UCC Article 12 – A sensible framework for secured transactions involving cryptocurrencies or other digital assets

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Introduction

Under the incoming UCC Article 12 and related amendments, cryptocurrencies and certain other digital assets will be treated as **intangibles, that are readily negotiable (like money), and over which a security interest can be perfected by way of control (like a financial asset).**

As background, the Uniform Commercial Code's (UCC) sponsoring organizations – the American Law Institute (ALI) and Uniform Law Commission (ULC) – have been working since 2019 on amendments to the UCC to address the evolving world of transactions involving digital assets. This is in response to the tremendous growth in the digital asset economy over the past decade.

The ALI and ULC adopted the proposed amendments in May and July 2022, respectively, and since then, various state governments have begun adopting the amendments into law, including Iowa, Indiana, Nebraska, New Hampshire, and the District of Columbia

As with previous amendments to the UCC – for example, with respect to taking security over investment property – we expect that a "Canadianized" version of the proposed UCC Article 12 and related amendments will be introduced in Canadian provinces in the future

Key takeaways

- The concept of **controllable electronic records** (CERs) makes it simpler for secured parties to take first priority security over certain digital assets by way of control.
- Control can be direct, through third party custodians, or by way of "**smart contract**" control agreements.

- Extension of the “shelter rule” to CERs ensures purchasers acquiring certain digital assets for fair value, in good faith, and without notice of adverse claims, will take the CERs free and clear of encumbrances and with the same rights as the transferor – in other words, CERs are readily **negotiable**.
- As with previous amendments to UCC, we anticipate and welcome analogous amendments to be made to Canadian personal property security legislation.

“Controllable electronic records”

At the heart of 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 can be subject to control under Section 12-105*…”. The definition specifically excludes certain types of collateral from the definition – among them, “controllable accounts” and “controllable payment intangibles”, which are discussed further below.

It’s critical to emphasize that controllable electronic records are merely just that – records. CERs may itself be valuable personal property (such as Bitcoin, Ether, or certain non-fungible tokens (NFTs)). Alternatively, CER may merely evidence other types controllable electronic assets introduced by the proposed UCC amendments – among them, controllable accounts or controllable payment intangibles.

“Controllable accounts” and “Controllable payment intangibles”

In addition to the new UCC Article 12, there are amendments to UCC Article 9 that categorize new types of electronic assets. These include, controllable accounts, controllable payment intangibles, and electronic money, among others.

“**Controllable accounts**” are defined as an account evidenced by a controllable electronic record that provides that the account debtor undertakes to pay the person that, under UCC Article 12-105, has control of the controllable electronic record.

“**Controllable payment intangible**” means a payment intangible evidenced by a controllable electronic record that provides that the account debtor undertake to pay the person that, under UCC Article 12-105, has control of the controllable electronic record.

The concepts of controllable accounts and controllable payment intangibles permit, among other things, certain assets to effectively become “tethered”, or attached to, corresponding CERs. These concepts are critical to digital assets such as NFTs, which in some circumstances are not themselves valuable personal property, but rather, merely refer to some other underlying right or property[1] .

“**Electronic money**” is defined as money in an electronic form, and would extend to any digital currency backed by a national government. However, the definition of “money” under UCC Article 1 has been amended to specifically exclude any “electronic record that is a medium of exchange recorded or transferable in a system that existed and operated for the medium of exchange **before** the medium of exchange was authorized or adapted by the government”. This exclusion ensures that cryptocurrencies adopted by a national government prior to these amendments (such as Bitcoin, which has been

legal tender in El Salvador in 2021) are **not** "electronic money" under the UCC. Conversely, any electronic currency subsequently adopted by a national government would be included in the definition of "electronic money" (assuming the other requirements of "money" are present).[2]

"Control" of a CER under UCC Article 12

Under the proposed UCC Article 12-105(a), a person has control over a CER if the electronic record, a record attached to or logically associated with the electronic record, or a system in which the electronic record is recorded:

1. gives the person:
    A. the power to avail itself **of substantially all benefit** from the electronic record; and
    B. **exclusive power** (…) to:
        i. prevent others from availing themselves of substantially all the benefit from the electronic records; and
        ii. 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 itself in any way, including by name, identifying number, cryptographic key, office, or account number, as having the powers specified under paragraph (1).

As set out in the definition, key to the concept of control are (1) the ability to **enjoy substantially all the benefits** from the electronic record, (2) and the **exclusive power** to prevent others from availing themselves of such benefits, and to transfer control of the electronic records to another person.

Exclusive power/control may be shared among more than one person. Further, a person may obtain exclusive power/control through a second person, where that second person (1) has exclusive control of the electronic record and (2) acknowledges that it has control on behalf of the first person, or that it will obtain control of the electronic record on behalf of that first person. This would permit, among other things, a secured party to take control of a CER held with a third party custodian, such as a cryptocurrency exchange, or through a control agreement (in similar manner to investment property).

Critically, the proposed UCC Article 12-105(b) permits control to be taken even if:

> "*the CER, a record attached to or logically associated with the electronic record, 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*".

Conceptually, this language makes it possible to enter into control agreements with respect to CERs by way of "smart contracts" – that is, software programmed to execute pre-determined actions upon completion of pre-determined conditions as communicated via code – as an alternative to the traditional, prosaic form of control agreement. Practically speaking, this change could potentially make it comparatively simple and

cost effective to perfect a security interest in CERs by way of control, dispensing with the need to prepare lengthy and costly control agreements.

Negotiability – Extension of the "shelter rule" to CERs

An essential attribute of cryptocurrencies and other digital assets is negotiability. Without negotiability, transferees of those digital assets would need to be cautious in accepting that medium as a form of payment, as any security interests attaching to those digital assets could continue encumbering the digital asset regardless of its ownership.

The proposed UCC Article 12 resolves this question: Similar to existing UCC provisions regarding money, the sale of goods, negotiable instruments or investment property, the proposed UCC Article 12 extends the "shelter rule" to CERs, ensuring that:

- a purchaser of a CER will acquire the same underlying rights attaching to the CERs as were held by the transferor; and
- so-called "qualifying purchasers" – that is, transferors that take control of a CER in exchange for fair value and without notice of any adverse claims (analogous to the "protected purchaser" concept under the *Securities Transfer Act* (BC)) – will take the transferred CER free and clear of encumbrances or other adverse claims.

It's important to note that, unless provided for under other law, the "shelter rule" under the proposed UCC Article 12 applies only to CERs, and not to any payment right or property right evidenced by a CER (other than a controllable account or controllable payment intangible).

Extension of the "shelter rule" to CERs is a critical component of the proposed UCC Article 12, and will give tremendous comfort to anyone accepting CERs as a form of payment[3] .

Attachment, perfection, and governing law

The proposed UCC Article 12 is complimented by proposed amendments to other articles of the UCC – in particular, UCC Article 9 regarding attachment and perfection of a security interest in CERs, and governing law provisions.

The incoming UCC amendments confirm that the existing rules of attachment apply to CERs, and that a security interest in a CER, controllable account, or controllable payment intangible may be perfected by way of registration of a financing statement (the same manner as any other "general intangible"). However, similar to a security interest in investment property, a security interest in a CER, controllable account, or controllable payment intangible may be perfected by control under the proposed UCC Article 12, and thereby receive super-priority over other security interests in the same collateral perfected by registration alone.

Finally, the incoming amendments to UCC Article 9 set out the governing law rules for collateral comprised of CERs. Similar to the governing law rules in respect of investment property, the amended UCC Article 9 sets out that the law of the jurisdiction

where the debtor is located governs perfection (but not priority) of a security interest in a controllable account, controllable payment intangible, or CER, where perfection is by way of registration. However, in all other circumstances, the local law of the CER's jurisdiction governs perfection, effect of perfection or non-perfection, and priority of a security interest in a CER, controllable account, or controllable payment intangible. Under the proposed UCC Article 12-107(c) and (d):

- where a CER expressly provides that a particular jurisdiction is the CER's jurisdiction for purposes of the UCC, then that jurisdiction applies;
- if no such jurisdiction is expressly provided, and the rules of the system in which the CER is recorded expressly provides that a particular jurisdiction is the CER's jurisdiction for the purposes of the UCC, then that jurisdiction applies;
- if still no such jurisdiction is expressly provided, and the CER expressly provides that the CER is governed by the laws of a particular jurisdiction generally, then that jurisdiction is the CER's jurisdiction;
- if still no such jurisdiction is expressly provided, and the rules of the system in which the CER is recorded expressly provides that a jurisdiction is the CER's jurisdiction generally, then that jurisdiction is the CER's jurisdiction; and
- finally, if still no such jurisdiction is expressly provided, then the District of Columbia is the CER's jurisdiction (effectively, the "jurisdiction of last resort").

To the extent the proposed UCC Article 12 and corresponding amendments are adopted into the Canadian PPSAs, an alternative "jurisdiction of last resort" will be necessary, to take the place of the District of Columbia. A sensible alternative might be to have the debtor location rules under Section 7 of the British Columbia PPSA (with respect to intangibles) apply to CERs, which would deem the jurisdiction in which the chief executive office of the debtor is located serve as the "jurisdiction of last resort".

Conclusion

The proposed amendments to UCC Article 9 and introduction of UCC Article 12 together bring much-needed clarity and structure under US law to the world of secured transactions involving digital assets. The new and amended UCC provisions provide a practical, sensible framework that is consistent with, and builds on, the existing provisions of the UCC. These developments will give lenders significant guidance and comfort in using such controllable digital assets as collateral security.

As with previous amendments to the UCC, we anticipate that Canadian provincial governments in the future will introduce analogous amendments and legislation. Such updates to personal property security legislation are much-needed, and would help ensure Canadian provinces remain leaders in the emerging digital economy.

In the meantime, we note that Canadian regulation over digital assets is becoming increasingly robust, with the Canadian Securities Administrators (CSA) recently confirming that platforms dealing with digital assets are prohibited from offering margin or leverage to any Canadian client, and must keep all Canadian client assets segregated from the platform's proprietary business.

For more information regarding secured transactions involving digital assets, please reach out to any of the key contacts listed below.

[1] To confirm, this does not imply that NFTs are derivatives, which is beyond the scope of this article.

[2] Since Bitcoin became legal tender in El Salvador in 2021, it technically exhibits the components of "money" under the British Columbia PPSA. For reference:

"**money**" means a *medium of exchange*
(a) authorized by the Parliament of Canada, or
(b) *authorized or adopted by a foreign government as part of its currency*;

[3] The existing "shelter rule" for money at Section 31(1) of the British Columbia PPSA could extend to Bitcoin, given Bitcoin exhibits the components of "money" under the Section 1(1) definition.

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