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NFTs - How Do They Fit in the Existing Legal Framework?

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NFTs
How do they fit in the existing legal framework?

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What is an NFT?

In simple terms, an NFT (non-fungible token) is an asset with ownership recorded on a digital ledger.

The digital ledger is based on blockchain technology, similar to cryptocurrencies.

‘Non-fungible’ implies that the asset is unique...which may not always be true.

Unlike physical assets, digital assets can be duplicated with ease. NFTs attempt to create scarcity by ‘tokenizing’ the digital asset, offering proof of ownership that can be bought and sold like any physical asset.

What is an NFT? *(cont'd)*

For example, it would be difficult to duplicate a physical sculpture. To do so would require the skill of the original artist, time, and money. In contrast, a 3D rendering can be copied, emailed, transferred, displayed, and saved all in digital form with the click of a button. NFTs can increase the value of a digital asset by making the asset unique.

Does minting an NFT actually prevent copying...not likely. The NFT owner can show that they are the 'original' owner of the asset, but copies can still be made. In addition, the original author of the work may retain ownership of the copyright, further restricting the NFT owner's rights.

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Examples

- Jack Dorsey (Twitter) sold an NFT of his first tweet for $2.5 million
  - The tweet sold on Valuables by Cent, a marketplace for tweets as NFTs. The company, in its FAQs, answers why a person would want to own a tweet as an NFT by stating: “Like an autograph on a baseball card, the NFT itself is the creator's autograph on the content, making it scarce, unique, and valuable.” What can you do with your NFT: “You can resell them on Valuables or display them in your digital gallery.”

- Mike Winkelmann, known as Beeple, sold artwork through an auction at Christie’s for $69 million.
  - Christie’s marketed it as the first purely digital work of art ever offered by a major auction house.
  - In addition, Christies noted: “He showed us this collage, and that was my eureka moment when I knew this was going to be extremely important. It was just so monumental and so indicative of what NFTs can do.”

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Examples *(cont'd)*

- NBA Top Shots – NFTs of clips from NBA games. It is estimated that there have been $700 million in sales in about 1 year. The sales figure represents original sales as well as sales in the secondary market. (We will revisit this particular NFT later in the presentation.)

Will the trend last? Coinbase cofounder Fred Ehrsam does not believe so. "I go so far as to say that 90% of NFTs produced, they probably will have little to no value in three to five years. You could say the same thing about early internet companies in the late '90s."

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Corollaries to Other Digital Assets / Legal Implications

(1) Napster was a peer-to-peer file sharing network digital music files, knowns as MP3s. P2P was a file sharing system that was touted as the next great revolution in technology and the internet. Napster's popularity rose quickly, but was ended just as quickly due to legal liability. In a lawsuit brought by record labels, the U.S. Court of Appeals for the Ninth Circuit affirmed the district court, which held that Napster could be held for contributory and vicarious copyright infringement. A&M Records, Inc. v. Napster, Inc., 239 F.3d 1004 (9th Cir. 2001).

Napster made technical arguments based on how files were transferred from user to user, but the court focused its decision within the context of existing laws, namely copyright law. Under 17 USC § 106, a copyright owner has the exclusive right to make copies, prepare derivative works, distribute copies to the public (via sale, rental, lease, etc.), perform the work, display the work, perform sound recordings via digital audio transmission.

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Corollaries to Other Digital Assets / Legal Implications *(cont'd)*

(2) DMCA: The Digital Millennium Copyright Act was signed into law by President Bill Clinton in 1998 and implemented World Intellectual Property Organization treaties. The law created two new provisions in US code relating to (1) circumvention of technological measures used by copyright owners to protect their work and (2) civil and criminal penalties for violation of prohibitions.

At this time, existing copyright laws were sufficient to protect the owners of the works. Enforcement was enhanced with the holding in A&M Records and the DMCA. The protections are still used today with the implementation of the High-Bandwidth Digital Content Protection (HDCP) scheme used on HDMI and other digital interfaces. HDCP restricts the playback of encrypted content on unauthorized devices. It would be a violation of the DMCA to circumvent HDCP encryption.

The comparison is imperfect—A&M Records and the DMCA deal with digital assets that are distributed as copies. As such, copyright laws are well-suited to protect these assets, despite the new mode of transmission/distribution.

So where do NFTs fit into the existing legal framework?

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Legal Classification of NFTs

The Problem – Uniqueness of NFTs. The rules and framework designed for not only early-era internet, but 2000s internet, had a focus on the *users*. NFTs are created (minted), sold, purchased, destroyed, displayed. These characteristics are that of personal property, as opposed to a digital asset that is simply used and licensed (think, e-book or digital movie).

There needs to be a legitimization of so-called "digital personal property interests."

If NFTs are not licensed property but rather ownership interests actually conveyed, then what legal doctrine should control/apply? UCC Article 2 (Sale of Goods)?

A true sale of digital assets is in direct contravention of the recent history of legal development governing "the internet" which had a predominant focus on licensing arrangements and contractual use arrangements, as opposed to a true conveyance of legal ownership.

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Existing Legal Doctrine

What is the doctrine governing NFTs?

Well, not much of anything quite yet. NFTs are in their infancy and there is very little by way of legal literature on NFTs. Rather, there is legal literature and doctrine on components and ancillaries to NFTs.

For example:

- Smart Contracts - A smart contract is a computer program or a transaction protocol which is intended to automatically execute, control or document legally relevant events and actions according to the terms of a contract or an agreement.

Existing Legal Doctrine *(cont'd)*

- Blockchain Technology – A blockchain is a growing list of records, called blocks, that are linked together using cryptography. Each block contains a cryptographic hash of the previous block, a timestamp, and transaction data. The timestamp proves that the transaction data existed when the block was published. As blocks each contain information about the block previous to it, they form a chain, with each additional block reinforcing the ones before it. Therefore, blockchains are resistant to modification of their data because once recorded, the data in any given block cannot be altered retroactively without altering all subsequent blocks.

- Cryptocurrency -- is a binary data designed to work as a medium of exchange wherein individual coin ownership records are stored in a ledger existing in a form of a computerized database using strong cryptography to secure transaction records, to control the creation of additional coins, and to verify the transfer of coin ownership

Let's explore...

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"Smart Contracts"

What is it? A "smart contract" is the program that in part creates, and conveys the NFT after it is created (minted).

- Smart Contracts - A smart contract is a computer program or a transaction protocol which is intended to automatically execute, control or document legally relevant events and actions according to the terms of a contract or an agreement.

The original desire to call this blockchain technology a "contract" let alone "smart contract" was the intent for it to entirely replace the need for a traditional legal instrument and have something that was automatically executable and, in turn, essentially infallible/indisputable due to the nature of how blockchain works.

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“Smart Contracts” *(cont’d)*

“Smart contract” is somewhat of a misnomer.

Why is it a misnomer? The early technologists who were the stalwarts and stewards of blockchain conflated the essence of a contract with the actual undertaking of the agreed upon exchange.

Blockchain and cryptocurrency focused initially on eliminating any unnecessary moving parts – including middle-men – banks, lawyers, etc.

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"Smart Contracts" *(cont'd)*

Smart contracts which are automatically executing code can't be deemed to be contracts if the essential elements for a contract to exist are not met.

For a contract to exist there must be: (i) offer, (ii) acceptance (manifestation of mutual assent), and (iii) consideration.

<u>Distinction</u> – Code of smart contracts assists in the *execution of a contract*. The code, in and of itself, cannot be *the contract*.

Contracts involve creation of legal obligations – exchange of promises or exchange of something in exchange for something else. Bargained for exchange.

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"Smart Contracts" *(cont'd)*

Note that we interact with and use self-executing agreements everyday – the easiest example is when we use a credit card:

- The code connected to the card and the card reader interact with one another to execute a transaction, based upon an already agreed to contract between you and the financial institution governing the use, repayment, obligations, etc., surrounding that credit card. This automatic execution by scanning the credit card is not a contract (seems obvious).

You create (mint) an NFT. You then promise that, upon payment of a certain amount of cryptocurrency by the purchaser, you will sell to the purchaser the NFT. This is the contract. The code involved in executing the contract is merely that, code. If the purchaser is under the impression that they are purchasing an NFT of a cat playing a keyboard, and you sell the purchaser an NFT of a dog playing a keyboard, what happens? That would be a breach of contract.

Contracts involve and create the creation of reciprocal legal promises and obligations.

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NFT Regulation

How are we using it? **How we use the technology will drive how it is regulated.**

Examples:

- Cryptocurrency used as an equity raise as capital for a business, such cryptocurrency is treated as an equity and regulated by the Securities and Exchange Commission (SEC).
- Blockchain technology used to convey value would be treated as a substitute for currency and be regulated under the Bank Secrecy Act. FinCEN has literature discussing regulations to certain business models involving convertible virtual currencies.
- The Internal Revenue Service (IRS) treats cryptocurrency as a commodity when it is used as such.

If digital assets (NFTs) are treated as personal property by those who create, buy and sell them, then it follows that the laws governing personal property should be applicable (perhaps, at least in part).

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NFT Regulation *(cont'd)*

Sustainable Holdings Letter – April 12, 2021, the CEO of Sustainable Holdings (by way of its subsidiary Arkonis Capital, LLC) wrote a letter to the SEC requesting rulemaking and regulatory clarity regarding NFTs. The letter set forth, in part, that the development of NFTs presents a unique challenge to the SEC's ability to protect investors from products that may be illegally offered securities.

The SEC has defined digital assets as "an asset that is issued and transferred using distributed ledger or blockchain technology."

What constitutes and investment contract has been determined based upon the applicability of the test set forth in the U.S. Supreme Court case *Securities and Exchange Commission v. W. J. Howey Co.* Under the Howey test, an investment contract is a contract, transaction, or scheme involving (i) an investment of money, (ii) in a common enterprise, (iii) with the expectation that profits will be derived from the efforts of the promoter or a third party.

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NFT Regulation *(cont'd)*

The SEC has noted that: "the main issue in analyzing a digital asset under the Howey test is whether a purchaser has a reasonable expectation of profits (or other financial returns) derived from the efforts of others. A purchaser may expect to realize a return through participating in distributions or through other methods of realizing appreciation on the asset, such as selling at a gain in a secondary market."

- If an NFT relates to an existing asset and marketed as a collectible with assurance of authenticity based upon blockchain, then it should not be a security.

- If an NFT promises a return on investment from the efforts of others, then it could be deemed to be a security.

The Sustainable Holdings Letter recommends that (1) the SEC publish a concept release on the regulation of NFTs – proposed rulemaking with opportunity for public comment, and (2) the SEC should propose rules to address when NFTs are securities.

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Purchase and Sale of NFTs

UCC Article 2 – governs the sale of goods.

Recap of sale of goods:

Goods are defined as "all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid..."

Article 2's provisions have been applied to sales of software and other digital assets. This application is easier to conceptualize when it is a physical item, such as a DVD or a video game. You may be buying a DVD or video game, but you're enjoying its content via software licensing agreements (whether you know it or not!).

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Purchase and Sale of NFTs *(cont'd)*

Should UCC Article 2 apply to NFTs? **Maybe.**

- **Pro**: If courts would apply UCC Article 2 framework to NFTs there would thus be a clear and thoroughly defined framework under which to analyze NFT transactions and any issues and disputes arising therefrom.
- **Con**: Often it is difficult to conform an existing framework to new technology (notion of "square peg in a round hole").
- **Compromise**: Likely a mixture of the two. Pulling concepts from existing doctrine and developing new laws/rules/policy for new technology. Likely developed and arising out of to be determined case law.

*Important sidebar – NFT transfers are not reversible as a matter of technology. Once the transfer has been recorded in the blockchain, only can that owner then transfer that token further.

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Purchase and Sale of NFTs *(cont'd)*

The components of a purchase/sale of personal property consist of: (i) an agreement (contract) to transfer the property and (ii) the actual interest in the property.

Contract formation under UCC Article 2:

> "A contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract."
>
> (UCC Section 2-204)

This definition provides for flexibility and applicability to new technology (in our case, NFTs).

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Purchase and Sale of NFTs *(cont'd)*

Purchasing an item from a convenient store forms a contract for the sale of a good, without the need for a written agreement between the parties. Applying that same UCC Article 2 governance to NFTs, then a contract will result when a party exchanges money for the NFT owned by the second party. <u>We have UCC Article 2 contract formation</u>.

If we have contract formation, then we (the courts) know how to analyze issues and apply appropriate legal doctrine.

What about the warranties (express and implied) offered under UCC Article 2?

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Purchase and Sale of NFTs *(cont'd)*

- Two implied warranties:
  - Merchantability – unless excluded or modified, a warranty that the goods shall be merchantable is implied in a contract for their sale if the seller is a merchant with respect to goods of that kind. Among other requirements "the goods must be at least of average quality, properly labeled, fit for the ordinary purpose they are intended to serve."
  - Fit for a particular purpose – This type of warranty is created if the seller has reason to know that: (1) the buyer intends to use the goods being sold for a particular purpose; and (2) the buyer is relying on the seller's skill or judgment in selecting which goods to buy for that purpose. When these two conditions are met, the seller will be bound by this warranty.

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Purchase and Sale of NFTs *(cont'd)*

- Express warranties:
  - Express warranties are affirmative statements (an "affirmation of fact or promise") by a seller to the buyer regarding the goods being sold. The UCC clarifies that specific words (such as "warrant") are not required to create express warranties. Express warranties can be created even when the seller did not have the specific intention to create a warranty.
  - A way in which an express warranty may be created is through the seller's description of the goods. As long as the buyer is depending on that description as part of the basis of the bargain, an express warranty is created that the goods will meet the description.

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Revisiting Copyrights

The creator of an NFT can not transfer an ownership right that was not expressly conveyed to him in writing by the underlying copyright holder. Pursuant to 17 USC § 204, "a transfer of copyright ownership, other than by operation of law, is not valid unless an instrument of conveyance, or a note or memorandum of the transfer, is in writing and signed by the owner of the rights conveyed or such owner's duly authorized agent."

<u>Roc-A-Fella Records, Inc. v. Dash, No. 1:21-cv-05411 (S.D.N.Y. filed June 18, 2021)</u>

- Roc-A-Fella Records ("RAF") filed a complaint against Damon Dash. Damon Dash owned a one-third equity interest in RAF, with Kareem Burke and Jay-Z holding the remaining two-thirds interest. RAF sued Dash and argued, which Dash does not dispute, that an individual shareholder does not own the corporation's assets, only the corporation does.
- Roc-A-Fella alleged in its complaint that Dash planned to sell the album as an NFT at an auction on June 23, 2021. Roc-A-Fella's attorney described the album as "one of the greatest recordings in history."

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Revisiting Copyrights *(cont'd)*

Roc-A-Fella Records, Inc. v. Dash, No. 1:21-cv-05411 (S.D.N.Y. filed June 18, 2021)

- Roc-A-Fella's pleaded in its complaint allegations that intermingled the rights associated with the NFT with copyright. "Dash ... sought to case in by auctioning the copyright to Reasonable Doubt as an NFT."
- Notably, there was no copyright claim brought against Dash and the claims were for conversion, breach of fiduciary duty, and unjust enrichment.
- The litigation is still ongoing and Judge Cronan entered a temporary restraining order against Dash and ruled that he is restrained "from altering in any way, selling, assigning, pledging, encumbering, contracting with regard to, or in any way disposing of any property interest in [the album], including its copyright and including through any means, such as auctioning a non-fungible token reflecting such interests."

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Revisiting Copyrights *(cont'd)*

Another consideration are the rights granted to a copyright owner under the 1990 Visual Artists Rights Act codified in Section 106A of the Copyright Act.

The Visual Artists Rights Act protects the rights of visual artists to the attribution of their work, protects them from being attributed to works they did not create, and prohibits any intentional distortion, or mutilation, or other modification of any work of "recognized stature."

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Revisiting Copyrights *(cont'd)*

- First Sale Doctrine (17 USC § 109): The copyright owner retains the rights to the underlying work. However, the purchaser may dispose of the particular copy they legally purchased.
- Nifty Gateway is an online auction platform for non-fungible token art. The platform has partnered with Sotheby's for auctions. One year revenue estimated at more than $300 million.
- Creators sell thousands of copies of their art and thousand of resells may occur.
- Is Nifty Gateway a seller: "Nifty Gateway is an administrative platform that facilitates transactions between a buyer and a seller but is not a party to any agreement between the buyer and seller of Nifties or between any users."

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Revisiting Copyrights *(cont'd)*

- What rights do you grant the platform: "By providing any User Content on the Website, you grant us and our affiliates and our respective licensees, successors, and assigns the right to use, reproduce, modify, perform, display, distribute, retransmit, publish, broadcast, and otherwise disclose to third parties any such material for any purpose."
- So what does rights does a buyer have: The buyer can buy, sell, trade, and display its NFT.

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Dapper Labs, Inc., No. 1:21-cv-05837

- In an ongoing class-action lawsuit, Dapper Labs, Inc., a blockchain startup, operating the NBA Top Shot market that promotes, offers, and sells NFTs of "NBA Top Shot Moments". The lawsuit alleges that the NFTs are unregistered securities.
- According to the purchasers, the "Moments" are "securities" because among other things, they "derive their value from the success or failure of a given project, promoter, or start-up." The complaint alleges that Dapper violated the securities laws because it did not register the alleged securities with the SEC.

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Dapper Labs, Inc., No. 1:21-cv-05837 *(cont'd)*

- Therefore, by selling these unregistered securities to its purchasers, "[Dapper Labs]:

  (1) reaped hundreds of millions of dollars in profits by selling unregistered securities to investors;

  (2) ensured that money stayed on the platform, propping up the market for Moments as well as the overall valuation of NBA Top Shot, by preventing investors from withdrawing their funds for months on end; and

  (3) as a result of defendants' issuance, promotion, and sale of unregistered securities, investors have suffered significant damages."

- Lawsuit is pending and was removed to the district court in June 2021.

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