin in El Salvador in 2021, are not considered "electronic money" under the UCC. Conversely, any digital currency subsequently authorized or adopted by a government would fall under the definition of "electronic money," given that the other criteria of "money" are met.

### **Smart Contract Control Agreements**

Control can be established through various means, including direct control, third-party custodians, or smart contract control agreements.

According to the proposed UCC Article 12-105(a), control over a CER is established by a person when such person has control over the electronic record itself, a record that is attached to or logically connected with the electronic record, or a system that stores the electronic record:

1. Gives the person (a) the power to avail such himself or herself of substantially all benefits from the electronic record; and (b) exclusive power (i) to prevent others from availing themselves of substantially all the benefits from the electronic records; and (ii) to transfer control of the electronic record to another person or cause another person to obtain control of another controllable electronic record as a result of the transfer of the electronic record; and
2. Enables the person readily to identify himself or herself in any way, including by name, identifying number, cryptographic key, office, or account number.

The notion of control is centered around two primary aspects: (1) the capacity to derive most of the advantages from the electronic record, and (2) the sole authority to prohibit others from accessing these advantages, as well as the power to pass control of the electronic records to someone else.



Exclusive power or control may not be limited to a single person and can be shared by multiple parties. Additionally, a person may acquire exclusive power or control through a second party, provided that the second party (1) has exclusive control of the electronic record and (2) acknowledges that such second party has control on behalf of the first person or will obtain control of the electronic record on behalf of the first person. This provision enables secured parties to take control of a CER held by a third-party custodian, such as a cryptocurrency exchange, or through a control agreement similar to an investment property. Importantly, under the proposed UCC Article 12-105(b), control may be obtained even if the CER, a record attached to or logically associated with the CER, or a system in which the electronic record is recorded limits the use of the electronic record or has a protocol programmed to cause a change, including a transfer or loss of control or a modification of benefits afforded by the electronic record.

In terms of concepts, this provision allows for the use of "smart contracts" in controlling CERs. Smart contracts are software that carries out predetermined actions based on pre-established conditions written in code. This creates an alternative to traditional control agreements. In practice, this alteration has the potential to simplify and reduce the cost of securing an interest in CERs through control, by eliminating the need for lengthy and expensive control agreements.

### **Extension of the "Shelter Rule"**

By extending the "shelter rule" to CERs, purchasers who acquire certain digital assets for fair value, in good faith, and without notice of adverse claims can obtain such CERs free and clear of encumbrances, and with the same rights as the transferor. This means that CERs can be easily transferred. One of the essential characteristics of cryptocurrencies and other digital assets is their transferability. If digital assets were not transferable, transferees would have to be careful in accepting them as payment because any security interests associated with those digital assets could continue to encumber them regardless of ownership.

The proposed UCC Article 12 addresses and resolves the issue by extending the shelter rule to CERs, which is similar to current UCC provisions governing the sale of goods, negotiable instruments, or investment property. This extension ensures that CER purchasers who acquire these digital assets for a fair value, in good faith, and without notice of adverse claims will obtain the CERs unencumbered and with the same rights as the transferor, making CERs readily negotiable, establishing that:

1. a buyer of a CER will obtain the same underlying rights associated with the CER as the transferor held; and
2. individuals known as "qualifying purchasers" - meaning transferors who obtain control of a CER for fair value and without knowledge of any adverse claims obtain such CER free and clear of encumbrances.

It should be noted that the shelter rule specified in the proposed UCC Article 12 pertains solely to CERs, and not to any payment or property rights represented by a CER, except for a controllable payment



intangible or account, unless stated otherwise by other laws. The expansion of the shelter rule to CERs is an essential element of the proposed UCC Article 12, providing significant reassurance to those who receive CERs as payment.

### **Additional Changes to UCC**

The proposed UCC Article 12 is not the only proposed amendment to the UCC. There are also proposed amendments to other articles of the UCC, such as Article 9, which deal with the attachment and perfection of a security interest in CERs and governing law provisions. These proposed amendments make it clear that the existing rules of attachment apply to CERs and that a security interest in a CER, controllable account, or controllable payment intangible can be perfected by registering a financing statement, just like any other "general intangible." However, a security interest in a CER, controllable account, or controllable payment intangible also can be perfected by control under the proposed UCC Article 12, similar to a security interest in investment property, which gives it priority over other security interests in the same collateral that are perfected by registration alone.

The proposed amendments to UCC Article 9 also provide clarity on the governing law rules for collateral consisting of CERs. As with investment property, the amended UCC Article 9 states that the law of the debtor's jurisdiction governs perfection, but not priority, of a security interest in a controllable account, controllable payment intangible, or CER where registration is used for perfection. However, in all other situations, the local law of the CER's jurisdiction governs perfection, the effect of perfection or non-perfection, and the priority of a security interest in a CER, controllable account, or controllable payment intangible. Proposed UCC Article 12-107(c) and (d) provide further details on this matter:

1. if the CER explicitly designates a specific jurisdiction as its UCC jurisdiction, then that jurisdiction applies;
2. if no specific jurisdiction is designated by the CER, but the rules of the system where the CER is recorded designate a particular jurisdiction as its UCC jurisdiction, then that jurisdiction applies;
3. if neither the CER nor the recording system rules specify a UCC jurisdiction, but the CER specifies a governing law jurisdiction, then that jurisdiction applies;
4. if still no jurisdiction is designated, but the recording system rules specify a UCC jurisdiction, then that jurisdiction applies; and
5. finally, if none of the above rules apply, then the District of Columbia serves as the CER's jurisdiction of last resort

The revisions to UCC Article 9, combined with the introduction of UCC Article 12, aim to provide clear and organized guidelines for secured transactions involving digital assets under US law. The new and modified UCC provisions establish a practical and logical framework that aligns with and expands upon the current provisions of the UCC. These advancements will offer lenders substantial direction and reassurance when



utilizing controllable digital assets as security.

If you have questions about the amendments to the Uniform Commercial Code, please contact Dale Werts.