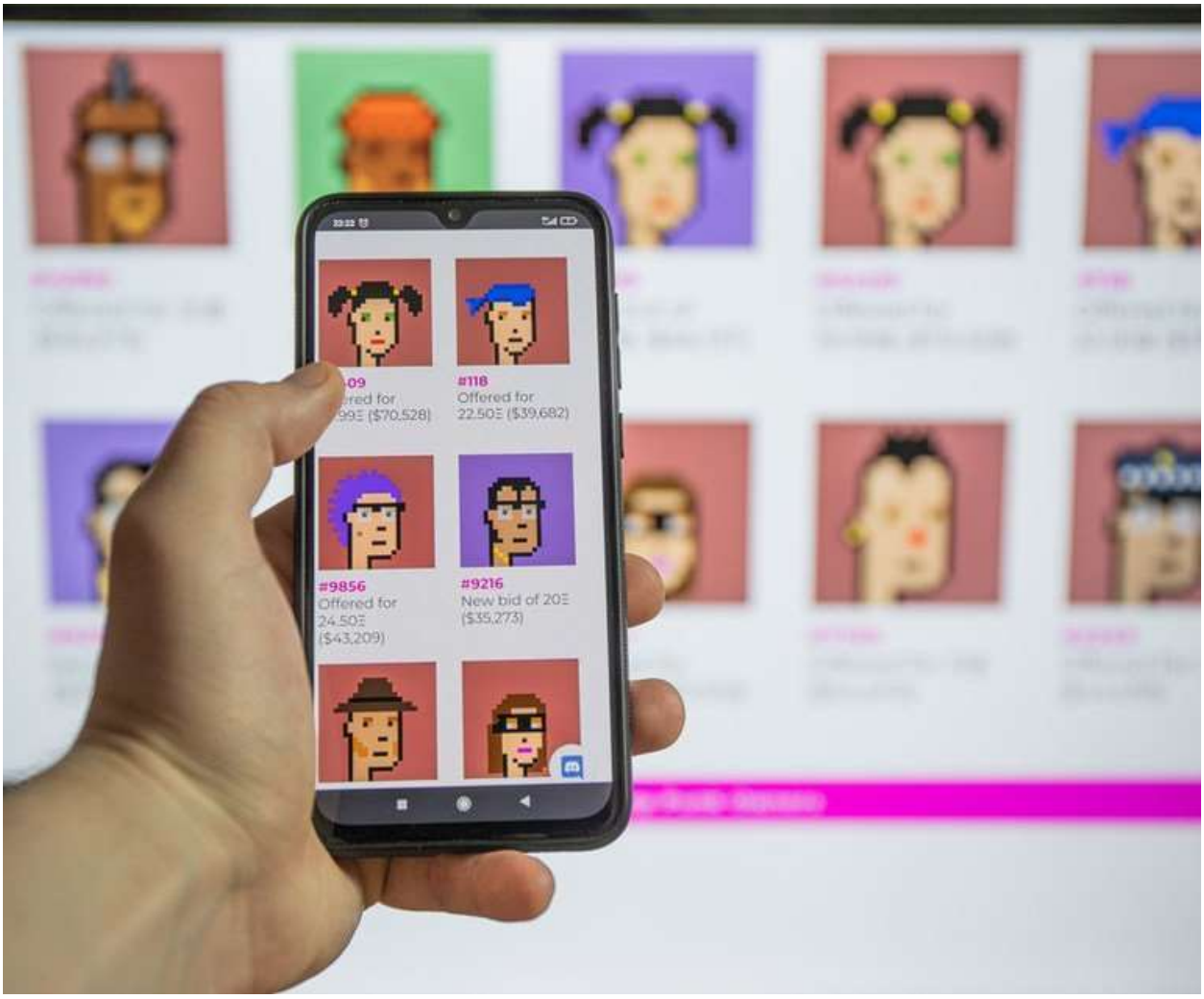

A non-fungible token is a special type of cryptographic token that represents something unique.

CONVERSATION

NFTs: What Lawyers Need to Know to Help Clients Navigate This Emerging Space

Some call it hype. Others see limitless potential. Either way, it is critical for lawyers and advisers to understand NFTs from a business, technical and legal perspective.

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Expert Columns

By Michael Kasdan

Everyone is talking about blockchain technology, crypto, and non-fungible tokens these days. If you just read the headlines, you may come away thinking that the technology will revolutionize not only the finance space, not only the technology space, but how we do business across all sectors, or—if you believe the naysayers—that it is a volatile Ponzi scheme, an unregulated folly, and a minefield of fraud and theft that overpromises and underdelivers. As with most things, the truth lies somewhere in between.

What is blockchain technology and why is it important?

A blockchain is a decentralized, permanent ledger of transactions, which acts as an immutable "state machine" that can record information about any digital asset or real-world asset that is "tokenized" into a digital representation. The ledger is stored on a distributed network of computers owned by different entities. The details of transactions involving the tokens are permanently recorded on the ledger.

Many believe that blockchain is central to creating the next generation of the internet, "Web3." Our current internet is dominated by the centralized gatekeepers such as Google, Facebook (Meta), Twitter and Instagram. When we "Log in with Facebook," we cede data, money and control to these large platforms. Web3 envisions an internet of decentralized apps running on the blockchain, which allow anyone to participate and store their own data on a blockchain that no single entity controls. In Web3, no one needs a bank or large internet company to

transact, because every user has control over their own wallet and their own data.

Proponents of Web3 and blockchain believe that the promise of decentralized technologies and tokenization have the potential to democratize access to markets and to enable greater power and control by content creators, inventors and makers.

Blockchain for NFTs: The potential applications for NFTs are vast

The first blockchain application was the creation of digital cryptocurrencies such as Bitcoin and Ethereum. The second "killer app" is NFTs, i.e., tokens that represent ownership interests in digital assets. These tokens are called NFTs or *non-fungible* tokens, because each one is unique, as distinct from *fungible* assets such as fiat currency or tokens such as Bitcoin or Ethereum. NFTs allow any digital thing to be "tokenized." A .jpeg or .gif file of a meme or a tweet, a video file, an audio file, a piece of digital art, or any other digital file can be tokenized and represented as an NFT.

The creation of a new NFT on a blockchain is referred to as "minting." The "rules" for that particular NFT are defined and automatically enforced by pieces of code that are recorded on a blockchain, which are referred to as "smart contracts." Once the NFT is created, it can be bought and sold and resold on such secondary market platforms as OpenSea, Rarible or Foundation.

NFTs encompass an incredibly broad and varied range of "digital stuff" that goes well beyond the art and collectibles space in which they have

drawn wide attention. As some have noted, NFTs can be compared with computer files in that their types and use cases are extremely varied.

Accordingly, the applications of NFTs are potentially massive. They range from indicating ownership of digital assets such as art, music and collectibles to acting such as access passes to exclusive communities, passports for traveling, or live-event and concert tickets to products that link online/real world products (e.g., Nike's "Crypto-Kick" sneakers) to digital assets for online or video game avatars (such as clothes, weapons, possessions, and skills for your digital avatars or virtual real estate or buildings in the so-called metaverse) to mechanisms for tracking title to real-world items such as real estate and automobile titles to vehicles to better monetize scientific research and intellectual property (the so-called "De-Sci" space) to Distributed Autonomous Organizations (DAOs), which rely on blockchain and smart contracts to bring individuals together to engage in coordinated transactions.

Who to believe? Are NFTs "the Next Big Thing" or "Much Ado About Nothing"?

Blockchain holds much promise as a technology which—more so than anything that has come before it—enables the efficient and effective monetization of digital assets. NFTs can act as incontrovertible and permanent sources of truth regarding ownership and authenticity for any manner of digital assets, and their use cases are vast and extend well beyond digital assets for collection and display and into the realm of digital assets with utility. That is exciting stuff.

That said, NFTs are a new asset in a still-emerging space. While Web3 holds great promise, we have a lot to navigate to get there. There is

currently a lot of risk, misunderstanding, and outright theft and fraud in the space. And the law and regulators have yet to catch up to the technology and business side. It is important to understand what you're selling, what you're buying, and to do appropriate legal and technical diligence and risk assessments. Market players and solutions that offer better transparency, analysis and diligence around NFTs and smart contracts are still developing.

As with all new industries, legal issues abound.

Here are four key takeaways on the legal side:

1. It is critical to get lawyers and advisers who understand the space from a business, technical and legal perspective.

A cross-functional skill set is required. According to Scott Shipman, the chief legal officer of Dapper Labs, "There is a significant scarcity of good lawyers practicing in the area of NFTs."

Lawyers cannot advise or do due diligence on something they do not understand. Risk assessors cannot do a good job assessing risk if they do not understand the underlying asset.

2. Contract law is key.

It is critical to understand the details of the smart contract for an NFT, as well as to understand the actual legal contracts and terms and conditions set forth by the platforms where NFTs are minted and sold.

The details of the terms and smart contracts determine what, if any, intellectual property and commercialization rights are transferred when

a particular NFT is sold or purchased. For example, in the art and collectibles space, IP rights beyond the right to display the digital asset, i.e., the right to create derivative works or exclude others from using or accessing the IP, are generally not conveyed to the purchaser. For example, a purchaser of an "NBA Top Shot Moment" NFT of the Grizzles' Ja Morant throwing down a ferocious dunk does not receive the right to create a Ja Morant movie, nor does that purchaser have the right to stop ESPN from showing that highlight on "SportsCenter." But a completely different application of NFTs, such as an "IP-NFT" offered by a DAO in the research science space, may convey exclusive copyright or patent rights to the purchaser.

The devil is in the details, and the details are important.

3. While Web3 is a new and exciting space, existing concepts of IP law remain critical to understand.

Despite the "community" and "code is law" gestalt of Web3, makers and creators still must be mindful. If you don't understand and protect your IP, you risk getting taken advantage of by fraudsters or knockoff artists. This is already happening. Education and smart strategic thinking on the IP side for those in this space is incredibly important.

In addition, misconceptions about IP law can be dangerous and expensive. For example, purchasing an NFT of a scene from the movie "Dune" gives you no more IP rights to make the next "Dune" movie as purchasing a T-shirt with the Coke logo gives you rights to make a new flavor of Coke. Yet, not all purchasers of NFTs seem to realize this.

Further, complex and unsettled IP issues abound with NFTs. Copyright and trademark law apply to NFTs, but the contours of how this will work in certain circumstances has already given rise to disputes. For example, how do copyright principles of fair use map on the purchase and sale of digital content? When is an NFT considered to be a referential pointer to a trademarked product as opposed to its own separate product which is likely to cause confusion in the context of trademark infringement? These issues are already being litigated in the closely watched *Hermes v. MetaBirkins* and *Nike v. StockX* cases.

4. Regulation is coming.

The Biden administration recently announced an inquiry into the appropriate regulatory governance of digital assets and cryptocurrencies.

One fundamental and important regulatory issue that has not yet been addressed, but will, is whether and when a given NFT is considered a "security." If a given NFT is regulated as a security, this would require compliance with U.S. Securities and Exchange Commission regulations, causing issuers/creators to seek an exemption from registration, which might create the need to prepare prospectuses and to attend to rules about sales to accredited investors. It would also expose issuers to potential liability for securities fraud.

Though has SEC not yet issued formal guidance on this issue, the definition of "securities" set forth in the hoary Supreme Court decision, *SEC v. W.J. Howey* depends on whether there is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the effects of the

promoter or a third party." How this analysis is applied by the SEC to different types of NFTs remains to be seen. At the same time, the question of whether and when a specific NFT is a "security" is being litigated in the pending class action suit *Friel v. Dapper Labs,* where plaintiffs allege that the defendants' NBA Top Shot Moments NFTs were sold to consumers in violation of the federal securities laws.

We are still in the early days of NFTs. There is the potential for incredible financial opportunities, innovation, and creativity in the NFT space. There is also the potential for risk, theft, fraud and misunderstanding. There likely will be many losers as well as a fair number of winners.

Even in a dynamic, creative new technology space, the law plays a critical role. Having expert legal guidance to help navigate this emerging space will help innovators create viable businesses around NFTs, do due diligence and assess their risk and value, and increase their chances of success.

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