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## **UCC ARTICLE 12 – SECURITY INTERESTS IN DIGITAL ASSETS**

### **I. INTRODUCTION**

With the passage of LB 649 (Nebraska Financial Innovation Act) in 2021 by the Nebraska Legislature, Nebraska adopted the then current “draft” of Uniform Commercial Code (UCC) Article 12 as proposed by the National Conference of Commissioners on Uniform State Laws. The new law addresses the perfection and priority of security interests in digital assets. **The provisions of UCC Article 12 and accompanying amendments to the Uniform Commercial Code take effect on July 1, 2022.**

### **II. PERFECTING AN INTEREST IN PERSONAL PROPERTY**

Digital assets constitute personal property. Perfection of a security interest in personal property under Article 9 of the UCC can generally be accomplished by filing a UCC-1 financing statement, by taking control of the property, or by taking possession of the property. While Article 9 lists a number of different property types, digital assets are not included.

### **III. PERFECTING AN INTEREST IN DIGITAL ASSETS UNDER CURRENT ARTICLE 9 - (PRE-JULY 1, 2022)**

Individuals and entities currently own digital assets such as cryptocurrency or non-fungible tokens (NFTs). Individuals or entities with borrowing needs may want to pledge their digital assets as collateral for a loan. Lenders willing to accept digital assets as collateral have raised questions regarding the manner in which to perfect a security interest in the digital assets.

Generally, a cryptocurrency is a digital medium of exchange that operates on blockchain technology. A blockchain is essentially a distributed database that allows transactions to be permanently recorded without the need for a central authority or trusted third-party to clear or verify the transaction and provides digitally authenticated record-keeping. In effect, cryptocurrency is a digital, decentralized “money” that has its transaction history recorded on a publicly available ledger.

NFTs use block chain to record and authenticate ownership of unique tangible and intangible assets such as digital collectibles. Unlike cryptocurrency, each NFT is intended to be unique and no two are alike—hence the name “non-fungible” token. NFTs authenticate ownership of digital

art and are also used to identify the location of a file such as a piece of digital artwork or audio clip.

Cryptocurrency and non-fungible tokens are generally referred to as digital assets, which constitute the category of assets issued and transferred using the blockchain.

Because Article 9 does not include a separate classification for digital assets, some lenders have treated them as “general intangibles” - which are perfected by filing a UCC-1 financing statement. Others treat digital assets as “investment property” (securities, entitlements, and commodity contracts) - which can be perfected by filing a UCC-1 or by control, with control being the preferred method for perfection. However, it is uncertain under current law whether “control” of the digital wallet for a digital asset is sufficient to perfect a security interest.

While filing a UCC-1 may perfect a lender’s security interest in most digital assets, lenders should also consider taking steps to ensure that they will be able to obtain possession and control over the collateral if the need to exercise its remedies against the collateral should arise in the event of default, such as conducting a sale or other disposition of the digital assets serving as collateral.

#### IV. **LB 649 – UCC ARTICLE 12-SECURITY INTEREST IN DIGITAL ASSETS**

##### *A. Introduction*

The provisions of UCC Article 12 adopted in Nebraska may be viewed at <https://www.nebraskalegislature.gov/laws/browse-ucc.php>. Among other things, the provisions of UCC Article 12 update the UCC by:

- addressing the transfer of digital assets and cryptocurrencies, providing conforming changes to Article 9 to deal with secured transactions in these assets, and utilizing the new term “controllable electronic records” (CERs) to define cryptocurrencies and NFTs (digital assets);
- facilitating secured lending against CERs;
- providing protections for qualifying lenders and purchasers so they may take security interests in cryptocurrencies and digital assets free and clear of conflict in property claims; and
- promulgating rules regarding assignment of controllable accounts and controllable payment intangibles.

**In general, UCC Article 12 provides that a security interest in digital assets or CERs can be accomplished by filing a UCC-1 and/or by controlling the asset. They also provide that a lender that has perfected by control takes priority over a lender that has perfected by filing a UCC-1 but does not have control.**

For purposes of UCC Article 12, control occurs when a person has (1) the power to enjoy substantially all of the benefits of the CER, (2) the exclusive power to prevent others from enjoying substantially all of the benefits of the CER, and (3) the exclusive power to transfer control of the CER.

Article 12 of the UCC is designed to address a limited set of transactions primarily involving emerging technologies, such as virtual (non-fiat) currencies, and distributed ledger technologies (so-called digital assets).

Article 12 addresses concerns regarding the lack of definitive rules under the current UCC for transactions involving digital assets, including rules relating to the negotiability of virtual (non-fiat) currencies and the difficulties of secured lending against digital assets, including virtual currencies.

Article 12 establishes rules for a class of digital assets – defined as “controllable electronic records” (CERs) – which includes certain virtual (non-fiat) currencies, non-fungible tokens, and digital assets in which specified payment rights are embedded. The amendments allow CER to be transferred in a manner that cuts off competing property claims (including security interests) to the CER. (“take-free” rule)

#### *B. Perfection*

The new provisions of UCC Article 12 provide for a security interest in a CER to be perfected by “control” (or by filing a financing statement) and for a security interest perfected by “control” to have priority over a security interest in the CER perfected only by the filing of a financing statement (or another method other than “control”).

#### *C. Definition of “Controllable Electronic Record” (CER)*

Article 12 covers only digital assets that are CERs. A CER is a record in electronic form that is susceptible to “control.” (e.g., bitcoin).

#### *D. Control*

For a person to have “control” of a CER, the person must have

- “the power to enjoy “substantially all the benefit” of the CER (does not have to be exclusive);”
- the exclusive power to prevent others from enjoying “substantially all the benefit” of the CER; and
- the exclusive power to transfer control of the CER.

The person with control must be able to readily identify itself to a third-party as the person having this power. Identification may be made by a cryptographic key or account number. The exclusivity requirement is satisfied even if there is a sharing of these powers.

Comments to proposed Article 12 include the following language: A virtual (non-fiat) currency would be an example of a CER. If a person owns an electronic “wallet” that contains a virtual currency, the person would have control of virtual currency if (a) the person may benefit from the use of the virtual currency as a medium of exchange by spending the virtual currency or exchanging the virtual currency for another virtual

currency; (b) the person has the exclusive power to prevent others from doing so; and (c) the person has the exclusive power to transfer control of the virtual currency to another person.

Digital assets are stored electronically in what is known as a digital wallet that can only be accessed by using a private key (similar to a password). Without the private key, lenders are unable to access the asset following a default. In order to protect their interests, lenders should consider either acquiring the private key upon execution of the security agreement or having the private key turned over to a third-party custodian to be held in escrow.

Merely having access to the borrower's private key will not prevent a borrower from transferring the asset to another digital wallet, such as a cold wallet, out of the lender's reach. To minimize this risk, it has been suggested that borrowers transfer their NFTs or cryptocurrency to a digital wallet solely controlled by the lender or by using digital wallets that require more than one key to authorize transactions. Another type of secured wallet is a cold wallet, which is stored off-line and not connected to the Internet, making it more resistant to being hacked. Both of these methods have similarities to obtaining control over a securities or deposit account and provide assurances that the secured lender will have access to the collateral when it needs it.

#### *E. Transferee of a Controllable Electronic Record ("Take-Free" Rules)*

A "qualified purchaser" takes free of third-party claims (which may include both buyers and secured parties). If a CER is purchased (including obtaining a security interest in the CER), the purchaser acquires all rights in the CER that the transferor had.

**Qualified purchaser** - A purchaser who obtains control of a CER for value, in good faith, and without notice of a property claim to the CER (filing of a financing statement in and of itself is not notice of a property claim to the CER).

Comments to UCC Article 12 provide as follows: Consider again the example of a person in control of a virtual (non-fiat) currency. If the person transfers control to another person, the transferee obtains whatever rights in the virtual currency that the transferor had. If the transferee is a "qualified purchaser" of the virtual currency, the transferee also benefits from the "take-free" rule.

#### *F. Tethering and Certain Payment Rights*

Establishing control over a CER does not "tether" to extrinsic rights and interests. As a result, if a CER does not have intrinsic value but rather derives its value from the tethered asset, control of the CER does not confer priority in the underlying tethered asset to the controlling party – just the rights in the CER.

An exception to this rule involves an "account" or "payment intangible," (as those terms are defined in Article 9 of UCC) embodied under such circumstances. The "account" or "payment intangible" is a "controllable account" or "controllable payment intangible" if

the account debtor (the person obligated on the account or payment intangible) has agreed to pay the person in control of the CER. If control of a CER with an embedded controllable account or controllable payment intangible is transferred, the controllable account or controllable payment intangible accompanies the CER, and the transferee is eligible to benefit from the same “take-free” rule that applies to the CER.

*G. Discharge of Account Debtor*

Similar to the rules under current UCC Article 9 relating to accounts and payment intangibles, an account debtor (the obligor on an account or payment intangible) receives a discharge by paying the person formerly in control until the account debtor receives a notification signed in writing or electronically by the debtor or its secured party that the secured party has a security interest in the controllable account or controllable payment intangible and a payment instruction (“deflection notification”) to pay the secured party as the person now in control. Following receipt of the deflection notification, the account debtor may obtain a discharge only by paying the secured party and may not obtain a discharge by paying the debtor.

Also, similar to current UCC Article 9, the debtor may ask for reasonable proof that the secured party is the person in control prior to paying the secured party. However, unlike current Article 9, for a controllable account or controllable payment intangible the method of providing that reasonable proof must have been agreed to by the account debtor. Absent an agreed method of providing reasonable proof, the deflection notification is not effective, and the account debtor may obtain a discharge by continuing to pay the debtor.

*H. Scope of Coverage-Exclusions*

If an electronic record is not susceptible to control, it is outside the scope of the proposed amendments. Excluded from coverage under UCC Article 12 are electronic chattel paper, electronic documents, investment property, transferable records under the federal E-Sign law or the Uniform Electronic Transactions Act, deposit accounts, and to some extent, electronic money.

*I. Applicability*

UCC Article 12 applies to any transaction involving a CER that arises on or after July 1, 2022 and does not apply to any transaction involving a CER that arises before July 1, 2022, even if the transaction would be subject to UCC Article 12 if the transaction had arisen on or after July 1, 2022. UCC Article 12 does not apply to a right of action with regard to any transaction involving a CER that has accrued before July 1, 2022.

*J. Savings Clause*

Any transaction involving a CER that arose before July 1, 2022 and the rights, obligations, and interests flowing from that transaction are governed by any statute or other rule amended or repealed by Laws 2021, LB 649, as if such amendment or repeal had not occurred and may be terminated, completed, consummated, or enforced under that statute or other rule.

*K. Conclusion*

The limitation of the applicability of UCC Article 12 to transactions involving a CER arising on or after July 1, 2022 and the savings clause described above provide protections for pre-July 1, 2022 security interests in digital assets. However, the uncertainty surrounding the manner in which a security interest in digital assets is to be perfected under current UCC Article 9 and concerns regarding the ability of lenders to exercise their remedies against digital assets serving as collateral should move lenders with a such a security interest to take steps to obtain possession and control of the collateral. Lender should take control of the digital wallet by (a) acquiring the private key or having the private key turned over to a third-party custodian to be held in escrow; (b) requiring the borrower to transfer their NFTs or cryptocurrency to a digital wallet solely controlled by the lender; or (c) requiring use of digital wallets that require more than one key to authorize transactions.

**The foregoing Compliance Update is for informational purposes only, and does not constitute legal advice. As a reminder, the NBA general counsel is the attorney for the Nebraska Bankers Association, not its member banks. The general counsel is available to assist members with finding resources to help answer their questions. However, for specific legal advice about specific situations, members must consult and retain their own attorney.**