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Applying UCC Notice Exemptions To Cryptocurrency Sales

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For secured parties, a collateral disposition in a default scenario requires significant forethought to avoid actions that violate the Uniform Commercial Code. The required planning and documentation is compounded when the collateral sold is a new and volatile asset class. In this article, we will consider whether certain exemptions to notice of sale under the UCC might apply to bitcoin (and similar cryptocurrencies), specifically when sold in an exchange or online platform.

Collateral Disposition Rules

Collateral disposition in the context of secured transactions is mainly governed by Section 9-610 et seq. of the UCC. Under Section 9-611(b), known as the notice requirement, secured parties must notify obligors (and specified persons[1]) of their intent to sell the collateral.

Certain types of collateral, however, are exempted from the notice requirement pursuant to Section 9-611(d), namely (1) collateral that is perishable or threatens to speedily decline in value (referred to as the drop exemption); and (2) collateral that is customarily sold on a recognized market (referred to as the market exemption).

The former is based on the asset's nature or its price volatility; the latter, on the pricing mechanism used in certain markets. They both allow secured parties to sell without notice but selling in a recognized market brings the additional (and substantial) benefit of shielding the sale from all potential claims based on commercial unreasonableness, not just those based on deficient notice.[2] Thus, whenever feasible, secured parties should sell their collateral in recognized markets.

Rationale for Notice and for the Exemptions

The rationale of the notice requirement and the drop and market exemptions is identical: maximize the sale proceeds.[3] In other words, the "evil" they try to prevent is underrealization of the collateral. This is achieved by providing obligors with prior notice (and thus the opportunity to, e.g., bid for the collateral, procure potential

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[1] See § 9-611(c). Note obligors may waive the notice requirement, but only by executed post-default agreement. Advance (pre-default) waiver is not allowed. Section 9-624(a).

[2] Under § 9-610(b), "every aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable." As a result, the scope of potential commercial unreasonableness claims is wide and varied. However, under § 9-627(b), "a disposition of collateral is made in a commercially reasonable manner if the disposition is made: (1) in the usual manner on any recognized market [or] (2) at the price current in any recognized market at the time of the disposition." Section 9-627(b). Thus, selling collateral at the price listed at the time of sale in a recognized market is commercially reasonable, regardless of any deficiencies in the sale process. Recognized market dispositions shield every aspect of the sale from claims based on commercial unreasonableness. See, e.g., *Bankers Trust Co. v. J. V. Dowler & Co. Inc.* , 47 N.Y.2d 128, 135 (1979) ("Thus, [secured party's] sale of the bonds through regular market channels is immune to attack on the grounds of commercial unreasonableness").

[3] "[Notice] serve[s] the ultimate goal of allowing the debtor to maximize the sale price of the collateral and, thus, minimize any deficiency for which [the debtor] may be liable." *Rushton v. Shea* , 423 F. Supp. 468, 469-70 (D. Del. 1976). "[S]ome authorities suggest that optimizing resale price is the prime objective of the code's default mechanisms." *Bankers Trust Co. v. J. V. Dowler & Co. Inc*., 47 N.Y.2d 128, 135 (1979) (citing *Mercantile Financial Corp. v. Miller* , 292 F. Supp. 797 (E.D. Pa. 1968)). See also, more generally, White & Summers, Uniform Commercial Code, § 26-11 (1972).

buyers or simply monitor the process), and, in certain circumstances, allowing secured parties to forego notice and sell without delay.[4]

Both serve protective purposes, striking a balance between competing interests, and benefit both secured parties and obligors. As a result, the need for notice is negated when (1) notice would likely result in substantial underrealization (i.e., the drop exemption) or (2) there is minimal or negligible risk of underrealization[5] (i.e., the market exemption).

Cryptocurrency Basics

Cryptocurrencies are digital currencies that use blockchain technology[6] to provide for the security and anonymity of transactions.[7] They are intended to function as money[8] and their basic units are typically referred to as tokens or coins.[9] Bitcoin was the first blockchain-based cryptocurrency, and it is presently the most widely known[10], followed by Ether[11].

From a U.S. legal perspective, cryptocurrencies are not legal tender[12] or securities[13] (though they might qualify as investment contracts (Howey securities) in the context of initial coin offerings) and they likely fall under the catch-all “general intangible” category under the UCC, which creates a host of thorny issues for purposes of perfecting a creditor’s security interest.[14]

Many cryptocurrencies are now traded in online digital exchanges which resemble, operationally, securities exchanges. For example, as noted in the matter of Zachary Coburn, EtherDelta’s website provides a list of

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[4] See, e.g., *Maryland National Bank v. Wathen* , 414 A. 2d 1261 (Md. Court of Appeals 1980); Hogan, The Secured Party and Default Proceedings Under the UCC, 47 Minn. L. Rev. 205, 220 (1962) (“To effectuate this, [§ 9-611] attempts to chart a path in the narrow area between two policy positions — one, a desire to impede dishonest dispositions, and the other, a reluctance to strangle honest transactions with red tape”). These policies and teleological considerations should guide and inform the application of the exemptions.

[5] See, e.g., *Community Mgmt. Association of Colorado Springs v. Tousley* , 505 P.2d 1314, 1316 (Colo. App. 1973) (“The reason for exempting from the notice requirement a transaction where there is a recognized market is that the price on the recognized market represents the fair market value from day to day. If there is a recognized market, theoretically, the best price at any given time is the current market price”).

[6] Blockchain technology is, essentially, a data storage method based on collaborative encryption on a decentralized public ledger on which users (“miners”) record changes in data (“transactions”) by creating new blocks that effect and reflect those transactions in a sequential chain of blocks that the network controls. For a more detailed explanation, see, e.g., https://medium.com/coinmonks/blockchain-for-beginners-what-is-blockchain-519db8c6677a.

[7] See, e.g., https://www.investopedia.com/terms/c/cryptocurrency.asp.

[8] See, e.g., *Pearce v. Mizuho Bank Ltd*. , Civil Action No. 18-306, (E.D. Pa. 2018) (citing Investor Alert: Bitcoin and Other Virtual Currency-Related Investments, SEC, May 7, 2014); *United States v. Murgio* , 209 F.Supp.3d 698 (S.D.N.Y. 2016).

[9] See, e.g., https://www.investopedia.com/tech/explaining-crypto-cryptocurrency/.

[10] D’Alfonso, et al., The Future of Cryptocurrency, The Economist, Oct. 17, 2016, https://www.economist.com/sites/default/files/the_future_of_cryptocurrency.pdf.

[11] https://www.investopedia.com/tech/most-important-cryptocurrencies-other-than-bitcoin. For more information on Ether, see https://www.ethereum.org/ether.

[12] See, e.g., In the Matter of Coinflip Inc., CFTC, No. 15-29 (Sept. 17, 2015) (“Bitcoin is a ‘virtual currency’ defined here as a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value, but does not have legal tender status in any jurisdiction”).

[13] Jay Clayton, chair of the U.S. Securities and Exchange Commission, declared that bitcoin and cryptocurrencies are not securities, but that they are likely securities when marketed in the context of initial coin offerings. Rooney, SEC Chief Says Agency Won’t Change Securities Laws to Cater to Cryptocurrencies, CNBC, June 6, 2018, https://www.cnbc.com/amp/2018/06/06/sec-chairman-clayton-says-agency-wont-change-definition-of-a-security.html. See also, Jay Clayton, Statement on Cryptocurrencies and Initial Coin Offerings (ICOs), Dec. 11, 2017, https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11. William Hinman, Director of Corporate Finance of the SEC, agreed. See, e.g., https://www.wired.com/story/sec-ether-bitcoin-not-securities/. Most recently, Jonathan Ingram, Deputy Chief Counsel of Corporate Finance of the SEC, added that certain very specific ICOs would likely not qualify as securities (which implies most would qualify). See Beyoud, “Chuck E. Cheese” Test May Tell SEC If Crypto Token a Security, Bloomberg Law, Dec. 12, 2018, https://news.bloomberglaw.com/banking-law/chuck-e-cheese-test-may-tell-sec-if-crypto-token-a-security.

[14] See, generally, Schroeder, Bitcoin and the Uniform Commercial Code, 24 U. Miami Bus. L. Rev. 1, 10 (2016).

tokens available for trading, confirmed trades, and current firm bids and offers by symbol, price and size.[15] "Users may enter orders to buy or sell specified quantities of any [available token] at a specified price and with a specified time-in-force."[16]

EtherDelta, as with most cryptocurrency exchanges, is conceptually based on and mimics the operation of traditional securities exchanges for equities. There is no negotiation or price haggling, and the tokens are interchangeable within their class like equity securities. Prices, in both cases, are theoretically the result of neutral market forces, i.e., one-directional, "blindly" placed buy/sell orders.

The Drop Exemption

Bitcoin, of course, is not perishable (not even cattle has been held to be perishable), but it might qualify as collateral of the type that threatens to speedily decline in value, considering both its recent and historical price volatility.[17]

Courts have noted that this exemption applies "if [delay] would probably result in a loss of or substantial decline in value of the collateral"[18] and that "its obvious intent [is] to apply to securities in a rapidly falling market, or any other item, such as gold bullion, which is subject to price fluctuations on a daily basis."[19]

Bitcoin has surely been subject to substantial, rapid drops in value and to daily (and even minute-to-minute) fluctuations. When comparing price volatility of cryptocurrencies and U.S. equities, Richard Turnhill, BlackRock's Global Chief Investment Strategist, remarked that the extreme volatility of the U.S. equities markets during the 2008 financial crisis seems "placid" compared to the price swings of cryptocurrencies.[20]

By way of example, bitcoin was trading at ~$900 in January 2017, rising steadily through the year and peaking at ~$20,000 in December 2017, dropping precipitously in the next two months to ~$6,900 in February 2018, i.e., a twelve-month ~2,100 percent increase, followed by a two-month ~65 percent decrease.[21] More pertinently, in its short life, bitcoin hit certain "milestones" that help illustrate its unprecedented volatility, including a 94 percent monthly drop[22], a 71 percent intra-daily drop[23] and a 10 percent 10-minute drop[24].

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[15] In the Matter of Zachary Coburn, SEC Release No. 84553, Nov. 8, 2018, at 2.
[16] Id.
[17] See, e.g., Roberts, 5 Big Bitcoin Crashes: What We Learned, Fortune, Sept. 18, 2017, http://fortune.com/2017/09/18/bitcoin-crash-history/ (concluding that bitcoin is extremely volatile); Marsh, Crypto Diehards Say Slump is 'Bump in the Road' Before Growth, Bloomberg Law, Dec. 7, 2018, https://www.bloomberg.com/news/articles/2018-12-07/crypto-diehards-say-slump-is-bump-in-the-road-before-growth?srnd=technology-vp (bitcoin had lost approximately 80 percent of its value in 2018 as of the date of publication); Russolillo, Bitcoin is Falling Fast, Losing More Than Half Its Value in Six Weeks, The Wall Street Journal, Feb. 2, 2018, https://www.wsj.com/articles/bitcoin-is-falling-fast-losing-more-than-half-its-value-in-six-weeks-1517556514 ("Bitcoin's sharp swings illustrate just how much the digital currency remains a highly illiquid and volatile investment, particularly relative to stock, bond or currency markets."); Turnhill, Look Beyond the Crypto Hype, BlackRock Blog, Feb. 27, 2018, https://www.blackrockblog.com/2018/02/27/cryptocurrency-hype/ ("Crypto markets are highly volatile").
[18] *United States v. Mid-States Sales Co.* , 336 F. Supp. 1099, 1103 (D. Neb. 1971).
[19] *Stensel v. Stensel* , 380 N.E.2d 526, 528 (Ill. App. Ct. 1978).
[20] Cheng, World's Largest Asset Manager Says Get Ready to "Stomach Complete Losses" in Cryptocurrencies, CNBC, Feb. 26, 2018, https://www.cnbc.com/2018/02/26/worlds-largest-asset-manager-says-get-ready-to-stomach-complete-losses-in-cryptocurrencies.html. See also, Seth, BlackRock Rips Bitcoin: Buy Crypto Only If You're Ready for "Complete Losses", Investopedia, March 1, 2018, https://www.investopedia.com/news/buy-cryptos-only-if-ready-complete-loss-blackrock/.
[21] See Seth, supra.
[22] Russolillo, supra (bitcoin fell 94 percent in less than a month in 2010).
[23] Roberts, supra (bitcoin fell 71 percent overnight in 2013).
[24] Rizzo, Bitcoin Price Falls $1,000 in Minutes to Drop Below $10k, Coindesk, Nov. 29, 2017, https://www.coindesk.com/bitcoin-price-falls-1000-minutes-erase-24-hour-gains.

When bitcoin prices are dropping (and they might be dropping through the night[25]), preparing and delivering UCC-compliant notice to obligors, not to mention dealing with potential issues and likely objections, surely provides ample opportunity for a substantial decline in value. Secured parties should be able to avail themselves of this exemption when selling bitcoin to maximize sale proceeds, and thus protect themselves and obligors from sudden, steep drops in price.

The Market Exemption

“Recognized markets” is not defined in the UCC, but the Official Comments provide examples and guidance. According to the drafters, recognized markets are markets in which fungible assets are traded using standardized price quotations or, put differently, without bilateral price negotiation.[26] In short, recognized markets require (1) fungible assets and (2) market pricing.[27]

The paradigmatic example provided by the drafters is stock exchanges.[28] Courts and scholars have added bond and commodity markets,[29] and deftly emphasized the pricing mechanism as the most important characteristic: “Any transaction which involves competitive bidding or haggling over price should not be considered as one conducted on a recognized market, because negotiations between buyer and seller rather than neutral market forces determine the price.”[30]

Similarly, one of the leading authorities, Norton v. National Bank of Commerce of Pine Bluff, defined recognized markets as markets “where sales involve many items so similar that individual differences are nonexistent or immaterial, where haggling and competitive bidding are not primary factors in each sale, and where the prices paid in actual sales of comparable property are currently available by quotation.”[31]

Bitcoin exchanges easily fit in these definitions. There is no opportunity for price haggling: Platforms only allow for the placement of bids to buy or sell. As with exchange- or OTC-traded securities, the best available price at any given time for bitcoin is, in theory, the current market price.[32] Thus, pricing protection under the UCC is not needed.

Even though there are liquid, long-established markets for many types of collateral in the U.S., most of them would not satisfy the recognized markets test. Used vehicles, for instance, are not fungible.[33] Loan

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[25] Most cryptocurrency exchanges operate 24 hours a day, seven days a week. They have no “closing bells,” which arguably contributes to their volatility, since there is no “cooling off” or respite for investors. See, e.g., Bennington, Crypto Assets Trade 24/7, July 24, 2017, https://www.coindesk.com/crypto-assets-trade-247-changes-uptime.
[26] See § 9-610, Official Comment 9; § 9-627, Official Comment 4.
[27] See 1A Bender’s, Secured Transactions Under the UCC, § 8.04(2)(a), at 901-902 (“a recognized market is a market dealing with fungible goods of sufficient depth and activity that efforts by any one party will not affect the price realized on the disposition of the collateral ... from which quotations are available that do not depend on the individual good sold in the market”).
[28] Section 9-610, Official Comment 9.
[29] “[A] recognized market is one from which quotations are available that do not depend on the individual good sold in the market. Many commodities and most investment securities would fall into the category of recognized market.” 1A Bender’s, Secured Transactions Under the UCC, § 8.04[2][a] at 901-902. See also, e.g., White & Summers, Uniform Commercial Code, § 26-10 at 1111 (2d ed. 1980); *Reno Financial Ltd. v. Valleroy* , 229 SW 3d 622, 624 (Mo. Ct. App. 2007).
[30] White & Summers, Uniform Commercial Code, § 27-12 (1988); see also, generally, Norton v. Nat’l Bank of Commerce of Pine Bluff , 398 S.W.2d 538, 540 (Ark. 1966).
[31] Norton, 398 S.W.2d at 540; see also, *State Bank of Towner v. Hansen* , 302 N.W.2d 760 (N.D. 1981).
[32] See generally, *Nelson v. Monarch Inv. Plan* , 452 S.W.2d 375, 377 (Ky. Ct. App. 1970) (“If there is an established and recognized market, theoretically the best price at any given time is the current market price”).
[33] “A good, such as used cars, may not be found to be within the recognized market exemption as the price for each good is determined individually and the trade price lists are based on an average of sales and are meant as guides to price.” 1A Bender’s, Secured Transactions Under the UCC, § 8.04[2][a] at 901-902.

participations, on the other hand, may be fungible within their class, but in both cases their respective markets allow price haggling, even when authoritative, widely disseminated price guides are readily available (e.g., Kelley Blue Book).

It is important to note that the market exemption is concerned only with the pricing mechanism. The price obtained, the number of bids received and any other concrete aspect of the sale are not relevant.[34] Accepting the one bid received for the collateral, even if the recognized market is depressed at the time, is deemed, by operation of law and conclusively, commercially reasonable.[35] Secured parties need not wait for the market to recover if selling through a recognized market.

Finally, it should be easy to establish bitcoin's fungibility under the UCC.[36] Bitcoin tokens are, in theory and in practice, interchangeable. Investor do not care about holding one token or another. In addition, the CFTC and federal courts have concluded that cryptocurrencies are commodities,[37] which assumes and requires fungibility.[38] Although courts have interpreted the market exemption narrowly[39], courts should give most bitcoin exchanges "recognized market" status.

Conclusion

The exemptions exist to maximize value for the creditor and debtor in a default scenario. The ability to sell the collateral without the notice and auction requirements of the UCC offers benefits to both parties. For secured parties and their counsel, evaluating in advance the different cryptocurrency marketplaces available and memorializing enforcement protocols will certainly benefit secured parties, and surely provide defenses in any potential disputes, more so if the debtors agree in advance to the sale protocols.

Bitcoin and other popular cryptocurrencies are undoubtedly a new, volatile and valuable asset class. Secured parties who believe these assets are likely to rapidly decline in value should be able to use the drop exemption to sell without delay. However, secured parties should also be able rely on the market exemption to prevent disputes based on price fluctuations or timing of the sale. The memorialized enforcement plan that identifies the recognized markets for the liquidation of cryptocurrencies may prove critical to recovery.

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[34] See, e.g., Bankers Trust, 47 N.Y.2d at 135-36.
[35] See § 9-627(b) ("A disposition of collateral is made in a commercially reasonable manner if the disposition is made: (1) in the usual manner on any recognized market [or] (2) at the price current in any recognized market at the time of the disposition").
[36] Section 1-201(18) defines "fungible goods" as "(A) goods of which any unit, by nature or usage of trade, is the equivalent of any other like unit; or (B) goods that by agreement are treated as equivalent," which easily fits bitcoin tokens. They are designed to be perfectly identical, and that is how they are treated by investors.
[37] See, e.g., CFTC Release No. 7820-18, Oct. 3, 2018, "Federal Court Finds that Virtual Currencies Are Commodities".
[38] See Daniela Pylypczak-Wasylyszyn, How to Invest in Commodities, CommodityHQ, June 24, 2015, https://commodityhq.com/investing-ideas/ultimate-guide-to-commodity-investing/ ("Fungibility is a critical concept in commodity markets, as it standardizes the market and allows investors around the world to trade high volumes of goods on a daily basis. No analysis of the underlying products is needed. … Fungibility as it relates to commodities simplifies the valuation of these assets considerably; pricing of commodities is derived from supply and demand for a given resource-- — nothing more"). In addition, futures markets for cryptocurrencies have developed (e.g., CME Group, CBOE, Digitex Futures) or are in the works (Nasdaq), which implies the fungibility of the underlying asset.
[39] See generally, Goldstein, Sale of Repossessed Collateral Under the Uniform Commercial Code, 89 Com. L.J. 180, 183 (1984); Reiner, *First National Bank of Minneapolis v. Kehn Ranch, Inc*.: An Expansion of the Recognized Market Exception of U.C.C. 9-504(3), 32 S.D. L. Rev. 344, 350 (1987); Chrysler Credit Corp. v. H & H Chrysler-Plymouth-Dodge Inc. , 927 F.2d 270, 273 (6th Cir. 1991).