

Perfecting digital assets: There's no control without power

By Joseph Cioffi, Esq., Adam Levy, Esq., and Christine DeVito, Esq., Davis+Gilbert LLP

MAY 19, 2023

In 2022, the Uniform Law Commission adopted new amendments to the model Uniform Commercial Code ("UCC") to address cryptocurrency transactions, including secured lending involving digital assets. These amendments have been enacted by at least five states (Washington, New Mexico, Colorado, Indiana and North Dakota) and introduced in another 21 states (including California and Texas, but not New York).

If the UCC amendments become widely adopted, it should be a welcome change to the crypto space, bringing uniformity to the law and reducing risk in virtual currency transactions.

A category of digital assets that controls

A new Article 12 creates a legal regime for transactions involving a new category of digital assets referred to as "Controllable Electronic Records" (CERs). A CER is defined simply as a "record stored in an electronic medium that can be subjected to control under Section 12-105." UCC § 12-102(1).

If the UCC amendments become widely adopted, it should be a welcome change to the crypto space, bringing uniformity to the law and reducing risk in virtual currency transactions.

To have such "control," a person must meet three elements. They must have (i) the "power to prevail itself" substantially of the CER's benefits; and (ii) "exclusive power" to prevent others from doing so and to transfer control. UCC § 12-105. Further, (iii) the CER must "enable[] the person readily to identify itself in any way ... as having [those] powers." *Id.*

Essentially, this concept of "control" is analogous to "possession" of a tangible asset. By way of example, holding Bitcoin or non-fungible tokens (NFTs) in your own digital wallet would likely constitute "control" under this test.

Note that the UCC intentionally makes the definition of a CER broad enough to sweep in forms of digital assets that have not even yet

emerged. Even so, the definition of CERs carves out certain items, such as deposit accounts and electronic money (virtual currency adopted by governments). See UCC § 12-102(1).

Crypto is negotiable

To reflect the reality that market players often use crypto assets as payment devices, the UCC amendments seek to increase the negotiability (*i.e.*, transferability) of CERs. For example, Article 12 creates a "shelter-rule" under which a purchaser of a CER "acquires all rights in the [CER] that the transferor had or had power to transfer." UCC § 12-104(d).

And, under the "take-free" rule, a "qualifying purchaser" acquires its interest in the CER free from any competing property claims. UCC § 12-104(e). 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. UCC § 12-102(a)(2). This definition is derived from UCC Section 3-302, which governs "holders in due course" of negotiable instruments.

In practice, these rules will avoid, at least for qualifying purchasers, the cumbersome task of performing a UCC-1 search before engaging in each crypto transaction. Qualifying purchasers, because they will have "control" over the digital asset, will acquire their interests free from any competing claims, including security interests perfected by the filing of financing statements.

Getting digital priorities straight

Under the UCC amendments, Article 9's definition of "general intangibles" now formally includes CERs. UCC § 9-312(a)-(b). Ordinarily, a person creates a security interest in a general intangible by filing a UCC-1 financing statement. If a general intangible is subject to a security interest perfected by such a filing, the person purchasing the property would typically take it subject to the security interest.

Again, this framework conflicts with market expectations and creates problems for market participants that use digital assets to make payments. To address this, the UCC clarifies that a security interest in a CER can be perfected by either: (i) "control" under Section 12-105 or (ii) filing a financing statement. UCC § 9-312. Significantly, a security interest in a CER perfected by "control"

has priority over a security interest perfected only by the filing of a financing statement. See UCC § 9-326A.

Under the UCC's new regime, potential ways a lender can perfect a security interest in a borrower's crypto include having the crypto transferred to an escrow account or obtaining the private keys to the borrower's wallet.

Auxiliary issues addressed by the amendments

In addition to providing clarity on fundamental commercial issues such as the negotiability of CERs and priority of security interests, the UCC amendments also address other important issues concerning digital assets. For example, amendments to UCC Article 8 address custody and ownership rights of CERs in the event of insolvency or bankruptcy. Also, the new Article 12 contains choice-of-law rules for CERs. See UCC § 12-107.

Looking ahead — the amendments' potential influence on state and federal laws

Over the last few years, multiple states have enacted their own crypto laws regulating the transfer of digital assets, including Idaho, Kentucky, Wyoming and Tennessee. These state laws often use different terminology and employ concepts and rules that conflict with each other.

As more states continue to adopt the UCC amendments, market participants will have clearer, more uniform, rules to guide virtual currency transactions. The amendments will also help courts, including bankruptcy courts, that are tasked with determining who has priority over digital assets held by debtors.

About the authors



Joseph Cioffi (L) is a partner at **Davis+Gilbert LLP**, where he is chair of the insolvency and finance practice. He has transactional, insolvency and litigation experience in sectors marked by significant credit and legal risks, such as, subprime lending and emerging industries. He can be reached at jcioffi@dglaw.com. **Adam Levy (C)** is an associate in the insolvency and finance group at the firm. He helps creditors resolve their most significant commercial disputes, including fraudulent and preferential transfer actions and financial products litigation. He can

be reached at alevy@dglaw.com. **Christine DeVito (R)** is an associate in the corporate and transactions and insolvency and finance groups of the firm. She helps creditors protect their rights in bankruptcy cases and supports borrowers and lenders in negotiating credit agreements. She can be reached at cdevito@dglaw.com.

Certain states' rules also appear to conflict even with the UCC amendments, including, for example, Wyoming's "take-free" rule. It provides that a transferee takes a digital asset free of any security interest two years after it is taken for value without actual notice of an adverse claim. See Wyo. Stat. Ann. § 34-29-103(d). As such, certain states that plan to adopt the UCC amendments may need to simultaneously amend their existing crypto regulations to eliminate conflicts with the UCC.

To reflect the reality that market players often use crypto assets as payment devices, the UCC amendments seek to increase the negotiability (i.e., transferability) of CERs.

The UCC's new rules may also influence federal law making. Since the emergence of digital assets more than a decade ago, regulators and lawmakers have grappled with the question of how to characterize them, for example as securities, commodities or something else. At least the UCC amendments have made clear that digital assets can be negotiable instruments.

Joseph Cioffi is a regular contributing columnist on consumer and commercial financing for Reuters Legal News and Westlaw Today.

This article was first published on Reuters Legal News and Westlaw Today on May 19, 2023.