

Fund Finance Friday



New UCC Article 12 Matters to More than Just Cryptocurrency

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By **Chris McDermott**
Senior Counsel | Corporate and Commercial Finance



By **Matthew Stempler**
Partner | Corporate and Commercial Finance

After being approved by its drafting committees last summer, a new article to the Uniform Commercial Code is now making its way through state legislatures for enactment. Because the new Article 12 and its related code amendments address digital assets, it may be tempting to assume the changes are irrelevant to fund finance. That would be a mistake.

We think these UCC amendments carry significant implications for fund finance attorneys, lenders and borrowers.^[1] Here are the main points:

- New Article 12 establishes new asset categories with new rules on perfection and priority. While we explain these in detail below, the upshot is that everyone involved in a fund financing transaction will need to consider whether the new types of assets are included as collateral and, if so, how the concept of control should apply. Broad collateral grants, such as those used in GP lines and management fee facilities, will need particular attention.
- While few and far between in fund finance today, loans secured by digital assets such as cryptocurrencies fall squarely within the ambit of the new provisions and will need to be structured accordingly.
- For transactions that do not rely on the new asset categories, opinion standards may need to adapt to provide lenders with the assurance that existing perfection and priority steps are adequate in the context of the code revisions.
- Enactment timing will vary by state and will likely be followed by a grace period in each state during which an Article 9 security interest perfected prior to the enactment will continue to be perfected. Attorneys will need to follow the progress on this front and be alert to perfection and priority risks.
- The new terms are broad and untested. Their impact may well reach into financing structures in unanticipated ways. Legal practitioners will need to pay close attention to court interpretations that emerge once Article 12 has been released into the wild. And don't assume that Article 12 will not affect you because your deal doesn't include crypto.

New Article 12 to the Uniform Commercial Code was approved by the Uniform Law Commission and the American Law Institute in July 2022.^[2] Most practitioners are aware that new Article 12 is an addition to the UCC to improve the statute's coverage of certain digital assets, such as cryptocurrency and NFTs. There has been plenty of commentary in the legal press about new Article 12; there have been excellent summaries and explainers about the general provisions contained in the new article. Get ready, we're told, change is coming.

Somewhat less frequent in the press coverage to date, however, have been attempts to tease out the potential effects and implications of new Article 12 in specific cases. Despite new Article 12 itself only consisting of seven sections (including the one called "Title"), the new Article also comes bundled together with a raft of further amendments to most of the other Articles of the UCC (collectively, with new Article 12, the "2022 Amendments"). How these pieces may fit together, and what effects they may have on commercial financing transactions, is too broad a topic to tackle all at

once. But, we thought it would be a useful project to begin thinking about narrower topics related to new Article 12, one at a time. In this piece, we propose to take a quick look at the impact of new Article 12 and the other 2022 Amendments on accounts and payment intangibles[3].

But to get to that particular topic, it is necessary to take a step back and more broadly review what Article 12 is. One thing that it is not – at least not yet – is law. The Uniform Law Commission and the American Law Institute have recommended Article 12 and the 2022 Amendments for enactment in the states, and the 2022 Amendments have been introduced in the legislatures of 21 states and the District of Columbia as of this writing, but they have not yet been enacted in any of those jurisdictions.[4] That, presumably, will change in due course.

More substantively, the 2022 Amendments are an attempt to reduce risks that are perceived to be posed by two trends in electronic commerce. The first trend is the attribution of economic value to some electronic records separate from any relationship with extrinsic rights and interests. The poster child for this trend is cryptocurrency – pure electronic records that have a value solely in themselves. The second trend is the accelerating use of the creation or transfer of electronic records as a means to transfer rights to receive payment, rights to receive performance of other obligations (e.g., services or the delivery of goods) and other rights and interests in personal and real property.[5] To try to mitigate the risk of disputes arising as these trends continue to develop in commercial markets, the drafters of the 2022 Amendments constructed a regime to specify certain legal rights and attributes of what they termed “controllable electronic records” (“CERs”).

A CER is generally defined in the 2022 Amendments as “a record stored in an electronic medium that can be subjected to control under Section 12-105”. [6] The idea of “control” under Section 12-105 is the linchpin concept. Section 12-105 specifies that three powers must be granted to a person with respect to an electronic record to establish that person’s control: (1) the power of that person to avail itself of all the benefit from the electronic record, (2) the exclusive power of that person to prevent others from availing themselves of substantially all the benefit from the electronic record, and (3) the exclusive power to transfer control of the electronic record to another person (or cause another person to obtain control of another CER as a result of the transfer). In addition, such control also requires that the person, whether through the electronic record itself or a record logically associated with the electronic record or the system in which it is recorded, be enabled to readily identify itself (whether by name, i.d. number, cryptographic key, office or account number) as the person having the above-listed powers.[7]

Control of a CER is relevant under the Article 12 regime for a number of reasons. One of the key reasons is that only a person having control of a CER is eligible to have the rights of a “qualifying purchaser” for purposes of Article 12’s “take free” rule. Another key reason is that, under Article 9 as revised by the 2022 Amendments, control of a CER is a new method of perfecting a security interest in the CER, and such control perfection has priority over other methods of perfection (such as filing a financing statement).

The “take free” rule established by Article 12 provides that a “qualified purchaser” – that is, a purchaser[8] of a CER or an interest in a CER that obtains control of the CER for value, in good faith, and without notice of a claim of a property right in the CER – will acquire its rights in the CER free of a competing property right in the CER.[9] This rule is similar to, and derived from,[10] the familiar rights of a holder in due course of a negotiable instrument under UCC Section 3-306. As a result, a qualified purchaser of a CER can take a better property interest in the CER than the person who transferred it to them. Imagine a circumstance in which a hacker hacks the system where a CER is maintained and takes control of the CER – effectively stealing it and depriving its rightful owner of it. Then imagine that the hacker turns around and sells the CER to an innocent buyer who meets the criteria of a qualified purchaser – for value, in good faith, without notice of the competing claim. That qualified purchaser could claim good title to the CER, even though the hacker had no title to the CER at all under general legal principles.[11]

This take-free rule may be a bracing concept, but it is important to appreciate key limitations. Most important, the concept generally applies to the *record* only, in and of itself. Article 12 makes it clear that assets other than the CER *qua* record, such as goods or rights to payment that are carried along with the CER (or, as they are referred to, assets “tethered” to the CER), do not get the benefit of the take-free rule.[12] And further, one of the key elements of the definition of CER in Article 12 not previously mentioned is that it excludes a litany of other UCC assets from the ambit of CERs. Controllable accounts, controllable payment intangibles, deposit accounts, electronic copies of records evidencing chattel paper, electronic documents of title, electronic money, investment property, and transferable records – all of these asset categories (some of which are defined for the first time in the 2022 Amendments) are excluded from the definition of CER.[13]

Note the references to “controllable accounts” and “controllable payment intangibles” in that litany of exclusions above. The 2022 Amendments change Article 9 to add those terms as new definitions, generally defining each as an account

(or payment intangible) evidenced by a CER that provides that the account debtor undertakes to pay the person that has control under Section 12-105 of the CER.[14] In view of the discussion immediately above, it may seem natural that such controllable accounts and controllable payment intangibles are excluded from the CER definition; they are payment rights, not records *per se*, and therefore just another species of tethered asset. You might assume that, consistent with Article 12's treatment of such tethered assets, law other than Article 12 would deal with those tethered accounts and payment intangibles.

It is here that the 2022 Amendments make a significant adjustment to the concept of tethered assets. Section 12-104(a) provides that Section 12-104 applies to the acquisition and purchase of rights in controllable accounts and controllable payment intangibles in the same manner the section applies to CERs – including the take-free rule in clause (e) of Section 12-104. Furthermore, to determine whether a purchaser is a qualified purchaser of a controllable account or controllable payment intangible, the purchaser obtains control of the controllable account or controllable payment intangible when that purchaser obtains control of the CER which evidences it.[15]

Article 9 as modified by the 2022 Amendments also provides special rules for controllable accounts and controllable payment intangibles. Currently, perfection of a security interest in accounts and payment intangibles is generally by filing (with a few exceptions[16]). Under the 2022 Amendments, however, control (as defined in Section 12-105[17]) is a new additional means of perfection,[18] and similar to the take-free rule under Section 12-104, control perfection of a controllable account or controllable payment intangible is established by taking control of the CER which evidences it. [19] Such control perfection of controllable accounts and controllable payment intangibles would have priority over other methods of perfection (including perfection by filing).[20]

Regardless of what you might think of Article 12's approaches as policy, you might appreciate the drafters of the 2022 Amendments setting up these principles, including the take-free rules, out of concern for issues respecting digital assets carried in distributed ledger technology. If the blocks in a blockchain are vulnerable to dispute and uncertainty as to property rights, digital commerce may be impeded. But what about the impact of these principles on commercial transactions that were not obviously in the sights of the Article 12 drafters' concerns? Currently, for example, transacting parties in deals involving accounts and payment intangibles do not consider whether they have, or should have, holder in due course-like rights in ordinary accounts and payment intangibles. Further, a UCC search generally suffices to give assurance of a proposed secured party's or purchaser's priority of interest in accounts and payment intangibles.

With the adoption of the 2022 Amendments, it seems that current transactional practice will have to be generally reexamined. Parties will want to examine whether the accounts and payment intangibles they are dealing with are "electronic," and whether they are capable of being "controlled" as described in Section 12-105. If they are, then taking new steps beyond filing to obtain control of those accounts and payment intangibles may be critical to assure a transacting party of the highest priority perfected security interest, and the strongest property interest, in those assets against potential competing claimants.

There may also be situations where the transacting parties strategically determine *not* to have Article 12 apply to their transaction – in which case the inquiry may be an exercise in how to have an asset fail to constitute a CER, a controllable account or controllable payment intangible, or how to have the asset fall into one of the numerous exclusions from the CER definition. And, of course – and perhaps most importantly – new Article 12 may help create opportunities for new financing structures and methodologies which can enhance value and efficiency in ways impossible to imagine today.

If the 2022 Amendments would require commercial transaction practices to adjust for new deals, how would the 2022 Amendments impact existing deals? The 2022 Amendments include transitional rules to aid the implementation of their provisions, but there are important issues practitioners should be alert for. In the first place, unlike the broad amendments to the UCC enacted in 1998, the 2022 Amendments do not require a uniform effective date. The dates of enactment in the states will likely vary, so the landscape for deals with collateral governed by differing state laws may need to encompass both pre- and post-2022 Amendment law.

Second, the 2022 Amendments provide for an "adjustment date," defined to be the date that is the later of July 1, 2025 and the date that is one year following the enactment of the 2022 Amendments in the particular state. The period from enactment until the adjustment date is a grace period during which an Article 9 security interest that was perfected pursuant to the rules in effect prior to the enactment of the 2022 Amendments will continue to be perfected (even if the requirements under the 2022 Amendments are not met), and after which the new rules would have to be complied with.[21]

However, issues of priority are potentially more complicated. The transition provisions provide that, to the extent that the priorities established with respect to CERs, controllable accounts and controllable payment intangibles before enactment of the 2022 Amendments would be modified by the new 2022 Amendment rules, those new priorities would take effect only on the adjustment date.^[22] But that one-year protection only applies if the priorities were “established” before the enactment date – and, as discussed above, the 2022 Amendments add the critically important *new* method of perfecting by control over CERs, controllable accounts and controllable payment intangibles, which establishes priority superior to perfection by other methods. Since control would only be available to “establish” such priority *after* the effective date, a security interest in accounts and payment intangibles that is properly perfected by filing prior to the effective date of the 2022 Amendments will be vulnerable to being primed by another creditor taking control, to the extent such accounts and payment intangibles satisfy the definitions of controllable accounts and controllable payment intangibles – and that vulnerability would arise immediately upon the enactment of the 2022 Amendments. Market participants will want to review their collateral pools to determine whether their collateral might fall into the Article 12 categories of controllable accounts and controllable payment intangibles to assess this risk, and determine what control methodologies are afforded by the electronic platforms in question.^[23]

Finally, the transition rules as to validity, perfection and priority that are included in the 2022 Amendments may be of limited use in many deals where accounts or payment intangibles are iteratively regenerated and repledged, as with certain fee-based collateral structures. Such assets generated after the effective date of the 2022 Amendments might be viewed as new transactions which would be assessed under the new rules, regardless of whether the relevant transaction documents were executed prior to the effective date; certainly, the security interests in them could only attach and be perfected after the effective date because those assets would not have existed before. Furthermore, the complex definitional changes in the 2022 Amendments may work unanticipated changes into the granting language in existing deal documentation, changing the effect of it or even punching holes in it.

Many of the provisions which would be added by the 2022 Amendments with respect to CERs, controllable accounts and controllable payment intangibles are intentionally vague. The drafters were candid that they intend Article 12 and related provisions to breathe and grow with changes in technology.^[24] But the open-endedness of the language may put lawyers and market participants under an unfamiliar burden of looking inside the workings of computers and software. What does it really mean, after all, when control under Section 12-105 requires an electronic record or a system to give a person powers to avail itself of all the benefit of a record, or to transfer it? What does it mean in the definition of a controllable account that the account is “evidenced by” a CER, and that the CER provides that the account debtor undertake to pay the person that has control? How is the lawyer to know? In old-fashioned, familiar control provisions in the existing UCC, such as control by possession or by entering a control agreement, the tests are determinable with familiar tools that lawyers and businesspeople have directly at their disposal: they can determine if a physical instrument is in possession by reference to the instrument’s reality in the physical universe; and they can tell if a control agreement meets the requirements of control by reading it. When the control characteristics are embedded in lines of computer code, how will lawyers and businesspeople assure themselves that the technology, in fact, satisfies the legal tests? Short of all lawyers going to computer coding boot camp, it would seem that the changes wrought by Article 12 may necessitate significant reliance on the work of technology consultants who *do* know how computers and software engineering works – but who may not themselves be lawyers or sensitive to the legal and commercial aspects of the transactions that their work may impact. Lawyers who have rendered or received complex reasoned legal opinions for electronic chattel paper might wonder if similar complexity will be required now for what has previously been a simple and straightforward legal opinion: a filing perfection opinion on accounts.

It may be difficult to reach conclusions about what specific impacts Article 12 may have on transactions, although it seems evident that the effects will be significant. But it is certain that lawyers and finance professionals working with transactions under Article 12 will need to adjust to a world where the convergence of law and technology is growing ever closer.

^[1] The implications of these developments go far beyond fund finance, of course. We anticipate that future Cadwalader articles and memos will explore specific applications in other areas of finance, including receivables financing and securitization.

^[2] See Uniform Commercial Code Amendments (2022), (2022 Am. Law Inst. & Unif. Law Comm’n) (“2022 Amendments”).

^[3] The UCC gives “account” a specific definition as a right to payment of a monetary obligation, whether or not earned by performance, for property sold or leased, services rendered or to be rendered, a policy of insurance issued or to be

issued, secondary obligations to be incurred, energy provided or to be provided, use of a vessel, use of a credit card, or winnings in a lottery. “Payment intangible” is defined more generally as a general intangible under which the account debtor’s principal obligation is a monetary obligation. Both definitions would be modified slightly in the 2022 Amendments. See Section 9-102(a), 2022 Amendments (2022).

In common parlance, “accounts receivable” or “receivables” would encompass both UCC accounts and payment intangibles. In this article we will generally try to stick to UCC terminology when discussing specific UCC applications; otherwise, we may use the terms interchangeably.

[4] Uniform Laws Commission, UCC, 2022 Amendments to, Enactment History, <https://www.uniformlaws.org/committees/community-home?communitykey=1457c422-ddb7-40b0-8c76-39a1991651ac#:~:text=Description,-Description&text=The%202022%20amendments%20to%20the,intelligence%2C%20and%20other%20technological> (last visited Mar. 8, 2023).

[5] Article 12, Prefatory Note to Article 12, 1. Introduction to Controllable Electronic Records, 2022 Amendments (2022), 229.

[6] Section 12-102(a)(1), 2022 Amendments (2022). Also note that the component terms in this definition themselves have defined meanings, which create further opportunity for interpretation. For example, “electronic” is defined as “relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities,” 2022 Amendments, Section 1-201(b)(16A), and a “record” (the definition of which is not being amended in the 2022 Amendments) is defined as “information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form”. UCC Section 1-201(31). Does this mean that my old vinyl copy of Bruce Springsteen’s album “Born To Run” is an electronic record that can be treated as a CER under Article 12, because it relates to an electrical or electromagnetic technology? What about a Gutenberg Bible, the information recorded in which is perceived by the eye (*i.e.*, optically)? Slightly facetious suggestions, surely. But how far afield from the paradigmatic case of cryptocurrency such broad definitions may take us is an interesting question.

[7] Section 12-105(a), 2022 Amendments (2022). It is notable that the definition of CER in new Article 12 does not specify that, in order to fall within the definition of a CER, the record actually be controlled in the manner specified, but only that it “can be subjected to” such control. This leads to other interesting questions: what is the effect of the potentiality for control on electronic assets that are not in fact subject to, or customarily subjected to, Section 12-105 type control? Will commercial practices need to change because such assets have been drawn into the Article 12 ambit in order to protect the interests of purchasers and lienholders? We briefly consider these questions below.

[8] Note that a “purchaser” under the UCC is defined as a person who takes by purchase, and “purchase” is defined to encompass a variety of transactions, including outright sales, security interests, leases and gifts. For our purposes, keep in mind that a purchase is both a buyer outright and the secured party holding a security interest. UCC 1-201(b) (29), (30).

[9] Section 12-104(e), 2022 Amendments (2022).

[10] Official Comment 7, Section 12-104(e), 2022 Amendments (2022).

[11] See Example 3, *Ibid*.

[12] Section 12-104(f), 2022 Amendments (2022). It is easy to imagine situations where this record-tethered asset dichotomy might emerge in digitized commercial transactions; for example, a smart contract license agreement which constitutes a CER, tethered to a copyrighted intellectual property such as a motion picture. What the effect of the divergence of property interest between the two elements of the tethered asset pair, resulting from the application of the take-free rule to one element, the CER, and not to the other element, the tethered asset, will be a further fascinating topic to explore.

[13] Section 12-102(a)(1), 2022 Amendments (2022).

[14] Section 9-102(a)(27A), (27B), 2022 Amendments (2022).

[15] Section 12-104(b), 2022 Amendments (2022).

[16] For example, certain security interests in assignments of accounts or sales of payment intangibles are perfected upon attachment. UCC Section 9-309.

[17] See Section 9-107A(a), 2022 Amendments (2022).

[18] Sections 9-314(a), 9-107A(b), 2022 Amendments (2022).

[19] Section 9-107A(b), 2022 Amendments (2022).

[20] Section 9-326A, 2022 Amendments (2022).

[21] Section A-302(b), 2022 Amendments (2022).

[22] Section A-305(c), 2022 Amendments (2022).

[23] See Official Comment 2., Example 3, Section A-305, 2022 Amendments (2022).

[24] “Article 12 creates a legal regime that is meant to apply more broadly than to electronic (intangible) assets that are created using existing technologies.... It also aspires to apply to electronic assets that may be created using technologies that have yet to be developed, or even imagined.” Article 12, Prefatory Note to Article 12, 1. Introduction to Controllable Electronic Records, 2022 Amendments (2022), 229.