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

Blockchain and the Law on **November 15, 2023**

Despite the protracted crypto bear market, innovators in non-fungible tokens ("NFTs") are hard at work. Gone are the days when NFTs were merely profile pictures ("PFPs") displayed on a pseudonymous social media account or shown for their prestige online or in real life to confused friends and colleagues. As discussed in our two-part series explaining Ordinals and their implications for NFT owners and creators, this year NFTs have expanded beyond the Ethereum blockchain, where NFTs initially grew to prominence as a result of the blockchain's ability to execute smart contracts, to the original blockchain, Bitcoin.

Beyond Ordinals, gaming-related innovations, new ERC standards, and other innovations, the industry continues to push forward to new frontiers, such as NFT-based lending.

This is Part I of a two-part article on NFT-based lending (Click here for Part II). In this part, we will discuss recent innovations in NFT-based lending, explaining various mechanics and functions. In Part II, we will dive into the legal issues for lenders involving secured transactions under the UCC, Pre- and Post- Article 9 and 12 Amendments.

Recent Developments in NFT Lending

Like traditional secured financing, where a loan is extended based on obtaining a security interest in the assets or cash flow of the borrower, NFT lending allows owners to log onto a NFT lending platform to borrow money peer-to-peer from willing lenders (or peer-to-protocol directly from a protocol liquidity pool) using the NFT as collateral. Such financing arrangements provide liquidity to creators and owners and will unlock monetization opportunities, all using smart contracts that clarify counterparty risk and default-related remedies.

Earlier this year, Blur, an NFT marketplace and aggregator, launched Blend, its so-dubbed "peer-to-peer perpetual lending protocol."[1] Blend protocol provides two different lending services: (1) purchase an NFT using a "buy now, pay later" service; or (2) leverage an already-owned NFT to provide liquidity to the owner. Technologists quickly determined Blend's protocol was a significant advance: whereas most prior iterations like peer-to-pool protocols use pools to provide leverage directly to borrowers at a set loan-to-value ratio, determined by oracles, which is a process less suitable to volatility due to the potential for automatic liquidations if the NFT valuation dips below a certain reserve or the borrower defaults before the end of the loan term (if an expiration exists), newer peer-to-peer services like Blur and others allow for individual borrower-lender negotiations, lending themselves (no pun intended) to greater flexibility as a result. Peer-to-peer protocols are more flexible, in part, because they avoid dependencies on oracles, which are third-party information feeds typically provided by centralized services that supply NFT prices, interest rates and other information. Oracles increase the risk that inherently volatile collateral will prematurely liquidate and are subject to manipulation by certain trading strategies; thus, many consider Blend's peer-to-peer lending protocol a much-needed breakthrough.

So, how do borrowers and lenders utilize a peer-to-peer protocol such as Blend?[2]

1. *Lenders*

Lenders begin with the same process as borrowers: connect a wallet containing necessary funds. If a Lender is willing to fund against a certain NFT, it states the maximum amount it is inclined to lend against *any* NFT in a collection, not the specific NFT itself. Some NFTs in an NFT collection are rarer than others, resulting in varying asset prices within the collection. Lenders set their fixed interest rate for a specified collection and wait for borrowers to accept.

Lenders may claim accrued interest by closing their perpetual loan at any time, which begins the automatic Dutch auction process; at this point, a new lender may purchase the loan. The loan's sale process initiates at a 0% interest rate and can climb to a maximum of 1,000% APR. If there's a buyer, the borrower has the option of accepting the new terms or not. If there's no new buyer after 6 hours, the borrower has 24 hours to repay the loan—failure to repay results in the liquidation of the NFT – the collateral.

2. *Borrowers*

First, a borrower who has connected their wallet with necessary funds selects the NFT collection and list of items to purchase or an NFT from their inventory to leverage. Borrowers then review their loan offers, which the protocol aggregates based on price and interest rate. Borrowers then select the price and interest rate they want to pay for a specified NFT or request a loan amount and interest rate for an already-owned NFT.

The loan is perpetual – hence, there's no expiry. Borrowers can pay it off at any time by either (1) selling the borrowed NFT and repaying the principal plus interest or (2) entirely repaying the loan and keeping the NFT. Borrowers should note that lenders can request payment whenever they choose (i.e., due to price volatility or if the NFT value drops precipitously), at which point a Dutch auction begins.

As illustrated NFT-based lending represents an innovation in the blockchain industry and NFT technology that may usher in a new wave of value and investment. In Part II, we will explore the legal issues implicated by NFT-based lending. Stay tuned!

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[1] Note that the whitepaper states that the protocol supports "arbitrary collateral," so the protocol can support any web3 asset.

[2] Note that we are describing the Blend protocol, but the general principles in this article apply to digital asset-collateralized loans more broadly.

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