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NFT Craze Generates Slew Of Legal Questions

By **Elise Hansen**

Law360 (April 2, 2021, 7:56 PM EDT) -- Non-fungible tokens have captured the imagination of cryptocurrency enthusiasts, artists, collectors and lawyers who say the burgeoning digital assets raise a host of legal questions spanning intellectual property rights, consumer protection and artist royalties.

Non-fungible tokens, or NFTs, attracted widespread attention when the digital artist known as Beeple sold an NFT associated with his work "Everydays: The First 5000 Days" for $63 million in mid-March. Twitter's Jack Dorsey recently auctioned off an NFT of his first tweet, and the NBA has collaborated to create a marketplace for digital highlight clips that has topped $478 million in sales in 2021 so far, according to NFT tracking site Cryptoslam.

NFTs are digital tokens that are managed with blockchain technology. "Non-fungible" means they are unique and not interchangeable — unlike, say, a nickel or a bitcoin. Blockchain serves as a record-keeping technology that keeps a secure record of transactions.

NFTs also involve so-called smart contracts, software code that memorializes the terms of a contract and can self-execute when pre-specified criteria are met. For example, a smart contract can be written so that it will automatically transfer cryptocurrency from one wallet to another when certain triggering events or conditions occur.

In addition to being a potpourri of digital technologies, even basic questions about NFTs raise an assortment of legal questions, attorneys told Law360.

What Do NFT Owners Actually Own?

NFTs are essentially digital tokens that represent ownership of an asset. In the case of digital art, the NFT is not the artwork itself: an NFT may refer to or "point to" an artwork, but the digital image or audio file is typically stored somewhere else on the internet. Lewis Cohen, a principal at DLx Law, said the concept could be loosely compared to having an autographed poster on your wall.

"One way it's often explained … is it's like buying a fine poster of an artwork: it's unique in itself, but it doesn't buy you any rights to the underlying work. It's just an authenticated version of this particular artistic endeavor," Cohen said. "In most of the NFTs I've seen, most people aren't even purporting to convey any meaningful transferable rights."

Ghaith Mahmood, a partner at Latham & Watkins LLP, agreed that typically the rights that are transferred to a buyer are limited and spelled out in a marketplace's terms of service.

"It usually lands at a personal, nonexclusive right to display that content, either in your wallet or within that marketplace's display portal or through third-party platforms, but not really to use for commercial purposes," such as putting the image on a T-shirt or other merchandise, he said.

But the conditions can be customizable. In addition to a marketplace's terms of service, the smart contracts inherent to NFTs can be written to include various terms.

Some marketplaces offer what are essentially smart contract templates with a standard set of terms. But the minting process, in which the smart contracts get defined, can also be outsourced to companies that will create more customized contracts, said Loeb & Loeb LLP partner Mercedes Tunstall.

"The distinction [between those options] is 'how much control do I have over the smart contract?'" Tunstall said. "Potentially, all the control — but not if you're minting it at the NFT marketplace."

Are NFTs Securities?

A fraught question in other parts of the digital asset world, the current predominant use of NFTs as unique assets makes them less likely to run afoul of securities law, Cohen said.

"Its status, whether it is or is not a security, is dependent on what is done with it," he said. "With anything that is truly non-fungible — that is, truly a unique and one-of-one thing — it is very unlikely that that thing, physical or intangible, will itself be a security."

But the NFT space is rapidly evolving, and different applications could start to move into the securities territory. If an NFT associated with a work of art were to be fractionalized, the fractionalized interests might be considered securities, Cohen said.

"Fractionalizing an NFT is much more likely to create those fractional units being considered securities," even if the underlying artwork isn't, Cohen said.

Alternatively, parties could create a scheme around NFTs in which participants expect to make money due to appreciating value. If the agreement amounts to an investment contract, as defined by the U.S. Supreme Court's Howey test, securities could be in play once again, Cohen said.

Trading NFTs on the marketplace in order to pull up the price, for example, could catch regulators' eyes, Tunstall said.

"The SEC has already stated that if you trade NFTs merely for the purpose of making money, if you effectively treat it like a commodity or security, if your activity with it is for that purpose, then it becomes a security or commodity-type transaction," Tunstall said.

What Could Go Wrong?

The highly technical nature of NFTs could quickly raise consumer protection issues, particularly as more users and more money flood the space, Susman Godfrey LLP partner Oleg Elkhunovich said.

"There's obviously a lot of excitement in this area about this technology, and maybe even more excitement about commercializing or monetizing it," Elkhunovich said. "I think that it's hard to get your head around and unlikely that people fully understand what rights are transferred."

Marketplaces can craft disclosures and terms of service to help dispel some of the confusion. But while the original buyer of an NFT will have accepted the marketplace's terms of service, ensuring those terms and conditions clearly transfer if the NFT gets resold can pose some tricky questions, Latham's Mahmood said.

"Part of the allure of NFTs is that they're transferable: buyers are buying them and transferring them to other buyers downstream," he said. "So the question then becomes, how do you clearly and conspicuously attach those terms and conditions to an NFT in a way that binds the subsequent owners and buyers downstream, who never accepted the original terms of service of the marketplace where the NFT was first purchased?"

Enter the smart contract: the software code inherent to an NFT that can spell out various terms and restrictions. But even that raises questions, Mahmood said. Typically, in order to enforce terms of service, there has to be some indication of consent, but software language isn't exactly easy for the average person to read.

"I think it's going to be an important question. I'll be very interested in how a judge grapples with it: How enforceable is the language that's embedded in the smart contract to bind the subsequent buyers and owners of the NFT to which that smart contract applies?"

People could also mint and upload NFTs that point to an artwork that the person doesn't have a right to, said Megan Noh, a partner at Pryor Cashman LLP and co-chair of the art law group.

"It's easy to imagine that unscrupulous platform users could tie NFTs to images of works not actually created or owned by them," Noh said.

Some marketplaces are trying to head off any such activity by asking creators to affirm that any images they're uploading don't infringe on others' intellectual property rights, Noh said. And under existing copyright law, the Digital Millennium Copyright Act, marketplaces are also providing a way for users to request that allegedly infringing content be taken down, she said.

But the recent explosion of interest in the NFT space could make it very difficult for artists to monitor for potential infringement, Noh said.

"The speed at which this marketplace is expanding is dizzying, and begs the question of how artists are going to effectively monitor for infringements," she said.

What Could Come Next?

One implication that's creating waves in the visual art world is the ability to craft smart contracts so that resale proceeds are automatically transferred to the original artist, Noh said.

"A number of platforms allow 'creators' to select the percentage 'resale royalty' they want paid to them on any downstream sales of their minted NFT," Noh said, adding that a "resale proceeds share" might be a better technical description.

"Because federal law does not currently include a statutory right to any share of the proceeds from resales of original visual works, artists in the U.S. have historically had to rely on contractual provisions to secure such a financial interest," Noh said. "What's novel about the NFT resale model is that it does not rely on human fidelity."

What's more, if sharing resale proceeds becomes the norm in the NFT space, that could spur change in the analog world, Noh said.

"As an attorney who works with artists selling in the studio, primary and secondary contexts, I will be closely watching to see if the widespread adoption of the 'resale royalty' model by the NFT platforms helps to similarly normalize the concept for contracts for non-digital artworks," Noh said.

For attorneys, the evolving NFT landscape could present new questions as new applications for NFTs are tested. Regulators could also become involved, and disputes could start to hit the courts.

If, or perhaps when, people in the space start suffering losses, "some of these questions will need to get answered in the practical sense by the courts, by virtue of applying existing laws to this new technology," Elkhunovich said.

And while many of the current, best-known examples of NFTs center around visual art, music and collectibles, enthusiasts have been brainstorming and developing different applications for NFT technologies, such as ticket sales and even insurance.

"There's so many different directions that [the technology] can take, and depending on the direction, I think totally different legal questions may arise," said Elkhunovich.

--Additional reporting by Dean Seal. Editing by Nicole Bleier and Philip Shea.