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EMERGING TECH AND THE UCC: AI, DLT AND VIRTUAL CURRENCY

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Background

- The Uniform Commercial Code (the “UCC”) is a uniform state law promulgated by the American Law Institute and the Uniform Law Commission and enacted in substantially uniform form in each state of the United States and the District of Columbia.
- The UCC covers the sale and lease of goods, negotiable instruments, bank deposits and collections, funds transfers, letters of credit, documents of title, investment securities and personal property secured transactions.
- In 2019 the American Law Institute and the Uniform Law Commission appointed a study committee to review the UCC and to recommend changes to take into account emerging technological advances, including artificial intelligence, distributed ledger technology and virtual currency.

Background

- The committee has 20 members appointed by the American Law Institute and the Uniform Law Commission. It also has American Bar Association advisors and over 130 observers. The committee has a chair and a reporter.
- The committee has had two in person meetings so far and is planning a virtual meeting at the end of May. Meetings are open to the public.
- The May meeting will be the first following the outbreak of the Covid-19 pandemic.
- The committee has been receiving strong encouragement from stakeholders to push forward on its work, especially given the need for physical distancing and to conduct transactions electronically and with more efficiency.
- The project will still take several years to complete and obtain approval from the sponsoring organizations before promulgation to the states for enactment.

Scope

- Electronic notes and drafts
 - Priority item
- Electronic chattel paper
- Virtual currency
- Other digital assets
- Payments other than checks
- Bundled hardware, software, information and service transactions
- Miscellaneous secured transaction issues

Electronic Notes and Drafts

- Intangible negotiable instruments would have the same formal requirements as written (tangible) negotiable instruments under UCC § 3-104, except that they would be intangible rather than written.
- Intangible checks, including intangible teller's checks, cashier's checks, and traveler's checks, would not be negotiable instruments under UCC Article 3.
- The substantive legal rules governing issuance, transfer, and negotiation of intangible negotiable instruments would be the same as the rules for written negotiable instruments insofar as possible.
 - Statutory terms that are limited to written negotiable instruments, *e.g.*, *negotiable instrument*, *issue*, *delivery*, *transfer of an instrument*, *possession*, and *indorsement*, would be adjusted (replaced or expanded) to cover intangible instruments.

Electronic Notes and Drafts

- The rights and obligations of parties to a negotiable instrument should not change if the form in which the instrument is maintained changes, *i.e.*, if an instrument is “converted” from a written record to an intangible record, from an intangible record to a written record, or from an intangible record maintained in one system to an intangible record maintained in another system.
- A negotiable instrument cannot be comprised of multiple records unless they are associated with one another.
- The substantive legal rules governing attachment, perfection, priority and enforcement of a security interest in intangible negotiable instruments would be the same as the rules for written negotiable instruments insofar as possible. An analogous concept of “control” would substitute for *possession*.

Electronic Notes and Drafts

- Indicative definition of “control”:

SECTION 3-104A. CONTROL OF ELECTRONIC INSTRUMENT.

(a) In this section, “record constituting the electronic instrument” means the electronic instrument together with any record that is attached to or logically associated with the electronic instrument and [provides] [indicates] [identifies] the original payee or the transferee, as the case may be, of the electronic instrument.

Electronic Notes and Drafts

(b) A person has control of an electronic instrument if:

(1) the record constituting the electronic instrument:

(A) is readily identifiable as the authoritative record of the electronic instrument [for the purpose of this Article]; and

(B) readily enables the person to be identified as the original payee or the transferee, as the case may be, of the electronic instrument ;

(2) the person has the power to cause the record constituting the electronic instrument to provide/indicate that another person is the transferee of the electronic instrument; and

(3) the person has the power to prevent another person from changing the record constituting the electronic instrument.

Electronic Notes and Drafts

(c) A record constituting an electronic instrument which [provides] [indicates] that it is the authoritative record of the electronic instrument [for the purpose of this Article] is readily identifiable as the authoritative record of the electronic instrument within the meaning of subsection (b)(1A).

- Issues under consideration
 - Bearer instruments
 - Negotiation without endorsement
 - Transfer regardless of purpose

Electronic Notes and Drafts

- Choice-of-law issue for control
- Conversion from tangible to electronic and vice-versa
- Relation to E-Sign and UETA
 - Not unsettling settled transactions

Electronic Chattel Paper

- Like issues on the definition of “control”
 - Plus not unsettling settled transactions
- Treatment of chattel paper that is in part tangible and in part electronic
- Conversion from tangible to electronic and vice-versa

Virtual Currency

- Fiat virtual currency (step 1)
 - Update the definition of “money”
 - Provide for perfection and priority of security interest by “control”
 - Provide for security interest “take free” rules
 - Clarify that an Article 3 instrument may be payable in fiat virtual currency
- Non-fiat virtual currency (step 2)
 - Define
 - Provide for perfection and priority of security interest by “control”
 - Direct vs. indirect holding
 - May an Article 3 instrument be payable in non-fiat virtual currency?
- Should UCC Article 4A (funds transfers) apply to fiat or non-fiat virtual currency?

Other Digital Assets

- That what extent already covered by
 - UCC Article 8 as uncertificated securities?
 - UCC Article 7 as electronic documents?
- Should the definition of “securities” in Article 8 be expanded to cover more digital assets?
- Should the use of other digital assets as “financial assets” under Article 8 be encouraged or at least not be precluded?
- Should there be other commercial law rules for other digital assets, including secured transaction rules?
 - Custody
 - Non-intermediated, directly-held

Payments - Bank Payment Systems

- Funds Transfers (Article 4A)
 - Are the words used in Article 4A sufficiently technology neutral to accommodate new technologies?
 - Distributed ledger technology
 - Artificial intelligence (e.g., for identifying the beneficiary)
 - Should the risk allocation rules in Article 4A for authorized payment orders be revised given new technologies?
 - Does a smart contract create a condition to payment when a payment order needs to be unconditional?
 - Do what extent does the definition of “bank” need to be refined so that only deposit-taking institutions are included?
 - Does the terminology in ISO 20020 for message formats create any tension with Article 4A?

Payments – Non-Bank Payment Systems

- Business need for codified rules?
- Possible issues to be addressed that may be solved by bi-lateral agreements or system rules
 - Discharge
 - Creditor process/adverse claims
 - Finality
- Inclusion of virtual currencies
- Coordination with bank payment systems
- Wholesale transfers or all transfers?

Other Payment Related Issues

- Allocation of risks on remote deposit capture
- Given new technologies, the default rules governing customer/bank relationship
- Expansion of Article 4 (bank deposits and collections) commentary to explain coordination with Regulation CC

Bundled Transactions

- Predominant purpose vs. graveman test
- Expansion of “hell or high water” treatment
- Expansion of the definition of “chattel paper”

Miscellaneous Secured Transactions (Article 9) Issues

- Confirm that the current provisions for searching and filing financing statements are technology neutral
- Email addresses on financing statements
- Limits on self-help electronic disablement
- Electronic notifications
- Smart contracts as creating security interests

Presentation Takeaways

1. Commercial law cannot remain static; it needs to change with commercial practices and new technologies
2. We are moving rapidly, especially in the light of the Covid-19 pandemic, towards a world in which paper is less important
3. The committee is trying to accommodate these changes but to do so thoughtfully and by consensus among all stakeholders and with a high probability of uniform state enactment
4. This is an opportunity for stakeholders who want their views known to make an impact

Questions?

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Morgan Lewis Coronavirus/COVID-19 Resources

We have formed a multidisciplinary **Coronavirus/COVID-19 Task Force** to help guide clients through the broad scope of legal issues brought on by this public health challenge.

To help keep you on top of developments as they unfold, we also have launched a resource page on our website at

www.morganlewis.com/topics/coronavirus-covid-19

If you would like to receive a daily digest of all new updates to the page, please visit the resource page to [subscribe](#) using the purple “Stay Up to Date” button.

Biography



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Edwin Smith is a partner in the Finance Practice. He concentrates his practice in commercial law, debt financings, structured financings, workouts, bankruptcies, and international transactions. He is particularly knowledgeable on commercial law and insolvency matters, both domestic and cross-border. His representations have included those in major bankruptcies including Refco, Lehman, and the City of Detroit. He often advises financial institutions on documentation and risk management issues.

Ed advises creditors and counter-parties on commercial and insolvency risks in sales, leasing, financing, investment securities, and derivatives transactions and has represented parties in major insolvencies. He has been a guest speaker for bar and trade organizations including ALI-CLE, the American Bar Association, the American Bankruptcy Institute, the International Insolvency Institute, the Association of Commercial Finance Attorneys, the Boston Hedge Fund Group, the Commercial Finance Association, the National Conference of Bankruptcy Judges, the Equipment Leasing Association, the Practising Law Institute, the Risk Management Association, and various local bar associations. Having actively participated as a Uniform Law Commissioner in the drafting of a number of the recent revisions to the Uniform Commercial Code (UCC), Chambers USA noted he “probably knows as much about UCC as anybody in the country.”

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Biography



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Thomas Plank is Of Counsel in the Structured Transactions Practice. Tom, who is the Joel A. Katz Distinguished Professor of Law at the University of Tennessee College of Law, located in Knoxville, Tennessee, has served as a bankruptcy structuring and Uniform Commercial Code specialist for mortgage backed and asset backed securities since 1987. Beginning in 2001, he has worked with the lawyers in the Morgan Lewis structured finance practice providing advice on bankruptcy law, commercial law, and real estate issues in connection with securitizations and other transactions. Before becoming a full time law professor in 1994, he practiced law for 19 years, concentrating his practice in real estate finance, commercial finance, public finance and securities transactions. Beginning in 1987, he specialized in the securitization of mortgage loans and other receivables as issuer's counsel, underwriter's counsel and bankruptcy counsel.

At the University of Tennessee College of Law, he teaches bankruptcy, secured transactions, property, and negotiable instruments. He has published more than two dozen articles on bankruptcy law, securitization, and the treatment of receivables under Article 9 of the Uniform Commercial Code, and he has served as an expert witness in several cases involving securitization structures.

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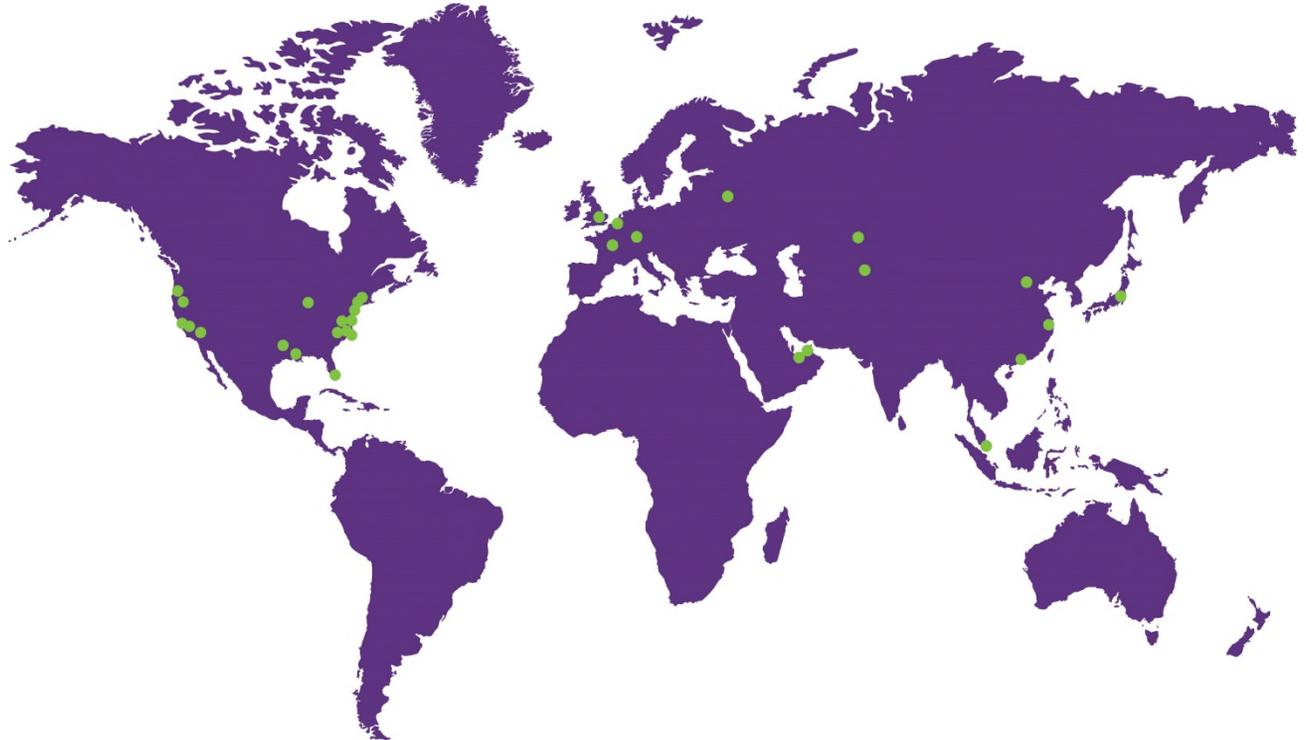
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