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Expert Q&A on Why New York Should Enact the 2022 UCC Amendments

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An expert Q&A with Michael Evan Avidon and Alan Kolod, Moses & Singer LLP, on the reasons New York should enact the proposed 2022 New York amendments to the Uniform Commercial Code dealing with digital assets and technologies, as recommended by the New York City Bar Association.

What Are the 2022 UCC Amendments?

In July 2022, the Uniform Law Commission (ULC) and the American Law Institute (ALI) jointly promulgated proposed digital assets and technologies amendments (Amendments) to the official version of the Uniform Commercial Code (UCC) (see American Law Institute: Uniform Commercial Code and Uniform Law Commission: 2022 Amendments to UCC). For more information, see Practice Note, Proposed 2022 Amendments to the UCC.

The ULC has published several position papers in support of the Amendments, and over 20 US jurisdictions are already considering their enactment (see Uniform Law Commission: 2022 Amendments to UCC: Legislative Bill Tracking).

The New York City Bar Association recently issued a report supporting enactment of the Amendments in New York and has prepared a version of the Amendments (New York Amendments) specifically tailored to accommodate the non-uniform provisions of New York's UCC and electronic signatures and records law (see New York City Bar: Member & Career Services: Committee Report: Report in Support of Enacting New York Version of 'Emerging Technology Amendments' to the Uniform Commercial Code).

These New York Amendments accommodate:

- The expanding use of electronic technology for commercial transactions.
- The continuing development of novel intangibles, such as digital assets, as a new category of potentially valuable commercial property.

Enactment of the New York Amendments should encourage technological development to decrease transactional and credit costs and improve the efficiency of, and consumer satisfaction with, commercial transactions. But enactment will also protect the security of these electronic transactions, preserve existing consumer protections, and expand the protections to transfers of newly recognized digital assets, while also leaving electronic commerce subject to appropriate public interest regulation. All of these outcomes should increase economic activity in New York for the benefit of all New Yorkers and help preserve New York's status as a financial and commercial capital.

How Has Technology Revolutionized Commerce Since Enactment of the UCC?

The UCC was published in 1952, when commerce consisted largely of transfers of goods and instruments, evidenced by manual signatures on documents and by physical possession of those goods or instruments. In that era, transfers of intangible or non-physical property were often evidenced by public filings with government offices describing the intangible property in question.

In the past 70 years, technology has transformed commerce. The volume of transactions requiring transfers of instruments, such as stocks, bonds, and checks, became unmanageable and required the "dematerialization" of these assets into intangible (and, eventually, electronic) forms. Goods now frequently incorporate software. Software and even newer types of intangible electronic assets have become an enormous source of value.

Technology has made possible new types of assets, some of which have been recognized as quite valuable

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in various markets. It has also transformed how transactions in both physical and intangible assets are conducted. Electronic records evidencing legal rights can be more secure than paper records against alteration, misappropriation, or forgery. Electronic transmission enables transactions to occur securely and instantaneously by computer among people anywhere in the world. Electronic transactions can be cheaper, more efficient, and more reliable than paper-based transactions, and have enormously increased consumer satisfaction. This evolution of technology continues, and it holds even greater promise for the future.

Why are Amendments to the UCC Needed Since States Have Already Passed Laws Recognizing Certain Electronic Records as Equivalent to Paper Records?

The Amendments are needed because commercial laws governing the rights of persons involved in these electronic transactions have not kept pace with the market. While the UCC's underlying principles and policies remain sound, many provisions are written as if they apply only to written, manually signed contracts, and as if physical possession of goods and documents is the most (or only) reliable or relevant evidence of control of those assets. In New York, the status of electronic drafts, electronic promissory notes, electronic documents of title and electronic chattel paper are confusing. In addition, the current New York UCC's concept of control of electronic records is wedded to older technology. This approach creates uncertainty regarding the legal rights conferred by electronic transfers of digital assets and by electronic transactions affecting rights to other assets. That uncertainty can only hamper continued improvement of commerce and resulting economic growth.

The Amendments are technologically neutral and therefore encompass both older forms of electronic transactions and novel distributed ledger systems (including blockchain). They provide a legal foundation for existing and future systems of obtaining control and transacting business electronically, including automated electronic settlement or payment systems that employ distributed ledger technology to promote efficiency and reduce transaction costs.

The Amendments clarify the commercial rights of transferors and transferees in all types of electronic commercial transactions, such as:

- Central bank digital legal tender.
- Non-fungible tokens (NFTs).
- Digital title documents.
- Other digital assets, including cryptocurrencies.

The Amendments clarify commercial rules, leaving to the market and appropriate regulation the determination of what forms of digital commerce are useful. They do not endorse Bitcoin or any other particular type of digital commerce. The Amendments preserve legislative authority to regulate the consumer and investor protection and environmental, financial institution, and other public interest aspects of digital commerce.

What Will the Benefits of Enactment Be?

The Amendments adapt and apply time-tested fundamental rules of the UCC to electronic transactions and, in particular, to transactions involving intangible digital assets. The goal of the Amendments is to enable the public to obtain the full benefits of past and future improvements in cost reduction, efficiency, security, and consumer satisfaction, by encouraging continuing development of electronic commerce and new forms of digital assets. The Amendments minimize the need to constantly amend the UCC as business practices involving technology evolve.

As they are enacted in various states, the Amendments will preserve the essential uniformity of US commercial law, reducing transaction costs and costs of credit in the enacting states. The New York Amendments, in particular, preserve important unique features of New York's UCC that have made New York the state of choice for many US and cross-border commercial and financial transactions.

How Confident are You that These Extensive Amendments to the UCC Work?

The proposed Amendments utilize the work and expertise of the ALI and ULC, and the consensus of approximately 350 expert advisors and stakeholder-observers who met many times over a three-year period, to craft overdue updates of the UCC made necessary by the digital revolution.

New York Involvement in Drafting

New York was well represented on the drafting committee for the ULC/ALI proposals. In addition, the Amendments have been vetted by the Digital Task Force of the New York City Bar Association, representing 44 City Bar committees. The task force has approved the New York Amendments, which are specifically tailored to preserve the unique features of New York's present UCC, particularly its protections for the negotiability of certain monetary obligations (see Unique New York Provisions).

What Do the Amendments Do Specifically?

The Amendments:

- Recognize new forms of intangible property, that is, controllable electronic records, controllable accounts, and controllable payment intangibles and set out the rules governing rights of transferees of this property.
- Update the rules for perfecting interests in these digital assets.
- Set out new rules for mixed sales or leases of goods that also involve services or rights in intangible assets, such as software.
- Update the rules governing transfers of electronic negotiable instruments and title documents.
- Update UCC terminology applicable to assets evidenced by electronic signatures and electronic records.

Making the UCC Media-Neutral

Current UCC provisions generally were written for parties using paper documents. Therefore, most of the Amendments simply make clear that UCC-governed transactions can be accomplished using electronic signatures on electronic records and, except where the requirement of a writing is retained, do not require manual signatures on paper. In short, they make the UCC neutral as to the media used to evidence UCC-governed transactions, furthering the goal of New York's Electronic Signatures and Records Act (ESRA) to make electronic records and signatures the legal equivalent of written documents and manual signatures.

Clarifying Rules to Establish the Means and Effect of Control of Electronic Records

New UCC Article 12 identifies a new category of intangible asset, referred to as a "controllable electronic record" (CER). CERs are electronic records subject to being "controlled" by an identifiable person. Originally, control of an electronic record was possible on closed systems that created and maintained a single unalterable, authoritative electronic copy and evidenced its pedigree. This can now be done using distributed ledger systems, which use consensus to identify the terms of a record and its pedigree.

These CERs are not limited to, but include, virtual currencies and crypto or non-fungible tokens, and may evidence electronic promises to pay. The Amendments provide rules governing, and the legal consequences of obtaining, "control" of a CER, including rules for the perfection and priority of a security interest in a CER. This updated law will stimulate economic activity by providing legal certainty to increasingly common financing transactions dependent on CERs for credit support.

Ensuring That the Rules for Control Can Evolve

The new rules for establishing control are functional and not wedded to any existing technology. In essence, control of an electronic record is the functional equivalent of exclusive physical possession of an original written instrument and turns on the ability of the person in control to avail itself of substantially all of the benefits of the record while excluding others from obtaining such benefits and having the exclusive right to transfer the record, regardless of the technology by which this may be accomplished.

The Amendments' expansive concept of control will accommodate both current technologies for achieving control and also future technologies. This change will promote innovation.

Creation of Controllable Accounts and Controllable Payment Intangibles as New Types of Negotiable Property

Article 12 identifies two other new intangible assets, controllable accounts and controllable payment intangibles, which are rights to receive payment evidenced by a CER in which the obligor has agreed to pay the person in control of the CER. These intangible rights to payment are transferred by control of the CER that evidences them, and this control perfects the transferee's interest without the need for a UCC filing under Article 9. Creation of these new intangible asset classes are the primary modifications of the UCC that may affect consumers, and the Amendments provide new consumer protections in each case.

Consumer Protection of Good Faith Purchasers of Controllable Accounts and Controllable Payment Intangibles

The Amendments retain and do not impair any current consumer protections in New York law. But they also add provisions strongly protective of the rights of purchasers of controllable accounts and controllable payment intangibles, whether outright or only for purposes of security or collateral. After the transition period which will allow holders of perfected security interests in intangibles to protect their rights, the Amendments will protect purchasers who obtain control of the digital assets from adverse property claims (including prior security interests perfected only by UCC filings against intangibles to such CERs so long as the purchaser obtains control in good faith and without notice of the adverse claim).

Consumer Protection of Obligors on CERs

The existing protections for obligors on accounts or payment intangibles (who may be consumers) also are preserved. In addition, the Amendments are extremely protective of the underlying obligors whose obligations become controllable accounts and controllable payment intangibles evidenced by CERs in three ways:

- The obligations become controllable accounts or controllable payment intangibles only if the obligor expressly agrees in the CER to pay only the person in control.
- By doing so, an obligor still preserves its defenses to claims asserted by a transferee of the CER.
- The obligors cannot be put at risk by uncertainty or ambiguity about who is in control of the CER and, therefore, who is entitled to receive payment.

Electronic Money

The Amendments clarify the rules governing security interests in CERs commonly called cryptocurrencies. The Amendments do not recognize Bitcoin or any other cryptocurrency as money. They are simply CERs. The Amendments therefore correct the flaw in the existing UCC, which arguably would treat as money any cryptocurrency adopted by a foreign government as legal tender, as El Salvador and the Central African Republic have done with Bitcoin. Only a cryptocurrency initially established by a government would be treated as "electronic money" under Article 9.

Governing Law

Because digital assets have no physical location, conflict of laws questions may arise. The Amendments contemplate that the parties may choose, in the CER or system hosting the CER, the law and forum that applies to their transaction for commercial law purposes, and provide default rules when no choice is made. Parties may be expected in many cases to choose New York law and courts, given New York's well-developed commercial law and unique protections for the negotiability of payment obligations.

Hybrid Transactions in Goods

Articles 2 and 2A of the UCC apply to the sale and lease of goods, respectively, and not to contracts for services or for the sale or licensing of intangibles. Legal uncertainty has increased as the line between these categories has blurred, as transactions increasingly involve both the sale or lease of goods and the provision of intangible property or services.

The Amendments provide that, for these "hybrid" transactions, absent the parties' agreement otherwise, the UCC rules will apply to the entire transaction if the sale/lease of goods is the predominant purpose of the transaction. But if the provision of services or intangible property predominates, the UCC rules will apply only to those aspects of the transaction that involve the sale or lease of goods. Whether or not the lease of goods aspects of the transaction predominates, the finance lease provisions of Article 2A will apply to those aspects of the transaction.

Negotiable Instruments

The Amendments do not purport to make Articles 3 or 4 applicable to those CERs which would be negotiable instruments if in writing. However, under Article 12, purchasers of CERs that evidence controllable accounts and controllable payment intangibles would obtain, as "qualifying purchasers," some key protections analogous to those applicable to Article 3 holders in due course of negotiable payment obligations evidenced by writings. The Amendments in Articles 3 and 12 clarify that a choice-of-law or choice-of-forum clause in a record, or a waiver of defenses in a CER that evidences payment rights, do not impair the record's status as an obligation for the payment of money only (and therefore would not impair negotiability of the payment obligation), and Article 12 contains a provision making explicit that CERs are effective and enforceable under ESRA whether or not Article 3 applies to them.

In addition, to protect existing online banking practices, the Amendments make clear that, for purposes of collection:

- An image of a negotiable instrument (that is, photos of the front and back of a check) may be substituted for the actual instrument in accordance with federal banking regulations.
- Destruction of the paper check in conjunction with the creation of the images, as often occurs where the check is submitted through a remote deposit capture system, would not discharge the drawer of the check.

Electronic Chattel Paper

New York's current Article 9 sections relating to control of electronic chattel paper fail to incorporate the rule found in Article 9 of every other state that recognizes control without the need for the existence of a single authoritative electronic record. There is no reason for the absence of this provision from New York law, and there certainly will be none once New York adopts the Amendments recognizing that control does not require such a single authoritative record. The Amendments would correct that deficiency and conform New York law to that of other states in this regard.

Electronic Documents of Title and Securities Entitlements

The Amendments preserve New York's existing recognition of electronic documents of title in Article 7. They also preserve the potential for CERs of all types to constitute "financial assets" governed by Article 8, entitlements to which may be credited to a securities account with a securities intermediary (such as a clearing corporation, bank, or broker). Therefore, the rules of Article 8, governing indirect holding systems for financial assets, will protect investors who hold or trade CERs through intermediaries.

Amendments Become Effective in Six Months and Include a Grace Period to Preserve Pre-Existing Priorities

The Amendments would not become effective for six months, providing a period for persons to accommodate to the new rules. They also contain transition provisions designed to protect the expectations of parties to preexisting transactions. For example, a secured lender who has a priority security interest in collateral under the prior law will retain its priority through a transition period, giving parties to preexisting transactions adequate time to revise their agreements to comply with the updated law.

Why Is It of Vital Importance to New York to Enact the New York Amendments?

Unique New York Provisions

The New York Amendments are tailored to New York in several important respects made necessary by the fact that New York is the only state that has adopted ESRA, rather than the ULC's Uniform Electronic Transactions Act (UETA), to govern electronic records.

First, as to controllable accounts and controllable payment intangibles that would be negotiable instruments if they were in writing, the New York Amendments preserve the special New York rule of Article 3 defining notice of an adverse claim.

Second, because of the differences in the ways ESRA and UETA function, it is necessary to provide that "transferable records" under UETA, which would be excluded from Article 12, are excluded from New York's Article 12 only if UETA actually applies to them.

Third, Article 12 makes clear that ESRA cannot be used to argue that a CER created after the effective date of the New York Amendments, and which would be a negotiable instrument if in writing, is either subject to Articles 3 and 4 by virtue of ESRA or should be excluded from ESRA's effectiveness and enforceability protections, depending on whether or not a single authoritative electronic copy of that CER is maintained. The New York Article 12 precludes an obligor on a controllable account or controllable payment intangible who has waived defenses from asserting that such a waiver itself deprives the purchaser of "qualifying purchaser" status.

Advantages for New York

Adoption of the New York Amendments would ensure that New York's commercial law with respect to digital assets and electronic transactions is up to date and consistent in material respects with the law of all other states which enact the Amendments. New York law is not currently up to date, and if other states enact the Amendments, New York law will be even less desirable for electronic transactions and digital assets than it is now.

But enactment would do more than bring New York up to date. It would preserve for negotiable digital assets the advantage of New York's current "negotiability" protections for good faith purchasers of paper instruments without knowledge of adverse claims or defenses. It would also make clear that choice of law and forum provisions in CERs and in Article 3 instruments that specify New York law or a New York forum would be enforceable.

Preservation of Additional Consumer Protection and Other Regulatory Regimes

Enactment of the New York Amendments would not limit the ability of New York to protect consumers or investors or otherwise regulate electronic transactions and transactions involving digital assets under its state consumer protection, environmental protection, financial institution regulatory, or commodities and securities laws. The New York Amendments do not diminish any existing protections for New York citizens or consumers. This is particularly important in light of recent news indicating the risks to the investing and the general public of inadequately regulated commerce in digital assets.

Risks of Failure to Enact the Amendments

New York's UCC is not uniform with the laws of other states. As a result, New York's UCC and its related electronic transactions law, ESRA, currently create uncertainty that makes them less attractive as the governing law for many electronic transactions or transactions involving digital assets.

At least 20 states and Washington D.C. are already considering enactment of some version of the Amendments (see Practice Note, Proposed 2022 Amendments to the UCC: State-by-State Adoption). If New York were to fail to enact the Amendments while other states do enact them, application of New York law and submission to New York courts would become even less desirable for transactions in digital assets. Furthermore, the provisions in the Amendments expressly permitting choice of law and forum provisions would make it easier for parties to affirmatively opt out of the selection of New York law or forum. These would be unfavorable developments for the New York economy and its citizens.

Conclusion

The New York Amendments are designed to benefit consumers and businesses alike and to encourage technological developments that provide all New Yorkers with the greater efficiency, reliability, security, and consumer satisfaction of electronic commerce, while also producing transactional cost savings. These benefits should encourage growth in business and employment, and enhance tax revenues, in New York and also preserve New York's status as the nation's preeminent commercial jurisdiction, all without increasing expenditures by state government. Failure to enact the New York Amendments may jeopardize New York's position as a national and international financial and commercial leader.

The views expressed herein are personal views and not necessarily the views of any of the authors' partners or clients.