

CRYPTO INSIGHTS

Crypto-Based Lending and the 2022 UCC Amendments

BY KIM DESMARAIS

In this article, the author revisits cryptocurrency-based lending and how the 2022 UCC amendments provide welcome clarity to lending transactions involving digital assets

Much has changed in the world of digital assets since bitcoin's debut in 2008. Blockchain and cryptocurrencies are no longer obscure technologies relegated to the outskirts of our financial systems; many industry participants and customers have come to view cryptocurrencies as mainstream financial assets. Cryptocurrencies and other digital assets, and the blockchain technology on which they are based, have taken on increasingly central roles in our financial systems. As digital assets and cryptocurrencies have grown in popularity, parties to financial transactions have sought to incorporate these assets into their deals. One area of the market that saw significant growth is cryptocurrency-backed lending. Borrowers with cryptocurrency assets sought to leverage their relatively illiquid crypto-assets for liquidity or for additional crypto-assets, including by using cryptocurrency assets as collateral in a financing transaction. Of course, financing structures are typically tailored to the specific operating and liquidity needs of borrowers and the use of illiquid assets, similar to cryptocurrencies, is not new to these financing structures. While there is a market for the trading of cryptocurrencies, certain adverse tax consequences of selling cryptocurrencies have resulted in crypto-owners using a buy-and-hold strategy. Lending against these types of assets unlocks value to these companies while avoiding these potentially adverse tax consequences.

In response to the changing financial landscape and borrowers' interest in cryptocurrency-backed lending, more and more financial institutions and direct lenders ventured into the world of cryptocurrency financing over the last couple of years. While the market experienced a "crypto winter" for much of 2022, the market also saw signs of a "crypto winter thaw." If there is less volatility in the crypto industry in 2023, it is possible that the use of crypto and other digital assets as collateral in traditional financing arrangements continues to be part of the lending landscape as companies continue to include cryptocurrencies and other digital assets in their business strategies. As further discussed below, the proposed 2022 amendments to the Uniform Commercial Code ("UCC") to address emerging technologies could aid in the continued financing of digital assets in the years ahead.

Considerations When Providing Loans Secured By Cryptocurrency

Lenders that accept cryptocurrency collateral must, in addition to the credit and market risks they evaluate for all transactions, consider certain risks specific to cryptocurrencies. Some considerations are similar to those involved in traditional lending arrangements, including lender due diligence to ensure the borrower's ability to repay and that the borrower owns the collateral, constraints on the borrower's ability to access or use the collateral, complying with the operative regulatory regime, and asset-specific tax considerations. Due diligence is particularly important in cryptocurrency-backed financing transactions as lenders will want to ensure the borrower's ownership of the assets securing the loan and, if applicable, that appropriate information and other security protocols are in place.

As noted above and as we've seen in 2022, cryptocurrencies are subject to significant fluctuations in value, including on a daily basis. While this is a significant factor in deciding whether to lend against these assets, lending transactions can be structured in a variety of ways to limit a lender's risk of loss due to such volatility, as discussed in more detail below.

Structuring Loans to Address Potential Risks Related to Cryptocurrency Assets

Similar to other asset-based loans that are tied to the value of the underlying collateral, when cryptocurrency is the sole or the most significant collateral, lenders may negotiate loan structures where the available amount is tied to a loan-to-value (or LTV) ratio and, if secured, outstanding advances are subject to margin calls. LTV ratios can be tested on a daily basis to capture changes in collateral values driven by price fluctuations in the underlying assets. If the LTV ratio falls below the compliance threshold, the borrower can be required to immediately either (i) pay down the loan, or (ii) place additional collateral in the collateral account, in each case to bring the LTV ratio back into compliance. These mechanics are useful when cryptocurrency is the only or main collateral due to its pricing volatility. Of course, there is still a risk of loss or non-payment on the amount of advances that exceed the value of collateral on any given date. With the volatility that we saw in the market in 2022, lenders might also consider requiring a certain percentage of the collateral to be non-crypto assets, such as a pledge of equity interests in the borrower or its subsidiaries or a pledge of material intellectual property, which assets could be realized upon by selling to another crypto- or digital asset-based company. Consideration could also be given to obtaining guarantees from



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subsidiaries or parent companies of the borrower in support of the loan. Those guarantees could also be secured by non-digital assets of the guarantor. Taking into account market dynamics at the time, it might also be prudent for a lender to consider requiring a cash reserve account into which a minimum amount of cash is required to be maintained.

The Importance of Ensuring Liens Properly Secure Any Cryptocurrency Collateral

Lending Against Cryptocurrency Collateral Under the Current Legal Regime

As with any secured financing, it is critical to ensure that the secured party has a valid and perfected lien over the collateral securing the financing. It is even more critical in crypto and other asset-based financings where availability is tied to the value of the collateral. Not only is it important to ensure that the lien over the collateral is enforceable against the borrower, but that it is also enforceable against any third party claiming an interest in the collateral, including customers of the borrower, other creditors of the borrower or a trustee in a bankruptcy of the borrower, and that the secured party's lien will rank first in a priority fight with those other creditors.

Article 9 of the UCC is the law applicable to the creation, perfection and priority of liens in personal property assets that are subject to Article 9. Under Article 9 of most states, cryptocurrency is not a defined collateral type and, putting aside “money” for the moment, does not fit within any of the defined collateral types other than “general intangibles”. Under Article 9, a secured party can perfect its lien in general intangibles of the borrower by filing a UCC-1 financing statement describing the general intangibles in the central office of the state where the borrower is located or, in the case of individuals, where the borrower resides.¹

Perfection by filing, however, is not the only way to perfect a lien in cryptocurrency collateral under the UCC of most states and a “workaround” of sorts has been used to perfect such lien by “control”. Under Article 8 of the UCC, a lien on “financial assets” that are held with a “securities intermediary” in a “securities account” can be perfected by control, including by the secured party, the “securities intermediary” and the borrower entering into a control agreement.² Perfection by “control” will give the secured party priority over any other creditor or lienholder claiming an interest in the “financial assets” that has perfected by filing.³ As a result, parties to crypto-based lending transactions will typically (i) agree to treat the “cryptocurrency” as a “financial asset” under Article 8 of the UCC, (ii) have the cryptocurrency collateral held in a “securities account” with a custodian or other “securities intermediary” that is in the business of holding cryptocurrency collateral for others and is acting in that capacity in the relevant transaction and (iii) enter into a control agreement with the custodian pursuant to which the custodian agrees to comply with entitlement orders on the securities account originated by the secured party without the consent of any other person, thus perfecting the secured party's lien by control.⁴

Returning to the issue of cryptocurrency as “money” under the UCC, “money” is defined as “a medium of exchange currently authorized or adopted by a domestic or foreign government.”⁵ Prior to 2021, no

cryptocurrency fit this definition. However, El Salvador in September 2021 and the Central African Republic in April 2022, officially recognized Bitcoin as legal tender in their respective countries. As a result, questions emerged in the market whether Bitcoin was now “money” as defined in the UCC and if the “perfection by possession” rules thus applied to Bitcoin, which would be practically impossible for an intangible currency. While the proposed 2022 Amendments to the UCC discussed below address this issue, market participants will need to continue to consider the issue prior to the adoption of the 2022 Amendments and it would be prudent to follow the workaround noted above for perfecting a lien in Bitcoin by control under Article 8 of the UCC instead of by filing.

Another point to consider is that while possession of the private key will give the secured party “practical” control of the relevant cryptocurrency and the ability to easily liquidate or otherwise enforce against the cryptocurrency, possession of the private key is not a way to perfect a lien under the UCC. Custodian arrangements have thus become an essential component of lending in the digital asset space. An added benefit to these types of arrangements is that lenders are able to take a perfected security interest in cryptocurrencies without having to alter the existing rights of the borrower to such cryptocurrency assets.

Lending Against Cryptocurrency and other Digital Assets Under the 2022 Proposed Amendments to the UCC

The laws of most states currently governing transfer of property rights (both ownership and security interests) that consist of, or are evidenced by, electronic records have not been updated to keep pace with evolving technological developments. This issue is particularly notable with respect to virtual currencies, non-fungible tokens and intangible money, including virtual fiat currency that has been authorized or adopted by a government. As a result, questions have emerged among market participants about how security interests can and should be perfected in cryptocurrencies and other digital assets. Furthermore, there are gaps in the current version of the UCC of most states with respect to how these interests can be transferred or monetized, and how owners of these assets can be protected from adverse property claims.

To address these gaps and lack of clarity, in 2019, the Uniform Law Commission (“ULC”) and American Law Institute (“ALI”) appointed a joint drafting committee (the “Joint Committee”) to consider and formulate proposed amendments to the UCC to accommodate emerging technologies. On May 18, 2022, the ALI⁶, and on July 13, 2022, the ULC⁷, approved the proposed amendments to the UCC⁸ (the “2022 Amendments”), which cleared the way for the 2022 Amendments to be sent to the U.S. states and territories for adoption. In particular, the 2022 Amendments add a new Article 12 regarding sales of, and security interests in, “controllable electronic records” (or “CERs”), as well as “controllable accounts” and “controllable payment intangibles” that are evidenced by a CER. While the term “CER” would include technologies that exist today, such as Bitcoin, Ether and NFTs, it has been designed to be flexible enough to also pick up technologies that are developed in the future. The 2022 Amendments also make changes to Article 9 of the UCC to address and incorporate CERs as a new asset

category, thus establishing clear perfection, priority and choice of law rules for transactions where the CER is pledged as collateral. Moreover, the 2022 Amendments provide legal assurance as to when a transferee (which includes a secured party) of a CER acquires its interest therein free of conflicting property claims.

Let's first consider the "take free" rules of the 2022 Amendments. Under these rules, a transferee of a CER will take its interest in such CER free of a conflicting property claim and will take all rights that the transferor has in the CER if the transferee is a "qualifying purchaser".⁹

To be a "qualifying purchaser", the transferee must: (i) acquire the CER in a transaction that constitutes a "purchase" (within the meaning of Article 1 of the UCC, and which includes grants of liens), (ii) have control of the CER, (iii) give value (within the meaning of Article 3 of the UCC), (iv) act in good faith, and (v) not have notice of a property right claim in the CER.¹⁰ Under the 2022 Amendments, a person has "control" of a CER if that person: (i) has the power to avail itself of substantially all the benefit from the electronic record, (ii) has the exclusive power to prevent others from availing themselves of substantially all the benefit from the electronic record, and (iii) has the exclusive power to transfer control of the electronic record to another person or cause another person to obtain control of another controllable electronic record as a result of the transfer of the electronic record.¹¹ In addition, such person must have the power to readily identify itself to a third party as having the above specified powers (i.e., via a cryptographic key or other identifying number).¹² If such transferee is a secured party and it obtains control of the CER, it will have priority over another secured party that does not have control, including a secured party that has perfected its security interest solely by the filing of a financing statement.¹³ It should also be noted that, under the 2022 Amendments, the filing of a UCC-1 financing statement is not by itself notice of a property claim to a CER.¹⁴ This is important since, as noted above, a good-faith purchaser for value of a CER that obtains control of the CER without notice of a prior security interest or other claim of a property interest in such CER will be a "qualifying purchaser" and will be afforded greater rights than the transferor of such CER.



The 2022 Amendments also address the workaround noted above under current Article 8 for perfection by "control" of CERs maintained in a "securities account" with a "securities intermediary". Article 8 has been amended to clarify that a CER is a "financial asset" for purposes of Article 8 if Section 8-102(a)(9)(iii) applies.

The 2022 Amendments also address the workaround noted above under current Article 8 for perfection by "control" of CERs maintained in a "securities account" with a "securities intermediary". Article 8 has been amended to clarify that a CER is a "financial asset" for purposes of Article 8 if Section 8-102(a)(9)(iii) applies.¹⁵ As a result, if a customer and a securities intermediary agree that CERs of the customer maintained in a securities account with the securities intermediary are "financial assets" under Article 8, those CERs are considered investment property for purposes of the perfection by control rules under Article 8.¹⁶

Now, back to "money" under the UCC. The 2022 Amendments solve for the conundrum noted above due to Bitcoin being designated legal tender in El Salvador and the Central African Republic by amending the definition of "money" to exclude "an electronic medium of exchange, or digital currency, that existed before a government adopted such pre-existing medium of exchange as legal tender".¹⁷ This means that existing digital currencies, including Bitcoin, can never constitute "money" under the UCC, but they could be a CER. A new term "electronic money" is also introduced that is defined in the amendments to Article 9 simply as "money in electronic form." Under the new rules in Article 9, the only way to perfect a security interest in electronic money as original collateral is by "control" and the

mechanism for control is the same as that for CERs noted above.¹⁸ As a result of these amendments, it is clear that digital currencies (including Bitcoin) that constitute electronic money or a CER can be perfected only by "control" and not by "possession" under the UCC.

Lenders and borrowers will want to watch the adoption of the 2022 Amendments, including to determine whether to amend existing or form loan documents to ensure that they continue to work under the changing legal landscape and to ensure compliance with the new choice of law rules applicable to CERs.

Looking Forward

Looking to the year 2023 and beyond, we expect the digital asset

industry to continue to evolve and mature, both from a financing and regulatory perspective, and it will be important to continue to monitor legal and practical developments.

First, we expect developments in the regulatory landscape governing cryptocurrencies and other digital assets to continue. Any such developments will likely create additional complexity, which could create short-term difficulties for holders, investors, and lenders. On balance, however, we expect regulatory developments to further spur predictability and stability in the cryptocurrency and digital asset space, which will likely be a net positive for the ecosystem.

Second, we expect to see new developments as the digital asset industry matures. Part of that maturity will involve developing strategies to address large-scale economic downturns and financial distress, which the digital asset industry has had little experience with and which we saw tested in 2022. Although the cryptocurrency market may rebound from the 2022 “crypto winter”, it remains to be seen how a large-scale and sustained economic downturn will impact the overall crypto market.

Third, we expect updates to state law, including as states begin adopting the 2022 Amendments, and federal law to spearhead new and unanticipated lending and collateral structures. We recommend monitoring such updates along with the impact that subsequent bankruptcy and out-of-court workouts might have on the market and on the lending and collateral structures employed prior to such state and federal law changes. ▣

The views and opinions set forth herein are the personal views or opinions of the author; they do not necessarily reflect the views or opinions of the law firm with which the author is associated.

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⁸ See <https://www.uniformlaws.org/viewdocument/final-act-164?CommunityKey=1457c422-ddb7-40b0-8c76-39a1991651ac&tab=librarydocuments>

⁹ See 2022 Amendments § 12-104(e).

¹⁰ See 2022 Amendments § 12-102(a)(2).

¹¹ See 2022 Amendments § 12-105.

¹² See 2022 Amendments § 12-105(a).

¹³ See 2022 Amendments § 9-326A..

¹⁴ See 2022 Amendments § 12-104(h).

¹⁵ See 2022 Amendments § 8-103(h).

¹⁶ See 2022 Amendments § 8-102(a)(9)(iii); UCC § 8-106.

¹⁷ See 2022 Amendments § 8-102(a)(9)(iii); UCC § 8-106.

¹⁸ See 2022 Amendments § 8-102(a)(9)(iii); UCC § 8-106.

¹ UCC § 9-310; 9-307; 9-501.

² UCC § 9-106(a); 8-106(d).

³ UCC § 9-328.

⁴ UCC § 8-102(a)(9)(iii); 8-106(d).

⁵ UCC § 1-201(a)(24).

⁶ See <https://www.ali.org/projects/show/uniform-commercial-code/>.

⁷ See <https://www.uniformlaws.org/discussion/ulc-2022-annual-meeting-highlights#bm2d8310fc-6e53-40e2-a082-22bdb5c1ab60>.