

Security Interests: Bitcoin and Other Cryptocurrency Assets

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Status: **Published on 02 Feb 2022** | Jurisdiction: **United States**

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A discussion on collateral comprised of bitcoin and other cryptocurrencies and the methods of perfecting a security interest therein under the UCC. This Note also examines other issues relating to cryptocurrency collateral.

With the continual growth in ownership of bitcoin and other cryptocurrencies, lenders should understand questions arising from borrowers issuing, holding, and trading cryptocurrencies. One fundamental question is whether cryptocurrencies owned by a borrower can be used as collateral for a loan.

In the US, Article 9 of the Uniform Commercial Code (UCC) governs the process of making an otherwise valid security interest in personal property enforceable against third parties (called "perfection"). Perfection requirements vary depending on the category of the property, with the categories being defined in the UCC. For more information, see [Practice Note, UCC Creation, Perfection, and Priority of Security Interests](#).

This Note provides an analysis of cryptocurrency collateral, including:

- How to transfer cryptocurrency collateral and what it means to own it.
- Its classification under the UCC.
- How a lender perfects its security interest in it.
- Pitfalls for secured lenders.
- Legal developments.

Cryptocurrencies and Blockchain Technology

A cryptocurrency is a digital asset that uses secured communication technology to make transactions between parties more secure than other currency transactions. Blockchain technology is a related and key component of cryptocurrency.

Use of a blockchain avoids a centralized database administrator to process and track transactions and, instead, shares data across a decentralized network of computers with records linked in chronological order. A blockchain maintains a history of all the transactions that have occurred since the beginning of that blockchain and uses cryptography to prevent tampering.

Cryptocurrency is a type of digital token or entry recorded on a blockchain. There are many uses for digital tokens, including as a medium of currency exchange, an investment or representation of an asset ownership, or for use as part of the operation of a particular blockchain.

Transfer of Cryptocurrency

The exchange of cryptocurrency between parties is recorded as a ledger entry on a blockchain. However, the blockchains on which ownership of cryptocurrencies, such as bitcoin, are recorded typically do not include any identifying information about the owner. These distributed ledgers instead list an address to which the amount of cryptocurrency is associated. The cryptocurrency at an address is controlled by way of a cryptographic private key issued by the blockchain network to the owner of the address. The bitcoin blockchain was deliberately designed this way: there is transparency regarding the address to which an amount of bitcoin is associated but there is no record of the identity of the owner of the bitcoin.

Significantly, if someone sends bitcoin to an address Person A controls but Person B obtains Person A's private key, Person B has the power to move the bitcoin out of Person A's wallet. The bitcoin system does not provide a way for a user to recover bitcoin lost in this way because knowledge of the private key is the mechanism by which

the bitcoin network determines which party has the right to transfer the bitcoin. This type of “theft” must be dealt with by a legal system outside of the bitcoin network.

Ownership of Cryptocurrency

As noted above, cryptocurrency blockchains, such as the bitcoin blockchain, are often set up so that there is no record of the identity of the owner of the cryptocurrency. Certain features of cryptocurrency do not fit well into the existing legal framework for property ownership and transfer. Even determining whether cryptocurrency is property (for purposes of the UCC and otherwise) and, if it is, which party owns that property is not straightforward. The market has struggled at times with a general consensus on the treatment of most cryptocurrencies. Consider a bad actor who transfers cryptocurrency using a key without the prior owner’s consent and the evidentiary burdens of determining ownership in a decentralized blockchain.

If a lender is taking a security interest in cryptocurrency assets, the lender must consider the risk that the purported owner of the asset cannot be recognized by a court as the owner as well as the possibility that cryptocurrency assets may be determined not to be personal property at all and therefore not subject to Article 9 of the UCC.

In the US, state law is typically the basis for determining ownership of most types of property, although federal law may control in certain cases. Wyoming law expressly recognizes property ownership, and thus transfer, of cryptocurrency. But most states do not, requiring analysis under existing property law. In California, for example, the standard for determining whether a property right exists is as follows:

“First, there must be an interest capable of precise definition; second, it must be capable of exclusive possession or control; and third, the putative owner must have established a legitimate claim to exclusivity.”

(*G.S. Rasmussen & Assocs., Inc. v. Kalitta Flying Serv., Inc.*, 958 F.2d 896, 903-04 (9th Cir. 1992).)

The first of the three criteria above (“an interest capable of precise definition”) is met regarding cryptocurrency. There is a specific amount of cryptocurrency in existence at any point in time and the ledger shows the distribution of the cryptocurrency.

The second of these criteria (“capable of exclusive possession or control”) appears to be met as well.

A user needs to know the relevant private key to move cryptocurrency from a particular address.

However, meeting the third of the criteria (establishing a “legitimate claim to exclusivity”) seems more difficult. As noted above, there is no definitive registry of real-world identities of owners of a given address. The ability to exercise exclusive control of cryptocurrency at an address is based on actual knowledge of a given private key. It may be argued that a party can claim exclusivity by demonstrating the ability to move cryptocurrency out of an address by using a private key, but this does not prove that no one else can do this.

Even if a user of a cryptocurrency may prove that the user created an address, there is no way to prove that only that user has exclusive access to a particular private key for that address. Therefore, while a user may be able to prove that the user can control the cryptocurrency at an address by using the appropriate private key to transfer cryptocurrency to another address, it is impossible for that user to prove that it is the only party that may do so. The user could have shared the private key with other parties, sold control of the address to a third party, or the private key may have been stolen. While it is true that there is a risk of duplication of physical keys to physical vaults as well, in the cryptocurrency context these risks are far greater; there are no physical objects or physical locations to safeguard, only information.

Cryptocurrency and UCC Classification

Perfection of a security interest under Article 9 of the UCC requires an initial determination of the collateral’s UCC category.

Article 9 provides a list of property categories including chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, as-extracted collateral, and a “catch-all” category of general intangibles (see the definition of General Intangible in UCC § 9-102(a)(42)).

Assuming that cryptocurrencies are personal property, treating cryptocurrency as “investment property” has become widely adopted in transactions involving security interests in cryptocurrency when there is an indirect holding framework, where property is held by a broker or third party intermediary. In addition, it is generally accepted that cryptocurrency may also fall into the catch-all “general intangible” category.

Investment Property

Investment property is defined as “a security, whether certificated or uncertificated, security entitlement, securities account, commodity contract, or commodity account” (UCC § 9-102(a)(49)). The Securities and Exchange Commission (SEC) has taken the position that many, but not all, sales of cryptocurrency are likely securities offerings requiring registration with the SEC, particularly where there is an investment goal with proceeds used to build a for-profit business. This determination by the SEC has no bearing on whether cryptocurrencies are securities for purposes of the UCC.

Under Section 8-102(a)(15) of the UCC, a security is “an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer:

- which is represented by a security certificate in bearer or registered form, or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer;
- which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and
- which:
 - is, or is of a type, dealt in or traded on securities exchanges or securities markets; or
 - is a medium for investment and by its terms expressly provides that it is a security governed by this Article.”

While it is conceivable that certain companies may decide to issue securities “on the blockchain” that may fit into the above definition, cryptocurrencies, such as bitcoin, do not qualify as securities under the UCC. A bitcoin, for example, is not an obligation of an issuer or an interest in an issuer, but rather is a standalone asset and medium of exchange.

However, while cryptocurrencies may not be securities under the UCC, they may in some circumstances otherwise qualify as investment property under the indirect holding system set out in Article 8 of the UCC.

Under Section 8-501(a) of the UCC, a “securities account” is defined as “an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset.”

The term “financial asset” is defined in Section 8-102(a)(9) of the UCC to include, among other things, “any property

that is held by a securities intermediary for another person in a securities account if the securities intermediary has expressly agreed with the other person that the property is to be treated as a financial asset under this Article.”

This is not a perfect conclusion as Article 8 of the UCC requires that financial assets be held in a securities account. Whether an account is a securities account can be complicated in some circumstances. Further, even if the parties conclude that the indirect holding framework applies, it could practically limit how the cryptocurrencies are used.

General Intangibles

If cryptocurrencies do not fall under the definition of investment property (if they are directly held or parties choose not to opt into Article 8 treatment), then it is generally accepted that cryptocurrencies are “general intangibles” under the UCC. This is a type of personal property that does not fall into the other UCC categories.

Perfection Under the UCC

The requirement under the UCC for perfecting a security interest in a general intangible is to file a UCC-1 financing statement identifying the debtor and describing the collateral in the appropriate jurisdiction.

If a cryptocurrency is classified as investment property by virtue of being agreed to be a financial asset in a securities account as described above, perfection by control would apply instead (see Section 9-314 of the UCC). Depending on the mechanics of how control is established, the secured party may have a stronger claim and easier enforcement (see discussion below in “Use of Securities Accounts for Perfection of Security Interests in Cryptocurrency”).

Issues with Cryptocurrency Collateral

Before taking cryptocurrency as collateral, a lender should consider, among many issues:

- How it controls the collateral.
- How it enforces its security interest in the collateral.
- How the general intangible classification affects cryptocurrency collateral.
- The regulatory issues facing cryptocurrency collateral.

Enforcement of a Lender's Security Interest in Cryptocurrency and Control of Cryptocurrency Collateral

Before taking cryptocurrency as collateral, a lender should consider how it would enforce its rights to foreclose on the pledged cryptocurrency after a default. Access to the debtor's private key controlling the cryptocurrency address is critical to enforcement. If the lender does not have the private key controlling the address at which the cryptocurrency is located, the lender must rely on the defaulting borrower to either:

- Send the cryptocurrency to the lender.
- Provide the private key in response to the lender's demand.

If the borrower is unwilling or cannot provide the private key, the lender will not be able to access the cryptocurrency.

Even if the lender has the private key, it is possible that either the borrower or another party with access to the private key may move the cryptocurrency to another address first. In this situation it would likely be difficult for the lender to recover the cryptocurrency. It also may be challenging for the lender to determine which party transferred the collateral. There is a risk that the borrower may transfer the collateral and then claim that it was actually moved by someone else.

Alternatively, the lender may require the borrower move the cryptocurrency that is collateral to an address solely controlled by the lender. This may not be practical if the terms of the security arrangements permit the borrower to freely trade the cryptocurrency before an event of default has occurred under the loan agreement.

Another advantage of utilizing the securities account structure under Article 8 is that a securities intermediary holds the private key(s). If there is a default scenario in a lending arrangement, the lender is then able to exercise exclusive control.

If cryptocurrency is considered a "security", additional rules may apply to a foreclosure sale of this collateral by the lender. Additionally, if there is no "recognized market" additional restrictions apply for disposal of these assets under the UCC.

Significance of General Intangibles Classification of Cryptocurrency

As discussed above, under the UCC a security interest in general intangibles is perfected by filing a UCC-1 financing

statement in the appropriate jurisdiction. A security interest in a general intangible, such as cryptocurrency, continues even after it is transferred or sold by the owner to another party unless the secured party consents to the transfer free of its security interest, the obligations secured by the security interest have been satisfied or the security interest has otherwise terminated. The secured party also remains perfected in the proceeds of the collateral, including any cryptocurrency received as proceeds (UCC § 9-315(a)).

Therefore, if cryptocurrency is transferred from one address to another address that transfer may not result in the release of the lender's lien. There is however a practical consideration that even if a court were to find that the lender's security interest still applied to cryptocurrency that had been transferred, it is not obvious whether it may be possible for the lender to foreclose on the cryptocurrency and take control of it. While the lender may identify the address to which the cryptocurrency had been transferred, it does not have the private key for that address and it is unclear whether it can easily determine the identity of the owner of that address.

Use of a Control Agreement

A secured lender's access to cryptocurrency collateral is important for foreclosure, yet blockchain technology renders this more complex. One commonplace solution is a control agreement in a form similar to a securities account control agreement, which is familiar to many lenders. Regardless of whether the parties categorize cryptocurrency collateral as investment property or general intangibles, using a control agreement will allow the lender access to the collateral for foreclosure and will avoid transfers to third parties.

The control agreement appoints an intermediary to hold the cryptocurrency collateral and the related keys. Depending on the business agreement, the borrower can transfer the cryptocurrency until a stated time or all transfers require consent of the lender. In the former case, the stated time is often at the time there is a default under the loan agreement and the lender has sent a notice to the intermediary.

Many intermediaries holding cryptocurrency are currently non-bank entities; however some traditional custodian banks are providing this service. While the traditional custodian banks have thus far generally limited the types of cryptocurrency that they will accept, these institutions may have more robust KYC and diligence controls. On the other hand, non-bank cryptocurrency custodians have typically

been in the market longer and have more experience with digital assets, but may not be subject to the same rules and regulations as the banks. In choosing a custodian, lenders should assess a number of key considerations, including the security features employed by a custodian in holding the private keys, the track record of a custodian, the custodian's policies with respect to staking custodied assets, as well as a thorough review of the custodian's custody agreement for standard custodial provisions.

Regulatory Issues

As noted above, different digital tokens have different purposes. The regulations that are applicable to particular cryptocurrency collateral must be determined on a case by case basis. For instance, the major US banking regulators have, to some degree or another, taken the position that their existing regulatory authority permits them to regulate cryptocurrencies. A lender with a security interest in cryptocurrency assets should analyze applicable regulatory regimes.

FinCEN

In March 2013 the Financial Crimes Enforcement Network (FinCEN) issued guidance concluding that an:

"administrator or exchanger that (1) accepts and transmits a convertible virtual currency or (2) buys or sells convertible virtual currency for any reason is a money transmitter under FinCEN's regulations." (FIN-2013-G001.)

However, mere use of cryptocurrencies by a user to "purchase real or virtual goods or services" does not fit within the definition of "money transmission services" under FinCEN regulations. This designation means that exchangers and administrators of cryptocurrencies qualify as money service businesses (MSB) under the Bank Secrecy Act (BSA). Covered entities must comply with AML and KYC regulations, including those that require the monitoring and reporting of suspicious transactions.

FinCEN noted in the guidance that "accepting and transmitting anything of value that substitutes for currency makes a person a money transmitter under the regulations implementing the BSA." The guidance requires people in the business of exchanging cryptocurrencies for traditional or other type of currency to register with FinCEN and follow other anti-money laundering measures.

SEC

The SEC has taken the position that certain digital tokens, including those that are essentially digital representations of traditional equity or debt interests, including many

cryptocurrencies, are plainly securities under the Securities Act. These include digital tokens representing things, such as partnership interests or bonds. For other tokens, the characterization as securities is less clear. An analysis is therefore needed on a case by case basis.

A digital token may be considered to be a security if the participants in the offering made an investment of money in a common enterprise with a reasonable expectation of profits that are derived from the entrepreneurial and managerial efforts of others. The SEC relies on the test developed in *SEC v. W.J. Howey & Co.* in making this determination. If the digital token is a security, several obligations are triggered under US securities laws, including the need to either register the offering of these securities with the SEC (unless an exemption is available).

Further, if the token is transmitted to purchasers on behalf of issuers or sellers, the party transmitting the token may be considered a "broker-dealer" for the purposes of the Securities Exchange Act of 1934 and that party may be required to register as a broker-dealer.

In a 2018 statement, the SEC said that bitcoin and ether were not securities under the Howey test including because these cryptocurrencies were sufficiently decentralized. However, that does not mean that other cryptocurrencies are not securities. On April 3, 2019, the Strategic Hub for Innovation and Financial Technology of the SEC published a "Framework for 'Investment Contract' Analysis of Digital Assets", intended to serve as "an analytical tool to help market participants assess whether the federal securities laws apply to the offer, sale, or resale of a particular digital asset." Although not a "rule, regulation, or statement of the Commission," the Framework provides useful insight into the SEC staff's analysis of whether transactions involving digital assets are investment contracts within the meaning of US federal securities laws.

In 2020, the SEC filed suit against Ripple Labs regarding a cryptocurrency (XRP), and claimed the cryptocurrency requires registration. Part of the SEC's argument is that Ripple uses XRP to finance its business, and litigation is ongoing. Regardless of its outcome, the suit evidences the continued lack of clarity on cryptocurrency's regulatory standing.

Certain cryptocurrency lending programs may also be considered securities. In September 2021, the SEC threatened to sue Coinbase Inc. over its Coinbase Lend program through which it would offer interest on cryptocurrency assets backed by US dollars, because the SEC considered the Coinbase Lend program to constitute securities. Ultimately, Coinbase decided not to launch the program.

CFTC

Since 2014, the Commodities Futures Trading Commission (CFTC) stated that cryptocurrencies may constitute “commodities” under the Commodity Exchange Act and thus be subject to CFTC jurisdiction. As a consequence, the CFTC claims broad jurisdiction over derivatives that reference cryptocurrencies and market participants involved in those contracts. This claim of jurisdiction includes authority to pursue allegations of fraud or manipulation regarding the cryptocurrency itself.

Other

In addition to the above US federal agencies, US state laws may apply to transactions involving cryptocurrencies. Non-US laws may apply as well.

Legal Developments

Several non-binding but important legal commissions have been reviewing and proposing uniform commercial laws that would need passage by states. For example:

- In July 2017, the Uniform Law Commission completed a uniform model state law, the Uniform Regulation of Virtual-Currency Businesses Act (the Act). The Act clarifies which types of entities require state licenses for “virtual-currency business activity,” essentially similar activities to existing “money transmitter” or “money services” activities.
- In July 2018, the Uniform Law Commission approved a supplement to the Act (the Supplement) which provides virtual currency businesses and their customers duties and rights comparable to those of customers of securities intermediaries under Article 8, Part 5 of the UCC. The Supplement requires that transactions governed by the Act include an agreement between the licensee and the user that among other things states that the cryptocurrency asset is a financial asset credited to the securities account of the user and that the licensee is a securities intermediary. However, the Supplement only applies if the licensee has “control” of the user’s cryptocurrency. Control is defined in the

Act as the “power to execute unilaterally or prevent indefinitely a virtual-currency transaction.”

- The Uniform Law Commission and American Law Institute Committee on the UCC and Emerging Technology proposed a draft amendment to the UCC to create new rules for controllable electronic records, which would include cryptocurrencies. The scope of the ULC/ALI draft also contemplates revisions to the definition of money to account for electronic money. The ULC/ALI Amendment is expected to be published in final form in 2022

Several US states have passed regulation relating to cryptocurrencies. For example:

- Wyoming was the first state to pass legislation amending the UCC to account for cryptocurrency and other related emerging technologies. The Wyoming UCC amendment creates new rules for digital assets, which under the Wyoming amendment include “representation[s] of economic, proprietary or access rights that is stored in a computer readable format, and includes digital consumer assets, digital securities and virtual currency.”
- New York passed legislation that defined the term “virtual currency” and created a new license for virtual currency businesses.
- Texas passed legislation to modify its UCC to address virtual currency. This amendment includes a new Chapter 12 that addresses “virtual currency” along with updates to Chapter 9 to ensure perfection of security interests in virtual currency.
- Nebraska adopted the current ULC/ALI Amendment on May 26, 2021, with a provision to further update the adopted amendment with the final ULC/ALI Amendment.
- Other states have enacted or are considering various laws and regulations applicable to cryptocurrencies.

Credit Considerations

While cryptocurrencies are considered by many to be a form of money or a financial instrument, their legal status as a form of property and how to determine legal ownership of cryptocurrency is unclear. Cryptocurrencies may be general intangibles under the UCC, but they are different from property that financial institutions are used to dealing with in the ordinary course of business. Lenders that accept cryptocurrency as collateral should consider both legal issues as well as practical considerations.

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