

The Distributed Ledger

Blockchain, Digital Assets and Smart Contracts

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Amendments to Uniform Commercial Code Aim To Provide Clarity on the Transfer of Digital Assets

Over the last few years, stakeholders in the digital asset space have questioned how digital assets should be treated for purposes of the Uniform Commercial Code (UCC), a comprehensive body of laws relating to commercial transactions that are adopted at the state level. There will soon be some clarification on this important issue: The American Law Institute and the Uniform Law Commission, the two sponsors of the UCC, approved amendments this summer to create a new Article 12 titled “Controllable Electronic Records” to address this point.

The sponsors also approved related amendments to many of the existing articles of the UCC. As discussed further below, these changes address, among other matters, the acquisition and disposition of interests (including security interests) in certain digital assets, including fungible virtual currencies such as bitcoin, non-fungible tokens (NFTs), and payment intangibles and accounts evidenced by an electronic record.

Article 12 also addresses how competing interests in a digital asset are to be resolved, an issue of growing concern in the Web3 space. The amendments will now be introduced for consideration by the states.

What Does Article 12 Govern?

The new article governs the transfer of property rights in a “controllable electronic record” (CER), which is defined as a record stored in an electronic medium that can be subjected to “control” (discussed below). By definition, a CER excludes any digital assets that are not subject to “control” as well as those that are already subject to other commercial laws such as E-SIGN, the Uniform Electronic Transactions Act or other articles of the UCC. Article 12 also does not address the regulation of any digital assets (e.g., how they are taxed, implications for banking regulations or the prevalent question in the Web3 space as to whether such assets constitute securities). Those involved in the Web3 space will note that the definition does not include any reference to blockchain or distributed ledger technology. This was to make the definition technology-neutral, although the clear intent of the new amendments was to address blockchain-based digital assets.

The amendments are intended to modernize and clarify existing commercial law governing the transfers of digital assets, including with a new definition of “control” of a controllable electronic record and with the recognition of three new subcategories of intangible property:

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1. CERs,
2. controllable accounts (accounts where the account debtor undertakes to make payment to the person in control of the CER), and
3. controllable payment intangibles (payment intangibles where the account debtor undertakes to make payment to the person in control of the CER).

By creating the concept of control over CERs, the amendments allow for negotiability of CERs, similar in concept to the negotiability of negotiable instruments, and for higher priority for a secured party that perfects its security interest in CERs by control rather than by relying on the filing of a UCC financing statement.

Control Under Article 12

A key component of the CER definition is whether a party can “control” the electronic record. Article 12 provides that control of a CER exists 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:

- gives a person (i) the power to avail itself of substantially all the benefit from the electronic record, (ii) the exclusive power to prevent others from doing so, and (iii) the exclusive power to transfer control to another person, and
- enables such person to readily identify itself as having these previously enumerated powers (including through the use of a cryptographic key or account number).

It is important to note that the requirement that the person have the exclusive power to transfer control to another person would be met in instances where such power to transfer occurred by the use of a multi-signature wallet or if changes occur automatically as part of the protocol built into the system where the CER is recorded.

The concept of control is noteworthy not only because it is a key prong of the CER definition but also because only a person having control of a CER can become a qualifying purchaser and so be able to take free of property interest claims in the CER pursuant to the “take-free” rule discussed below.

Take-Free Rule

Article 12 contains a take-free rule similar to the rules provided in Article 3 with respect to holders in due course of negotiable instruments and under Article 8 with respect to protected purchasers of securities. Under Article 12, if a good faith purchaser (including a secured party) of a CER obtains control without notice of a competing property right in the CER, they will acquire rights in the CER free of any competing claims

of a property interest in the CER. This could have significant ramifications in the case of a stolen NFT, since it would mean that a good faith downstream purchaser of the stolen NFT would acquire the NFT free of any claims by the victim of the theft.

Note that, except for controllable accounts and controllable payment intangibles (accounts or payment intangibles where the account debtor undertakes to make payment to the person in control of the CER), the Article 12 “take-free” rule applies to the CER but not to other rights tethered to such CER. In the case of NFTs, this might mean that the good faith purchaser might own the NFT free of any claims but would not necessarily enjoy any rights granted under any license to the content associated with the NFT. The rights regarding such tethered rights are governed by law other than Article 12.

Choice of Law

Article 12 provides that the local law of the CER’s jurisdiction governs matters covered by Article 12. The CER’s “jurisdiction” can be specified in the CER or in the rules governing it. If the jurisdiction is not so specified, then the default rule is that the CER’s jurisdiction is the District of Columbia (or, if the District of Columbia has not enacted the official text of Article 12 without substantial modification, the governing law would be the law of the District of Columbia as though the official text of Article 12 were in effect there).

Transition Rules

In order to balance the interests of preexisting holders of interests in CERs with those of new holders who comply with the rules contained in the amendments, the amendments provide for an effective date and a separate adjustment date. The effective date will be the date on which the new rules (other than certain priority rules) will go into effect. In order to give preexisting holders of interests sufficient time to comply with the new rules, however, certain priority rules that may override priorities established before the effective date will not go into effect until the adjustment date.

Takeaways

States are expected to enact the amendments over the next few years. Once the amendments are in effect in a particular state, the parties to a transaction should comply with the new rules concerning transfers of these digital assets and should consider preparing documentation in anticipation of the amendments’ eventual enactment. Parties that have already completed a transaction under current law should also be cognizant of the new rules and examine whether the amendments would affect their rights and relevant priorities.