M E M O R A N D U M

TO: Joint Committee on the Uniform Commercial Code and Emerging Technologies

FROM: Steve Harris and Chuck Mooney

RE: Overarching approach to the Committee's work

DATE: July 26, 2020

As we reach the end of the first year of the project, we think it useful to consider how the Committee might approach its work in the years ahead.

At the outset, the Committee's charge was to move forward on UCC amendments to address electronic negotiable instruments. The working premise was "medium neutrality," which was understsood to mean that, insofar as possible, the rules governing an electronic negotiable instrument would be identical to those governing tangible negotiable instruments.

The rules governing tangible negotiable instruments developed organically as a response to the commercial realities of the eighteenth and nineteenth centuries. Commercial realities have changed substantially. More than 40 years ago, Grant Gilmore observed, "What Article 3 really is in a museum of antiquities—a treasure house crammed full of ancient artifacts whose use and function have long since been forgotten." G. Gilmore, "Formalism and the Law of Negotiable Instruments," 13 Creighton L. Rev. 441 (1979).

Efforts have since been made to adapt Article 3 to changing practices, thereby undercutting the very basis of the traditional law. Consider the traditional need for an indorsement to transfer the right to enforce "order" paper. When negotiable notes developed, indorsements were a simple way for a transferor to incur secondary liability with respect to the maker's obligation to pay, and they provided at least some evidence that the person claiming to be the holder was the holder in fact. But under the 1990 amendments, John Jones can enforce a note payable to the order of Susan Smith, even without Smith's indorsement.

Were we to approach the matter anew, we might conclude that the need for negotiable instruments is long gone. The ability of a holder in due course to take free of defenses can largely be replicated by creating a non-Article 3 promissory note with a waiver-of-defense clause. A good-faith purchaser for value of such an instrument who takes possession would take free of conflicting security interests—including conflicting claims of ownership—under UCC § 9-330(d).

And even if we were to conclude that there is a need for an electronic instrument that replicates the functional attributes of an Article 3 negotiable note, the statute that we would draft would look nothing like Article 3.

Given these realities, why should we use Article 3 as a template for electronic instruments that function like Article 3 instruments?

A working subgroup of the Virtual Currency and Digital Assets Working Groups has been exploring the possibility of a single legal structure that would work as the basic framework for transfers of any electronic record that is susceptible of control, regardless of whether it evidences an obligation to pay, an obligation to make other performance, or a right with respect to an exogenous asset. There is no reason to believe *a priori* that a functional equivalent to an electronic negotiable instrument would not fit neatly into this legal structure. If, upon further deliberation, this proves to be the case, then there would be no need to amend Article 3 to create the possibility of an electronic negotiable instrument.

Our proposal is simply this: The Committee should defer further consideration of electronic negotiable instruments until the basic legal structure concerning digital assets has been determined. At that point, we can determine the extent to which that structure provides the functional equivalent of an electronic negotiable instrument. To the extent that different, or additional rules are necessary, the basic structure can be tweaked. During this process we also can consider any needed adjustments to the treatment in the UCC of electronic chattel paper and electronic documents of title.

Thank you for your consideration.