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Adam Chernichaw | Pratin Vallabhaneni | Shobha Lizaso

The Rise of NFTs – Opportunities and Legal Issues

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As we progress into 2021, the beat of the drum of the cryptocurrency and broader digital asset industry continues and, with it, has come the rise in popularity non-fungible tokens (NFTs). In the month leading up to the writing of this article, a total of more than $208 million[1] of NFT-based artwork was sold (in primary and secondary sales), as compared to the $250 million of total NFT volume traded in all of 2020. In addition, creators are utilizing NFTs to generate novel methods of monetizing digital creative works and other experiences, as the music band, the Kings of Leon, accomplished when it released its new album as a limited edition NFT, with six NFTs providing lifetime tickets to front row seats for the band's shows. Further, we are witnessing creators experience a new era of incredible sales figures, like the artist known as Beeple, who sold an NFT representing a collage for $69 million. Prior to this NFT sale, Beeple had sold his art for as little at $100. This article explores some of the legal issues behind NFTs and their underlying technology.

The utility of NFTs for digital creative works is premised on blockchains. Blockchains are permanent, unchangeable digital ledgers that are used to record transactions in "blocks" of computer code that are time stamped and linked together, demonstrating the provenance of a digital asset. Blockchains also function as decentralized networks that transparently reveal the history of transactions for digital assets, making it impossible for recorded digital assets to be pirated, modified, or deleted. Assets that are digitally transferrable between two parties in the blockchain ecosystem are commonly referred to as "tokens," and tokens can be assigned specific uses and properties. Bitcoin or other cryptocurrency tokens are identical and are readily exchangeable for equal value (i.e., they are fungible). An NFT, on the other hand, contains a unique identification code and metadata that distinguishes one NFT from any other, and represents items on the blockchain that cannot be replicated. For example, a cryptocurrency like a Bitcoin can be substituted in a transaction with another Bitcoin without a loss of value or change in attributes for the transaction parties, much like one US dollar can be substituted for any US dollar. Because an NFT contains data that distinguishes it from every other NFT, it is non-fungible; rather, it is a one-of-a-kind asset, like a ticket for a specific seat at a concert. Moreover, NFTs are composed of software code in the form of "smart contracts" that can be crafted to provide significant benefits to NFT creators. Smart contracts are open-sourced blockchain protocols that directly control the transfer of digital currencies or assets between parties under certain terms and conditions. To illustrate, the code could detail limitations on the use of the NFT by a purchaser, provide for automatic royalty payments from resale transactions, and prove ownership. After the code for the smart contract is written, it is then permanently minted into a token on a blockchain, such as Etherium, where it will serve as a non-replicable digital certificate of ownership of a digital creative work. Additionally, this technology lays the foundation for creators to have more control over the value and the conditions of the sale of their digital creative works and create new distribution channels of art, performance access, or other valuable property.

Prior to the recent surge in the use of NFTs, creators faced limitations on the revenue that they could generate from their digital creative works because copies could be easily made an infinite number of times and distributed throughout the internet with no degradation of quality, which has historically made it difficult for creators to monetize their digital creative works. However, NFTs make it possible for creators to generate unique and finite tokenized versions of digital creative works and to commodify such assets, while ensuring that the digital creative work cannot be counterfeited and that the work remains scarce online. For example, NFT creators can set both the sales price and the maximum number of replicas of the digital creative work that can be sold. This allows the NFT creator to perpetuate the scarcity of their asset and artificially increase the NFT's value in the initial market as well as the resale market, similar to a lithograph that grows in value because of its exclusivity and limited number of prints. Also, NFTs can spare creators from losses related to piracy since NFTs cannot be replicated. Finally, NFTs provide for the improved ease of transferring digital creative assets over traditional sales models since NFTs can be sold on any NFT market or peer to peer, without the need for an intermediary, rather than being restricted to the use of third-party platforms to distribute content.

While the excitement relating to NFTs is growing exponentially and on a global level, the legal treatment of NFTs continues to evolve and is unsettled. We highlight a few legal issues concerning NFTs below:

Data Hosting and Storage: An NFT and the digital asset it represents are typically stored separately. The NFT is stored on the blockchain and contains information on where the digital asset is located. The NFT is connected to the digital asset via a link. However, if the digital asset is deleted or the server hosting it fails or otherwise goes offline, the link will break and the NFT that remains will be worthless because it would no longer be associated with the digital asset and there is no way to back up the NFT. Since the NFT is unique and cannot be replaced, the NFT purchaser might be left without recourse. Based on the use of the specific NFT, this can result business interruptions, regulatory record keeping violations, and loss of data.

Royalties: Smart contracts written into the code of NFTs allow for the distribution of funds for the payment of royalties to the creator each time the work is resold. However, these automated resale royalty payments might not occur unless the NFT is resold through the same platform. US law does not recognize resale rights relating to creative works, so the law provides no recourse for unpaid resale royalties in the US, as it does in approximately 70 other jurisdictions, including the UK and the EU.

Data Protection Laws: Some data protection laws give individuals the right to the erasure of their personal data, but the immutable nature of the blockchain poses an obstacle to the execution of this right. Data protection laws also sometimes provide individuals with the right to rectify inaccuracies in their personal data, and blockchain technology might make this right functionally impossible to exercise. As such, NFTs that contain personal information might violate data protection laws.

Intellectual Property Rights: People of all backgrounds are participating in the NFT market, and many are not familiar with the legal restrictions relating to copyrighted work, which leads to potential infringement liability. For example, an NFT purchaser might assume that he purchased the underlying art that is associated with the NFT; however, in reality, the original creator is the copyright owner who retains the exclusive right to copy, distribute, modify, publicly perform, and publicly display the art (unless specifically granted to someone else). Alternatively, the purchaser of the NFT typically only receives the token and the right to use the copyrighted art associated with the NFT for personal use. A purchaser who believes that the rights associated with the underlying art were misrepresented, and who faces a loss in value, might create litigation liability for the NFT seller under a variety of legal theories.

The introduction of NFTs has the potential to strongly influence a transition to a more digital world. NFTs are making it possible for creators to imbue physical properties like scarcity, uniqueness, and proof of ownership to digital assets. They have inspired new methods and means of monetization of items that were previously lost to the depths of the internet. The NFT market is still nascent, however, and significant infrastructure will likely continue to be built in the form of intermediaries, tokenization platforms, distribution channels, custodial solutions, e-commerce integrations, and the like. As the market continues to evolve, so do the legal and regulatory issues.

1 Nonfungible.com - NFT Market Tracker