

Lender Considerations for Cryptocurrency and Other Digital Assets

Dec 10, 2019

Categories:

Blockchain and Digital Assets
Blogs

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The increasing popularity of cryptocurrencies and other digital assets, most notably, Bitcoin and Ethereum, raises interesting questions for lenders seeking to secure their exposure with these digital assets. While lack of familiarity with both the nomenclature and the technology may be the first hurdle a lender encounters, how to perfect a security interest in these assets is the bigger challenge – and one that impacts both debtors and lenders. The Uniform Commercial Code (the "UCC") governs the perfection of security interests in most types of personal property, and its treatment of these assets is paramount in a lending context.

Cryptocurrencies Basics

Bitcoin is the most well-known cryptocurrency – and the one with which most of the public are familiar. Nevertheless, a multitude of cryptocurrencies exist which function as digital representations of value that users may use as currency. Unlike traditional, government-backed currency, cryptocurrencies exist outside the control of a central authority such as the Federal Reserve.

Users create and exchange Bitcoins and other cryptocurrencies on decentralized computer networks through a distributed-ledger platform known as a blockchain. The blockchain enables parties to transfer cryptocurrencies by recording the transaction as a ledger entry, visible to anyone with a public key. Similarly, the blockchain also provides the address, or digital wallet, of the asset's owner but does not display the owner's private key or other identifying information about the owner. The owner then accesses the cryptocurrency using a private key that is not visible to any public viewer of the blockchain. Under this architecture, there is no need for intermediaries such as banks and traditional clearing houses because the blockchain ledger (which is typically maintained by a consensus of electronic "miners" worldwide) records the entire

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transaction history of an individual unit of cryptocurrency while preventing someone from spending the same currency twice.

Cryptocurrency's Classification under the UCC

Article 9 of the UCC governs the creation and perfection of a security interest in most types of personal property. Using a written security agreement, the debtor grants the lender a security interest in whatever personal property the parties have agreed will secure the loan. The lender must then "perfect" this security interest to obtain priority over other parties with a claim upon the asset. Under Article 9, the secured party may perfect its security interest either through possession or control of the asset, or by filing a UCC-1 financing statement. Filing a UCC-1 financing statement is the most common method of perfection.

The classification of the asset held as collateral under Article 9 governs the appropriate method of perfection. Although no definitive guidance exists concerning cryptocurrency's classification under the UCC, most commentators and regulatory agencies agree that cryptocurrency is neither "money" nor a "deposit account" within the meaning of Article 9. Because no government has authorized cryptocurrency as a medium of exchange, these assets fall outside the UCC's definition of "money." Moreover, the IRS has explicitly stated that Bitcoin is property, rather than money. Similarly, the unique architecture of the blockchain network prevents holders of cryptocurrency from classifying their digital wallets as deposit accounts. Whereas a lender may perfect a security interest in a traditional bank account with a control agreement, the absence of any intermediary maintaining possession of the digital wallet prevents anyone from having "control" over the cryptocurrency.

Although several proposed laws seek to classify Bitcoin and other cryptocurrencies as "financial assets" under Article 8 of the UCC, for now, cryptocurrency is most likely a "general intangible" under Article 9. "General intangible" is the catch-all category of collateral under Article 9. If an asset is not some other type of collateral, it's a general intangible. A lender must perfect a security interest in general intangibles by filing a UCC-1 financing statement, typically

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with the Secretary of State in the state where the debtor is located. Filing a UCC-1 is a straightforward process, requiring the lender to identify the debtor and describe the collateral used as security. However, cryptocurrencies and the associated blockchain platforms present several risks to lenders.

First, a UCC-1 without access to the private key is effectively worthless. The lender must be able to access the asset upon the debtor's default. Even if the lender had the private key, however, there is no guarantee that the debtor has not already given the key to another party, enabling the party to access the cryptocurrency before the lender can enforce its rights against the collateral.

Second, at present, a lender cannot verify whether a particular digital asset is encumbered with a lien except by searching for existing UCC-1 filings (or comparable international filings). Because the law around perfection of cryptocurrencies and digital assets is unsettled, knowing where to search and what to search creates the possibility of missing a critical filing.

Finally, depending upon how the debtor holds the cryptocurrency, certain applications of Article 8, governing financial assets and securities, may apply. If a broker or other "securities intermediary" holds the debtor's cryptocurrency assets, lenders must determine whether Article 8 or Article 9 controls the perfection of these assets.

Conclusion

Concerns regarding the treatment of cryptocurrency under the UCC should not dissuade lenders from considering these assets as part of their collateral package. Any collateral possesses inherent risks and is susceptible to a debtor's fraudulent conversion. Instead, lenders should apprise themselves of both the legal and practical considerations involved with taking a security interest in cryptocurrency and consider how other technology solutions, such a smart contracts with restricted access digital wallets, might help to alleviate some of these concerns. Those lenders who can appropriately manage these credit risks may find a lucrative opportunity in the emerging sector of the economy reliant upon

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cryptocurrency and blockchain technologies.

For guidance on these issues, please contact Joseph Brammer or Courtney Rogers Perrin.

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