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Non-Fungible Tokens and Secured Lending

Legal Update

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Just as the 2010s witnessed the rapid rise and adoption of cryptocurrencies, the 2020s have thus far provided the backdrop to a boom of another blockchain utilizing technology: Non-Fungible Tokens or "NFTs." An NFT is a unique and non-interchangeable unit of data that is stored on the blockchain ledger (Ethereum). Much like a certificate of authenticity, NFTs are used to establish a verified and public chain of ownership for original copies of digital assets, such as videos, photos, trading cards, and even "memes." Because digital assets are easily duplicated, NFTs provide a trustworthy chain of ownership for the original files. This enables immense value to be assigned to original copies, which was previously impossible in the digital collectible world (similar to the value of an original painting against a reproduction). The momentum of the NFT market is clearly apparent. First appearing in 2014, NFTs slowly increased in popularity throughout the remainder of the 2010s. In 2020, the market tripled to over $250 million. According to Forbes, in the first half of 2021, NFT sales further grew to $2.5 billion (with $1.2 billion of volume in July alone). This includes one NFT selling for almost $70 million: "Everydays—The First 5000 Days" by the now famous artist, Beeple.

This exponential growth and the general push into an increasingly digital world will likely lead to broader applicability in NFT markets for institutional actors. The NFT industry's popularity in social media and pop culture makes it even more reasonable that NFTs are here to stay. One readily apparent application is the use of NFTs as loan collateral. "NFTfi" is one such platform that facilitates peer to peer NFT secured loans and provides a secondary loan market among lenders. As NFTs continue to increase in popularity, it is reasonable to envision individuals seeking loans backed by their valuable NFTs (among their other assets).

While lenders may be interested in the value NFTs can provide, there are a host of practical and legal issues that lending against NFTs presents. First, lenders should apply caution when valuing these digital assets. Like cryptocurrency markets, the NFT market is notoriously volatile. However, this sort of volatility can present financial opportunity, and rapidly growing secondary markets (such as Opensea, which reported two million transactions in August 2021) should allow for more accurate price valuations.

Additionally, lenders who wish to make loans against NFTs as collateral should carefully consider how they handle perfection of their security interest in such assets. While collateral treatment of NFTs under the UCC remains unclear, a lender might decide to consider NFT collateral as “general intangibles” under the UCC and file a UCC-1 financing statement to perfect its interest. However, certain practical realities with NFTs may prevent a foreclosure from effectively recovering the asset. Blockchain transactions rely on the public ledger to confirm ownership. If an NFT subject to a lender’s security interest is transferred on the public ledger, it may be beyond the secured lender’s reach, even if properly perfected. A possibly more effective method of perfection may already exist under the current framework. Under UCC 9-314, a security interest may be perfected by control of the collateral. This is typically utilized when a secured lender takes a security interest in a deposit account and a deposit account control agreement (or similar agreement) is established among the secured lender, the financial institution offering the deposit account, and the debtor.

While these methods were originally designed for investment securities, they potentially can be applied to cryptocurrency and digital assets. Secured lenders wishing to utilize these methods would have the collateral transferred to a securities account with a bank or similar financial institution or intermediary where an account control agreement can then be established. Such account control agreements will include provisions that the intermediary will comply with orders from the secured lender. Thus, if the debtor defaults on their loan, under the account control agreement, the secured lender will be able to quickly take control of the collateral. Furthermore, restrictions in the account control agreement will help prevent the debtor from making unauthorized and irreversible transfers. While debtors may be hesitant to transfer their assets like this, this would alleviate a secured lender’s concerns with foreclosure process for these digital assets. As a bonus, perfection by control will typically give a secured lender priority over other secured parties that perfected their interest just by filing a UCC-1 financing statement.

NFTs are in their infancy but appear ripe for opportunity and have the potential to dramatically shape the creative arts. Related industries such as NFT backed lending show great potential for associated growth. Despite this exciting potential, any lenders seeking to unlock these possibilities should carefully consider and plan for risks associated with NFTs.