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TECHNOLOGY MAY-RATHON

Digital Assets and Commercial Law: What Are The States Doing?

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Organization

- What is a digital asset?
- The role of commercial law
- The role of state law, especially the Uniform Commercial Code
- The market pressure
- The American Law Institute (“ALI”)/Uniform Law Commission (“ULC”) project to amend the Uniform Commercial Code
- Existing and pending state legislation
- What’s next for the ALI/ULC project?

What is a Digital Asset?

An “electronic” record in contrast to a paper record



UCC 1-201(b)(31) defines “record” 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.”

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Despite the word “asset,” the electronic record may or may not have value

An electronic contract to receive goods has the same value as a paper contract to receive goods.

- Merely possessing the paper contract does not entitle the possessing party to the goods
- Merely receiving and storing the electronic contract does not entitle the receiving party to the goods

However, some digital assets do have value.

- Bitcoins and other virtual currencies
- Non-fungible tokens (“NFTs”)
- Electronic records in which other rights are embodied under applicable law, e.g., a transferable record under the Uniform Electronic Transactions Act embodies a payment right

The Role of Commercial Law

Commercial law in relation to digital assets deals with the rights of private parties. It addresses such questions as:

- To what extent does a buyer of a digital asset take the asset free of property claims?
 - Consider virtual currency
- How does a secured party perfect a security interest in a digital asset, ensure that the security interest has priority, and enforce the security interest?

Commercial law does not include other law, such as:

- Whether a digital asset is a security or a commodity for regulatory purposes
- Taxation of digital assets
- Money transmission laws
- Anti-money laundering laws

The Role of State Law

Commercial law has been largely left to the states.

- Contract law among private parties
- The Uniform Commercial Code
 - Sale or lease of goods
 - Negotiable instruments
 - Some aspects of payment systems
 - Letters of credit
 - Transfers of investment securities
 - Secured transactions
- Creditors' rights
 - Enforcement of claims and judgments in state courts
 - Voidable transactions (fraudulent transfers)

The Market Pressure

Virtual Currency

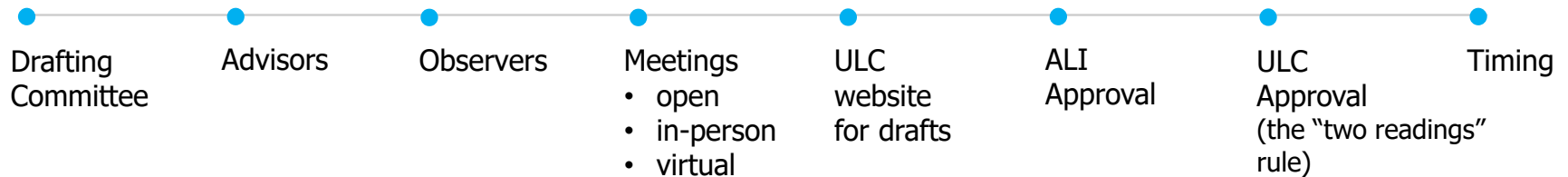
- Buyers
 - No “take-free” rules
- Secured parties
 - General intangibles
- Electronic money and secured transactions

Trade Finance

- Electronic promissory notes and bills of exchange
- UCC Article 3 requirement of a writing
- Limited role of “transferable records” under E-Sign and the Uniform Electronic Transactions Act
- Greater clarity on the effect of choice-of-law and choice-of-forum clauses in negotiable instruments

The ALI/ULC Project - Background

- The Uniform Commercial Code
- The sponsoring organizations
- The process



The Project – Controllable Electronic Records (CERs)

- General discussion (nuances, continuing discussions, possible further changes)
- Concept of technological neutrality
- Definition of “record”
- Definition of “electronic”
- Must be subject to “control” (more later)
 - A digital asset that is not subject to “control” is outside of the scope of the amendments
- Exclusions

X Electronic chattel paper

X Investment property

X Deposit accounts

X Electronic documents

X Transferable records

X Electronic money (more later)

The Project – “Control” of a CER

Elements:



Power to enjoy “substantial benefits” of the CER

The electronic record must have some “use” that one person can enjoy to the exclusion of all others, e.g., the power to “spend” a Bitcoin.

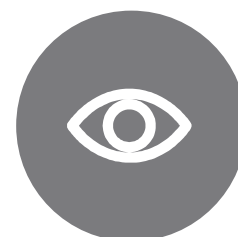


Exclusive power to prevent others from enjoying the “substantial benefits” of the CER



Exclusive power to transfer

A person must be able to transfer to another person this exclusive power to use the electronic record. To remain exclusive, the transfer must divest the transferor of the power to use the electronic record.



Identification

The person must be able to demonstrate to a third party that the person has the power to “use” the electronic record (can be done by cryptographic key or account number).



Exclusivity requirement is satisfied even if sharing/multi-sign or changes built into the system in which the CER is recorded

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The Project – Qualifying Purchaser

A “qualifying purchaser”

- is a person who obtains control of a CER for value, in good faith, and without notice of a property claim to the CER.
 - The filing of a financing statement is not notice of a property claim to the CER.
- acquires all rights in the CER that the transferor had.
- takes free of any property claim to the CER.

The Project – “Tethering” – General Rule

What rights are embodied in the CER and whether “take-free” rules apply to those rights upon a transfer of the CER are all determined by other law.

- e.g., a non-fungible token where copyright law may be well be applicable.

The Project – “Tethering” – Exception for Certain Payment Rights Embodied in the CER

- An “account” or “payment intangible” embodied in a CER is a “controllable account” or “controllable payment intangible” if the account debtor has agreed to pay the person in control.
- A controllable account or a controllable payment intangible travels with the CER, and the transferee benefits from the same “take-free” rule as with the CER.
- The effect is to create an electronic instrument.
- If the terms of the CER provide that the account debtor will not assert claims or defenses against the transferee of the CER (see UCC 9-403), then the effect is to create a negotiable electronic instrument.

The Project – “Tethering” – Exception for Certain Payment Rights Embodied in the CER

- Account debtor discharge rule (similar to UCC 3-602 and 9-406)
 - Account debtor agrees to pay the person in control.
 - After a transfer of control and absent notification of the transfer and a payment direction, the account debtor may obtain a discharge by paying the person formerly in control.
 - Once the account debtor receives a notification of the transfer and a payment direction, the account debtor may obtain a discharge by paying the transferee and may not obtain a discharge by paying the person formerly in control.
 - The account debtor may request “reasonable proof” that control of the CER has been transferred to the transferee.
 - The notification is ineffective unless the account debtor has agreed in an authenticated record with the person at the time in control to a method by which the transferee can provide “reasonable proof” that control has been transferred to it.

The Project – “Tethering” – Exception for Certain Payment Rights Embodied in the CER

- Account debtor discharge rule – practical issues
 - Likelihood that there will be no change in payment directions.
 - Likelihood that there will be no request for “reasonable proof.”
 - Agreement as to how to provide “reasonable proof” is the last safeguard for the protection of the account debtor.

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The Project – Secured Transactions

- Collateral categorization: no need to change collateral descriptions in security agreements or collateral indications on financing statements.
 - A CER is a “general intangible.”
 - A controllable account is an “account.”
 - A controllable payment intangible is a “payment intangible.”
- Attachment: normal rules apply
- Perfection
 - By filing
 - By control
- Priority: Non-temporal priority for a secured party who perfects by control
- Choice-of-law for perfection and priority: the law of the debtor’s location.

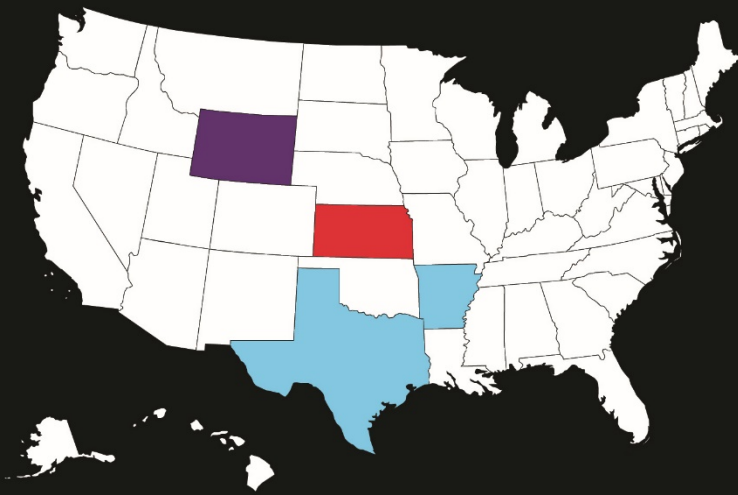
The Project - Electronic Money

- The current definition of “money” in the UCC is sufficiently broad to include a virtual currency authorized or adopted by a government.
- Under current Article 9 a security interest in money can be perfected only by possession.
 - Electronic money is not subject to possession.
- The proposal
 - If electronic money is credited to a deposit account (even one at a central bank), the normal deposit account rules apply
 - If electronic money is money that is not credited to a deposit account, a security interest may be perfected by “control” similar to control for a CER.
 - Except for UCC 9-332(a), any “take-free” rule would be determined by the law governing the electronic money.

The Project - Limitations

- Timing
- Uniform state enactment
- Cross-border transactions
 - UNCITRAL
 - UNIDROIT
 - U.K. Law Commission
 - G7 Digital and Technology – Ministerial Declaration (28 April 2021)

Early Action by Some States



Wyoming (Wyo. Stat. § 34-29-101 et seq.)

- Broad scope for digital assets
- Treats virtual currency as money
- Treats control (broad definition) as possession
- Adverse claim cut-off rule applies after two years
- Aggressive choice-of-law rules

Nebraska (LB 649)

- would adopt earlier version of CER proposal

Arkansas (HB 1926) and **Texas** (HB 4474)

- would adopt CER proposal just for virtual currencies

These and other state proposals may be “place savers” until the uniform amendments are promulgated.

- The uniform amendments will solve, among other things, choice-of-law issues within enacting UCC jurisdictions.

This Next Year for the Project

- Three hybrid meetings planned
- Likely short, virtual meetings
- Smaller working groups
- Observers welcome: contact edwin.smith@morganlewis.com
- ALI approval – May 2022
- ULC “second reading” approval – July 2022
- American Bar Association approval
- Enactment process

QUESTIONS?

Morgan Lewis and Global Technology

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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.

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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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Ed 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, the City of Detroit, and PG&E. 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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Kristen represents a wide variety of direct and alternative lenders, particularly those involving private sources of capital, including private debt funds, hedge funds, specialty finance companies, business development companies, private equity investors, and issuers in domestic and cross-border financings across the capital structure in connection with acquisitions, leveraged buyouts, convertible debt, equity investments, letters of credit, and project financings.

Kristen has experience in bankruptcy reorganizations and liquidations, work-outs, and distressed debt purchases and sales, as well as second lien and mezzanine financings, and other subordinated debt financings. She represents debtors, debtor-in-possession lenders, pre-petition lenders, and unsecured creditors' committees, as well as other creditors in bankruptcy proceedings. She also advises clients on energy company and real estate restructurings, and provides general credit review analysis for lenders and potential debt purchasers.

Our Global Reach

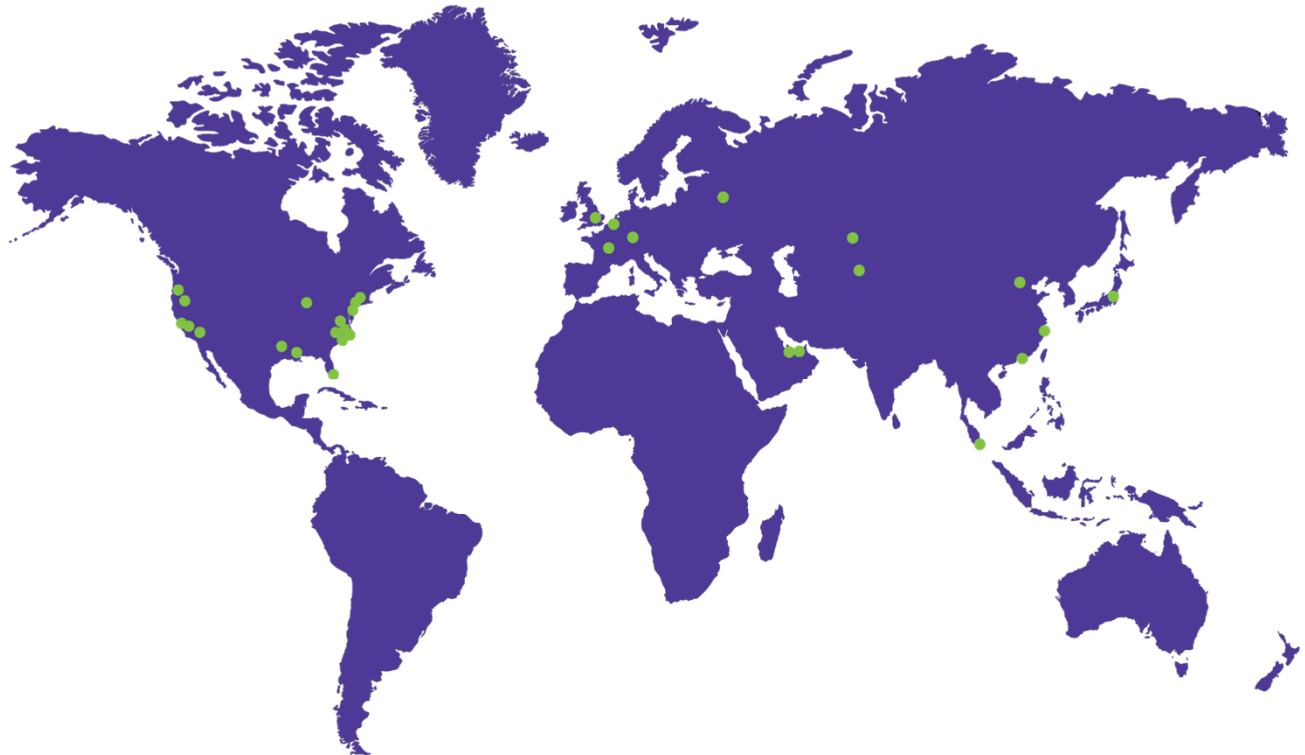
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