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Expert Q&A on the Effect of the 2022 UCC Amendments on Fund Finance Transactions

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An expert Q&A with Chris McDermott, Trent Lindsay, Christopher Montgomery, and Eric Starr, of Cadwalader, Wickersham & Taft LLP, on the potential impact of the 2022 amendments to the Uniform Commercial Code (UCC) on fund finance transactions. The 2022 UCC amendments include a new UCC Article 12 that creates a new UCC asset type (controllable electronic record (CER)) and new types of payment obligations (controllable accounts and controllable payment intangibles).

Based on a typical investment fund structure, why might it be surprising to practitioners that new UCC Article 12 could have an impact on fund finance transactions?

Fund finance practitioners may not have paid close attention to new Article 12 to the Uniform Commercial Code (UCC) and the 2022 UCC Amendments (2022 Amendments) because they may believe that the scope of the 2022 Amendments is limited to cryptocurrency, and that if a deal does not involve cryptocurrency, the 2022 Amendments are not something to worry about. (The UCC as amended by the 2022 Amendments is referred to in this Q&A as the Amended UCC). While crypto assets may have been the paradigm digital assets that the Article 12 drafters had in mind, the 2022 Amendments in fact cover a much broader territory. If fund finance transactions involve assets and rights evidenced in electronic format, it is possible that Article 12 may come into play.

For more information on the 2022 Amendments, see Proposed 2022 Amendments to the UCC Toolkit and the Uniform Law Commission 2022 Amendments to UCC website.

The key innovation made by Article 12 was the definition of a new UCC asset type, the controllable electronic record (CER) (Amended UCC Section 12-102(a)(1)). CERs are a subcategory of general intangibles and are defined under Article 12 in quite broad, open-ended terms. A CER is generally any "record" stored in an "electronic" medium that can be subjected to "control" under a new UCC provision, Amended UCC Section 12-105. The quoted words also have specialized definitions under the Amended UCC, which are likewise broadly worded. The drafters of Article 12 intentionally used broad language so that the 2022 Amendments would be technology-neutral and future-proof, and would not become obsolete as technology evolves.

The new definition of CER also expressly excludes several existing categories of UCC assets from the scope of CERs, including deposit accounts, investment property, and electronic versions of chattel paper and documents of title. Therefore, if an asset falls within the ambit of those previously defined UCC assets, that asset would not be a CER even though it would otherwise satisfy the definition of CER, and non-Article 12 portions of the UCC would apply.

In addition, the 2022 Amendments define certain new types of payment obligations as controllable accounts (CAs) and controllable payment intangibles (CPIs). A CA or CPI is generally an account or payment intangible, respectively, that is evidenced by a CER, and as to which the account debtor under the payment obligation has undertaken to pay the person who "controls" the CER under Article 12.

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"Controllability" is the key concept for CERs, CAs, and CPIs, and yet, it is the most amorphous. Amended UCC Section 12-105 defines control primarily by reference to certain powers a person must have with respect to the subject electronic record. Assessment of these powers would typically require an analysis of the technical functionality of the record and platform, tasks for which many lawyers are ill-suited. Technological experts and consultants will likely play an important role in making these assessments. (See Question 7 below.)

Note that there is no specific mention of cryptocurrency, digital tokens, blockchain, or distributed ledger technology (DLT) in Article 12. All that is required for an asset to fall within Article 12 is for that asset to be appropriately electronic and controllable. The breadth of the statute can give rise to the risk that practitioners may not recognize when Article 12 is applicable.

What assets are typically used as collateral in fund finance transactions, and how could this collateral be affected by new UCC Article 12?

The collateral supporting fund finance transactions varies by the type of deal. In a subscription facility, the collateral is typically the subscription obligations of investors to the fund obligor. In a net asset value (NAV) facility, the collateral is the assets held by the fund obligor, such as equity interests in downstream fund entities and related contract rights. For more information on fund finance, see Practice Notes, Fund Finance: Overview and Security Interests: Fund Finance.

These types of collateral are intangible assets, which are good candidates to be evidenced electronically and digitally. Indeed, it is apparent that many fund finance market participants view these assets as viable use cases for blockchain-based subscription processes and tokenized fund interests, and some have begun to implement these digital solutions.

If collateral assets take the form of electronic records, practitioners should consider the application of Article 12. These electronic assets could themselves be CERs, or they could be "tethered" to CERs even if the underlying assets fall outside the new Article 12 categories.

What changes does new UCC Article 12 make that could affect fund finance transactions?

Perhaps most interesting about the new UCC asset categories of CERs, CAs, and CPIs is that the 2022 Amendments imbue them with two special "negotiability" properties that enhance their financeability.

First, CERs benefit from a "take free" right. This right allows a purchaser of a CER in good faith and without notice of another claim in the CER to take it free of other property claims (Amended UCC Section 12-104(e)). Such a purchaser of a CER is referred to as a "qualifying purchaser" (Amended UCC Section 12-102(a)(2)). In this context, remember that a "purchaser" under the UCC includes a secured party, so holders of security interests can benefit from this take free right. This right is similar to the negotiability rights enjoyed by a holder in due course of a negotiable instrument or a protected purchaser of securities.

The second special property Article 12 affords CERs is the ability of a secured party to perfect a security interest in a CER by control. Under the pre-Amended UCC, a CER would be characterized as a simple general intangible, and the method to perfect a security interest in general intangibles as original collateral is to file a financing statement. Under the 2022 Amendments, CERs (though still a subcategory of general intangibles) are granted an additional method to perfect, which is control under Article 12.

Further, a secured party that perfects in a CER by control has priority over the security interest of any other secured party that does not have control. Therefore, a security interest in a CER perfected only by filing could be vulnerable to being primed by a competing creditor that perfects by control, even if the filing perfection was earlier in time.

Importantly, the newly defined Article 12 payment rights, CAs and CPIs, are also afforded the benefit of the same take free rights and higher-priority control perfection of the CER that evidences them.

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What advantages could new UCC Article 12 provide to fund finance transactions?

If the collateral assets underlying a fund finance deal fall within the new Article 12 asset categories of CERs, CAs, or CPIs, the special properties given to these new asset types could make that collateral of a better quality than the same assets would be under the pre-Amended UCC.

For example, consider a fund that has established a digital subscription protocol whereby investors' subscription obligations are represented by digital tokens residing on a blockchain, which can be moved from the fund's wallet to a secured party's wallet. Further, assume that the subscription token operates by moving funds from the investor to the fund (or another person in control of the token) automatically when a smart contract protocol executes on the satisfaction of defined conditions.

Under these facts, there would be a good chance that those subscription tokens might constitute CPIs, and a fund finance lender who takes control of those tokens as collateral for a subscription financing would have a stronger position in its collateral under the Amended UCC than would be possible under the pre-Amended UCC. This is because, if these tokens were indeed CPIs and the lender could qualify as a qualifying purchaser, the fund finance lender's interest in the tokens could "take free" of any third-party property claims. Further, the fund finance lender could perfect a security interest by control of the tokens and get a higher-priority security interest than the pre-Amended UCC method of filing, even priming a pre-existing security interest in the tokens perfected only by filing a financing statement.

What impact could there be if NAV collateral includes interests in Decentralized Autonomous Organizations (DAOs) or smart contracts?

The collateral supporting fund finance transactions that are NAV facilities could also take electronic and digital form and therefore require consideration of Article 12. As noted, the collateral for NAV facilities is typically equity interests in downstream funds or other entities, or contract rights.

One organizational type that has emerged from the blockchain ecosystem is the DAO (see Practice Note, Decentralized Autonomous Organizations (DAOs): Overview). A DAO is a software-enabled organization that is governed by smart contracts on a blockchain. Smart contracts are essentially coded computer programs that enable the participants to cause pre-programmed transactions to be executed once defined conditions have been satisfied (see Practice Note, Smart Contracts: Best Practices).

Participants in a DAO may get tokens to evidence their interests in the DAO, which may include rights to participate in voting, governance, and operations. These tokens could well be characterized as CERs under Article 12, and the use of the tokens as collateral in a NAV facility could implicate the same Article 12 issues discussed in previous questions.

A DAO in and of itself does not imply any particular legal structure. DAOs are made of computer code. Furthermore, as earlier noted, the definition of CER excludes various existing categories of UCC assets, including investment property.

Investment property is defined in the Amended UCC to include securities, securities accounts, commodity contracts, and commodity accounts (Amended UCC Section 9-102(a)(49)). Equity interests in traditional legal entities such as corporations, limited liability companies (LLCs), and limited partnerships may in some cases be characterized as investment property, and in other cases may not be characterized as investment property (Amended UCC Section 8-103(a), (c), (h); Box, Investment Property).

Therefore, if a DAO is organized as (or wrapped in) a traditional legal entity such as an LLC, or if the DAO has established legal organizational "bridges," such as Cayman Islands companies, the UCC analysis of the collateral requires the examination of both Article 8 regarding its legal entity status (to determine whether it is excluded from the CER definition as investment property) and Article 12 (if applicable).

The rights of beneficiaries of smart contracts raise similar issues of characterization as CERs (or potentially CAs or CPIs). Smart contracts are integral parts of DAOs but theoretically could be considered to be inherent in the DAO tokens evidencing ownership or governance rights, or to be something separate.

Further, smart contracts are extensively used separate from DAOs to effect on-chain transactions. A NAV lender would need to determine the specific nature of a smart contract it seeks to use as collateral to be satisfied of its credit support, and whether and how Article 12 might apply.

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What disadvantages could new UCC Article 12 provide to fund finance transactions?

There are several risks that Article 12 poses to fund finance lenders. We have already mentioned the special negotiability characteristics of the new Article 12 asset types. The flip side of these characteristics is that they could pose new risks. For example, an innocent purchaser could acquire a fund finance lender's Article 12 collateral and cut off that lender's interest via take free rights, or a competing creditor could get a priority security interest perfected by control in the same Article 12 collateral in which the lender has perfected its security interest only by filing.

The transition rules applicable to adoption of the 2022 Amendments in a given state also add potential pitfalls. For example, say secured party 1 and secured party 2 both perfected by filing prior to the effectiveness of the 2022 Amendments in a given state in collateral that would constitute CERs, CAs, or CPIs if the 2022 Amendments were in effect. Further, say secured party 1 has priority as first to file. If secured party 2 were to obtain control of the CERs, CAs, or CPIs after the effectiveness of the 2022 Amendments in that state, secured party 1 would still have priority over secured party 2 for at least a year from effectiveness (the adjustment date, which is the later of a year from effectiveness and July 1, 2025) because their relative priorities had been "established" by their time of filing prior to effectiveness.

But, if only secured party 1 had perfected by filing prior to effectiveness (and secured party 2 had not perfected in the collateral), but after effectiveness secured party 2 perfected by control, then secured party 2's security interest would defeat secured party 1's security interest, even if secured party 2 took control only a day after the effectiveness of the amendments. In other words, secured party 1 would not get the year's grace period to establish control perfection. The reason is that the transition rules in the second case do not consider the relative priorities of secured party 1 and secured party 2 to have been established prior to the effectiveness of the statute (Amended UCC Section A-305(b) & official comment 2).

A further risk is that there is not a single effective date for the 2022 Amendments across the states. At publication of this Q&A, there were 25 states (including DC) that have enacted the 2022 Amendments. This patchwork of enactment creates serious and difficult conflict of laws issues. It is entirely possible for a court sitting in a state that has not adopted the 2022 Amendments nonetheless to be faced with applying them, because applicable choice of law rules bring in the UCC of another state that has enacted the amendments. The Permanent Editorial Board for the UCC has helpfully considered these issues in detail in a draft report on the subject (see American Law Institute: Joint Committees: Permanent Editorial Board for the Uniform Commercial Code (PEB)).

What is control under Article 12 as it relates to CERs, CAs, and CPIs, which may be collateral in fund finance transactions?

The lynchpin concept under Article 12 in the 2022 Amendments is the concept of control. CERs, CAs, and CPIs fundamentally must be controllable within the meaning of Article 12 for any of the other consequences to flow (Amended UCC Section 12-105).

Unlike control concepts for pre-Amended UCC electronic asset types, such as electronic chattel paper, which embedded concepts from then-cutting edge electronic vaulting technology into a safe-harbored means of control, the Article 12 drafters took a technology-neutral approach. Section 12-105 of the Amended UCC defines a person to have control of an electronic record if the record, an attached or logically associated record, or the system in which the electronic record is recorded (1) gives the person three powers: (a) the power to avail itself of substantially all the benefit of the electronic record, (b) the exclusive power to prevent others from availing themselves of substantially all the benefit of the electronic record, and (c) the exclusive power to transfer control of the electronic record, and (2) enables the controlling person to be identified (including by such means as cryptographic key or identifying number). The non-specific wording of this control definition will likely require fund finance lawyers to consult with technological experts to assess whether in fact the operation of the system and the electronic record meet these criteria.

In addition, determining exclusivity under Article 12 with respect to the second and third powers listed in clause (1) of the preceding paragraph can be complicated. The control person's exclusive power is not lost if the power is properly shared. However, that sharing would not work under the statute (and the control person would fail to have exclusivity) if the control person were only able to exercise the power if the other person also exercises it

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and the other person can exercise the power without the control person (or if the other person is the person who transferred the electronic record in the first place, that is, the debtor).

The sharing issue is crucial to assessing consensus mechanisms for many blockchain-based digital assets, such as multi-signature (multi-sig) arrangements (Amended UCC Section 12-105).

Sharing of control of CERs, CAs, and CPIs could arise in various ways in fund finance transactions, including in arrangements that would call for control agreements for pre-Amended UCC asset types. Fund finance lawyers and their clients will need to work with technology experts to translate these arrangements to the on-chain environment in ways that have the intended legal effects, and that take advantage of (and avoid the risks of) Article 12 (see Box, Power Versus Right).

Does digitization of subscription obligations or NAV collateral raise any new concerns with fraud in fund finance transactions? If so, does Article 12 suggest any mitigants? What other approaches might be worth investigating?

One issue that everyone needs to be concerned about with any electronic process is cybersecurity, and an electronic platform does not need to be blockchain-based for the risk of hacking to rear its head. Basic features of DLT tend to enhance security. Decentralization means that hackers do not have a single point of attack, and immutability of records stored on a blockchain adds protection against bad actors attempting to corrupt records.

However, the same immutability of DLTs that can be protective can also raise concerns. When smart contracts are deployed to a blockchain, they typically are not thereafter changeable. They will be set to execute automatically on the occurrence of any necessary conditions or receipt of any necessary inputs. If there are later-discovered flaws in the computer code of the smart contracts, there is a risk that the flaws could be exploited or cause losses or other unintended results. Under arguments that “the code is law,” the unfairly benefited parties might claim that the smart contract be executed exactly as programmed.

Article 12 and the 2022 Amendments, being intentionally technology-neutral, do not take a stand on specific technological aspects of digital assets. However, as discussed above, CERs, CAs and CPIs are given take free rights and control perfection of security interests by Article 12. It is possible that, in novel transaction structures, fund finance practitioners may find ways to use those attributes to isolate these security risks. In addition, the distributed nature of participants in blockchain transactions suggests opportunities to create chain-native insurance or insurance-like features in a digital transaction, to spread security risks that cannot otherwise be reduced.

Ultimately, the mitigation of fraud risk from hackers and other online security threats is not a commercial law issue so much as a technological issue. Creators of smart contracts and distributed applications typically put significant effort into auditing the code of their solutions before they are deployed. The ability of users of those digital products to verify these audits would likely be a difficult process requiring the assistance of the users’ own technology experts. If the stakes are high enough, however, this diligence may be required.

Does the advent of Article 12 require or suggest any modifications to standard documentation for fund finance deals?

If a fund finance subscription or NAV transaction encompasses assets or structural elements that are clearly digitized or tokenized, current standard documentation should be modified to explicitly address those novel assets. For example, if in a deal where a pledged subscription obligation takes the form of a digital token that is a CER, CA, or CPI, and a contemplated remedy on default is to utilize a private key to move the token from a borrower’s wallet to the lender’s wallet, the loan agreement and security agreement should be modified to describe the terms of that remedy expressly. Because digitized and tokenized deal structures are still evolving, it is not possible to generalize about how documents should be modified, other than that they should track the transactions and the technology.

It is possible, in addition, that traditional deal structures may find themselves encompassing digital assets. For example, if subscription obligations or NAV collateral in an existing deal can be added to over time, this collateral

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may in the future include assets evidenced by digital records, even if digital assets were not present when the deal first closed. To cover these cases, fund finance lawyers should consider adding new Article 12 asset categories to security interest granting clauses, including representations directed at the absence of other Article 12 control parties, and including enhanced further assurance provisions obliging borrowers to put fund finance lenders in control of CERs, CAs, and CPIs if those asset types appear in the deal.

What are the current digitization proposals for money? How would digitized or tokenized money products affect fund finance transactions? What effect does Article 12 have on digital money?

One key feature of a fund finance transaction, like any financing, is the funds used to settle obligations. Parties need to fund borrowings, repayments, interest payments, and fees. Fund borrowers need to move funds around the structures in connection with investments and distributions. In traditional deals, these funds flows typically take the form of familiar bank funds transfers.

As finance transactions begin to migrate onto blockchain platforms, funding settlements off-chain becomes problematic. Many of the advantages articulated for blockchain solutions, such as immutability, decentralization, security, instantaneous and irrevocable settlement (so-called atomic settlement), and 24/7 operation, are lost if value transfer can only happen via traditional off-chain channels. As a result, various alternative approaches have been suggested to create digital-native, on-chain money, and fund finance deals involving digital assets may need to engage with these options.

Note that an analysis under the Amended UCC could potentially characterize different proposed variants for blockchain-native money in different ways, and these different characterizations can result in differing attributes and effects when these assets are deployed in transactions, including whether or not Article 12 would apply. Ultimately, the development and use of these products will require input from many market participants (including lenders, counsel, and technology experts), as well as a period of practical commercial experience, to insure they meet transactional goals in fund finance.

Investment Property

A share of stock or other equity interest in a corporation is treated as a "security" and therefore investment property (Amended UCC Section 8-103(a)). An interest in a partnership or limited liability company is not a security (and therefore not investment property) unless it is dealt in or traded on securities exchanges or securities markets, expressly provides by its terms that it is a security subject to Article 8 (that is, "opts in" to Article 8), or is an investment company security; but these interests are financial assets for indirect holding purposes if held in a securities account (Amended UCC Section 8-103(c)).

CERs, CAs, and CPIs are not financial assets for purposes of the indirect holding regime of Amended UCC Article 8 unless they are held in a securities account and the securities intermediary has expressly agreed to treat them as financial assets (Amended UCC Section 8-103(h)). However, even if a CER, CA, or CPI is a financial asset held in a securities account (and therefore subject to Article 8 rules rather than Article 12), if this financial asset itself constitutes a CER and the securities intermediary holds it directly, then the securities intermediary's rights in that financial asset-CER could be subject to Article 12 (Amended UCC 8-102 official comment 9).

Power Versus Right

Assessing the ability of a control person to exercise a power may require deeper inquiry. In its recent report on legal opinions under the 2022 Amendments, the TriBar Committee noted, in the context of these Article 12 control powers, that the "power" to do something is not the same as the "right" to do it. To have the power to exercise the element of control under Section 12-105, the control person must have the ability to actually produce the change in legal relation by doing the given act. Simply having the right to do so, such as by a contractual agreement, is not by itself enough. (See ABA: The Business Lawyer: TriBar

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Report on Opinions Under 2022 Amendments to the Uniform Commercial Code Regarding Emerging Technologies, 79 Bus. Law. 407 (2024), 414 fn. 52 (citing Restatement (First) of Property § 3 (Am L. Inst. 1936); but see Amended UCC Section 12-105 official comment 2 (powers and sources of powers).)

This rather philosophical statement is likely to trigger some head-scratching, because as a practical matter, the frontier dividing "power" and "right" is anything but a bright line. For example, in other UCC control perfection contexts, such as collateral consisting of deposit accounts or securities entitlements, control agreements are a common perfection mechanism and are contemplated under UCC Sections 9-104(a)(2) and 8-106(d)(2). This is despite the fact that control agreements are contractual mechanisms.

Further, the status of a depositary bank or securities intermediary as a third party separate from the two transacting parties (debtor and secured party), which is what gives assurance of arm's-length treatment underpinning control in such an arrangement, typically derives from an account agreement with the debtor, which is also a contractual arrangement. It is not so clear, then, where power as opposed to rights exists in such an arrangement, and therefore, to what extent fund finance lawyers dealing with Article 12 control can analogize to these control agreement arrangements.

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