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# Overview of 2022 Amendments to the Uniform Commercial Code – Emerging Technologies

The Uniform Commercial Code (UCC) is a set of rules to govern commercial transactions. For over sixty years the UCC has worked to facilitate commerce throughout the United States because it has been adopted in nearly identical form by every U.S. jurisdiction. As a result, it does not matter if the parties to a transaction are in different states – the law governing the transaction is substantially the same.

The UCC has been so widely accepted because its provisions are sensible and consistent with most people's expectations. For example, if a merchant agreed to sell the same television to two different buyers, obviously only one of them could take delivery of the television and use it. Under the UCC, the merchant would be required to either provide an equally good television to the second buyer or to refund the purchase price. This is a simple example, but illustrative. The UCC contains many such rules to provide ready answers when something goes wrong with a transaction.

Most UCC rules, when third party rights are not involved, are default rules. The parties to any particular transaction can agree to different terms in a contract and their agreement will be enforceable. But if they have not agreed otherwise the UCC default rules will apply. In this way, the UCC provides legal certainty, which in turn gives many millions of Americans the confidence to conduct business with strangers. Because this uniform set of rules is in place, strong commercial markets have developed and thrived.

The UCC is updated periodically to keep pace with legal and technological developments. The 2022 amendments will ensure that the UCC continues to facilitate commercial activity well into the future by implementing the following updates:

- **Digital Assets.** A new Article 12 provides rules for transactions involving certain new types of digital assets, including cryptocurrency and non-fungible tokens (NFTs). Under the UCC, these intangible assets are called "controllable electronic records," or "CERs." To ensure that the UCC remains relevant, CERs are defined to include not only assets created using today's distributed ledger or "blockchain" technology, but also any assets that may function similarly using future technologies.

    - **Control of Digital Assets.** Section 12-105 introduces the concept of "control" as it applies to intangible property such as cryptocurrency. Control of an electronic record is roughly analogous to possession of a tangible asset – the person with control has the power to "spend" the intangible asset by transferring it to another person in exchange for goods or services. The person with control can also prevent anyone else from using the property. The person with control can be anonymous, but must be positively identifiable in some manner, such as through the use of a cryptographic key.

    - **Security Interests in Digital Assets.** Amendments to Article 9 will facilitate the use of digital assets as collateral for loans. Under the prior version of Article 9, there was no effective way for a lender to perfect a security interest in digital assets except by filing a financing statement, and no way to ensure priority of the security interest without obtaining a release or subordination from all other secured parties, if they are even disclosed. The amended Article 9 will provide that a lender with control of digital assets has a perfected security interest with priority over the interests of any other lenders who do not have control.

- **<u>Tethered Assets.</u>** Some digital assets may not have intrinsic value, but rather represent a right to payment. A simple example would be an electronic promissory note with terms stating the borrower agrees to pay the lender a fixed monthly payment for a period of time. When the promissory note was executed on paper, the paper itself could be sold by the original lender to another party who bought not just the paper itself, but the right to receive future payments from the borrower. The right to payment was "tethered" to the paper. The 2022 amendments will provide similar rules for "controllable accounts" and "controllable payment intangibles," which are simply digital versions of a tethered asset, e.g. a promissory note in electronic form rather than in a writing.

- **<u>Take-Free Rules.</u>** The UCC includes rules to protect innocent parties who receive digital assets subject to competing property claims. For example, imagine a bank robber who uses stolen cash to purchase goods at a store. If the store accepted the cash in exchange for valuable goods without knowing that the cash was stolen, the store is not liable for the bank's loss even if the cash received is later traced to the robbery. The robber remains liable for the amount stolen. Similarly, new UCC provisions will protect innocent parties who accept in good faith digital assets in exchange for value without knowledge of any other property claim to the assets.

- **<u>Governing Law.</u>** Because digital assets have no physical location, conflict of laws questions may arise. The UCC amendments will allow the parties to a transaction involving digital assets to choose the law that applies to their transaction for commercial law purposes and incorporate the choice into their CER or the system in which the CER is recorded. If the parties do not choose a governing law in the CER or system, the law of the District of Columbia will apply.

- **<u>Tangible and Electronic Money.</u>** "Money" is defined under the UCC as a medium of exchange authorized by a domestic or foreign government and was presumed under many UCC rules to exist only in tangible form. Recently, some countries' central banks have proposed creating virtual currencies to supplement or replace traditional forms of money, and at least two countries have adopted the virtual currency Bitcoin as an alternate form of legal tender. An amendment to the Article 1 definition of money clarifies that governmentally created forms of money may be tangible or electronic and that pre-existing virtual currencies, like Bitcoin, while they may be CERs, are not "money" for purposes of the UCC. New amendments in Article 9 provide that a security interest in "electronic money," i.e. virtual currency created by a government's central bank, like a security interest in a CER can only be perfected through control.

- **Chattel Paper.** “Chattel paper” is defined under the former Article 9 as a record containing both a monetary obligation and a security interest in goods, e.g. the documents governing an automobile loan. The 2022 amendments modify this definition to refer to the right to payment evidenced by the record, rather than to the record itself. This makes the rules for chattel paper more consistent with the new rules for CERs. Similarly, the rule governing control of electronic chattel paper is amended for consistency with the rule governing control of CERs.

- **Hybrid Transactions.** Articles 2 and 2A of the UCC apply to the sale and lease of goods, respectively, and not to contracts for services. The line between these categories has blurred with the emergence of transactions involving both the sale or lease of goods and the provision of other property or services. As a result, a new rule is needed for these hybrid transactions. The UCC amendments provide that, absent the parties’ agreement otherwise, the UCC rules will apply to a hybrid transaction if the sale/lease of goods is the predominant purpose of the transaction. If the sale of services or provision of other property predominates, the UCC rules will apply only to aspects of the transaction that involve the sale or lease of goods. Whether or not the lease of goods aspects of the transaction predominate, the finance lease provisions of Article 2A will apply to those aspects of the transaction.

- **Negotiable Instruments.** Changes to Article 3 clarify that a choice-of-law or choice-of-forum clause included in an instrument does not affect the negotiability of the instrument, and that an image of a negotiable instrument (i.e., photos of the front and back of a check) may be substituted for the actual instrument in accordance with federal banking regulations.

- **Terminology.** Various UCC provisions are amended to replace obsolete terms that applied only to transactions on paper. For example, the term “sign” is redefined to include electronic signatures, the term “record” is substituted for “writing” to encompass electronic documents, and the term “conspicuous” is redefined to apply more broadly to the terms of both paper and electronic agreements.

- **Transition rules.** The UCC amendments will be effective on the effective date in the enacting legislation. However, to protect any lenders who hold a security interest in digital assets that were perfected under the prior rules, there will be a transition period during which the lender’s priority established on the effective date will be maintained. This provides a grace period during which the parties to a pre-existing loan agreement can renegotiate terms as necessary and comply with provisions of the new law to ensure that their respective interests remain protected.