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Part II: NFT Lending — Legal Issues Involving Secured Transactions under the UCC, Pre- and Post-Article 9 and 12 Amendments

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As discussed in Part I of this series, NFT-based lending is pioneering a new avenue of investment and activity on the blockchain that will enable new and innovative use cases. In this Part II, we will discuss the implications for Lenders.

I. Issues for Lenders:

These on-chain loans secured by digital assets present a question for lenders: how do lenders get comfortable extending secured financing to borrowers where the secured asset is digital, like an NFT? In traditional financing, lenders and borrowers negotiate a security agreement, which governs the rights a lender will have in a transaction. Per the Uniform Commercial Code (the "UCC"), which regulates interests in personal property as collateral for debt, a security interest in tangible collateral can be perfected against third parties by possession of the collateral or by filing a financing statement. At the same time, a security interest in many kinds of intangible collateral can be perfected against third parties only by filing a financing statement. Sometimes, best practice calls for possession and filing (when both types of perfection are permitted under the UCC).

Mechanically, when the lender and borrower agree to terms on a peer-to-peer marketplace like Blur (as discussed in Part I of this series), the NFT is placed into a vault – a smart contract with specific storage and security features – with a lien on it; at this point, the principal is transferred to the borrower. As discussed below, the UCC, as currently adopted in most states, does not account for perfection of a security interest in digital assets by any method other than the filing of a financing statement, so a vault & lien combination is insufficient to perfect a security interest in the NFT collateral against third parties; however, the 2022 UCC Amendments provide certain clarity for perfecting a security interest in digital assets against third parties.

In general, the UCC is periodically updated to incorporate emerging technologies and trends. Among other updates, the 2022 UCC Amendments address digital assets and distributed ledger technologies, affording transactors in goods and services updated default rules under the UCC. As such, lenders should be aware of the varying new measures to ensure their loans are adequately secured and perfected against the borrower and any third party, including customers and other creditors of the borrower. Hence, the lender would be first in line to realize on the collateral in a fight with other creditors of the borrower.

Pre-2022 Amendment Regime:

There is uncertainty regarding the treatment of digital assets, NFTs or otherwise, under the pre-2022 Amendment regime. Article 9 of the UCC governs attachment (creation or enforcement) and perfection (priority in relation to other creditors) of a security interest in personal property used as collateral in secured transactions.

Digital assets typically only fit into the “general intangibles” category under Article 9, which can be perfected only by the filing of a financing statement. Thus, if a lien is placed on a vault via a filing with the Secretary of State where the borrower is located, a lender should be secured against third-party claims to the collateral, assuming the security interest in the collateral was created free and clear of any other property claim. Though possessing a private key to a vault may give a lender practical control of the digital asset, under the UCC, possessing a private key is not sufficient to perfect the security interest.

Parties leverage custodial arrangements to perfect a security interest in digital assets by control, which, under Article 8 of the UCC, will give the lender priority over any other creditor or lienholder claiming an interest in the same collateral. Such an arrangement requires something of a workaround: control perfects an interest in a "security entitlement" relating to "financial assets" held with a "securities intermediary" in a "securities account," so typically, parties will agree to treat the digital asset as a "financial asset" under Article 8, place the digital asset collateral into a "securities account" with the "securities intermediary" that is in the business of holding such collateral and enter into a control agreement. (See UCC §§8-102(a)(9)(iii), 8-106(d)). While sophisticated parties and their attorneys have used this workaround for the current gaps, setting up this relationship can be cumbersome and leaves something to be desired.

2022 Amendments

The American Law Institute and Uniform Law Commission's joint drafting committee sought to clarify the treatment of digital assets as collateral in secured transactions by proposing the 2022 Amendments, which were approved and sent to states and territories for adoption. To date, the Amendments have been adopted in eleven states and are effective in seven of those states (including Delaware) (see ULC enactment map). The Amendments will become effective in an additional three of those states on January 1. The 2022 amendments add Article 12 and make significant amendments to Article 9, among other provisions.

The 2022 Amendments include several notable items: (i) the addition of Article 12, governing purchases of, including sales of and security interests in, a "controllable electronic record" (a "CER").

1. Article 12: CERs and Control

Under Article 12, NFTs and other digital assets, whether now existing or created in the future, can be classified as CERs, so long as the digital asset is susceptible to control. To have control, the holder must have (1) the power to enjoy “substantially all the benefit,” (2) the exclusive power to prevent others from enjoying “substantially all the benefit,” (3) the exclusive power to transfer control, and (4) ability to prove control, of the CER. The private key may be used to prove control. Notably, some vaults and lending platforms allow for multi-sig wallets (i.e., shared control). Such an arrangement often would not impede the establishment of control under the 2022 Amendments, nor would the fact that automatic changes resulting from a smart contract or protocol be a barrier to establishing control.

2. Purchasing a CER

The “take-free” rules of the 2022 Amendments govern when a purchaser of a CERs, who acquires all rights in the CER held by the transferor or a security interest in the CER, becomes a “qualifying purchases that benefits from the “take-free” rule. A purchaser must be a “qualifying purchaser” to benefit from the “take-free” rule, which provides that the purchaser takes an interest in such CER free of conflicting property claims when such “qualifying purchaser”: (1) purchases the CER for value, (2) controls the CER, (3) acts in good-faith, (4) and does not have notice of property right under the CER.

3. Implications for Secured Lending

Article 9 of the UCC includes CERs in the definition of “general intangibles,” meaning that security agreements granting a security interest in general intangibles include NFTs, cryptocurrency, and other digital assets. Moreover, Article 9 also allows the perfection of a security interest in a CER by either filing a financing statement or, under the Amendments, by control.

Lenders should note, however, that filing a financing statement while sufficient to perfect a security interest in a CER, is subject to the risk that another secured party obtains control and that another person becomes a "qualifying purchaser" that obtains control of the CER and in each case is afforded greater rights in the CER than the secured party that only filed a financing statement. Thus, lenders should be sure to obtain control of the CER under Article 12 of the UCC (which counts as control under Article 9). Moreover, the amendments to Article 8 clarify that a CER can be a "financial asset" such that the custodial arrangements as explained above apply, and such agreements remain enforceable. Finally, these amendments should feel familiar to secured lenders because, other than Article 12's definition of "control," the application of the existing UCC frameworks is clarified.

II. Conclusion:

As discussed in Part I of this two-part series, innovations in NFT lending are pushing the industry forward and enabling new and unique business models. The law always plays catch-up to innovation, so industry participants should be aware of their rights, obligations, and risk-mitigation procedures to protect their investments. Fortunately, once adopted by additional states, the 2022 Amendments will provide even more clarity to secured and commercial and commercial transactions, giving participants the confidence to develop and invest in the arena.

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