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NFTs May Come With Rewards, But Also Legal Risks

By **Anne-Laure Alléhaut** (July 21, 2021, 4:17 PM EDT)


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When digital artist Beeple's "Everydays: The First 5000 Days" sold at Christie's International PLC for $69.3 million in March, nonfungible tokens, or NFTs, officially became the art market's newest bright shiny object.

The auction houses responded enthusiastically: Sotheby's and Phillips Auctioneers LLC announced their own upcoming NFT sales, and Christie's doubled down, including a CryptoPunk NFT in its marquee May evening sale that sold for $16.9 million.

Buyers who entered the NFT market early are experiencing enormous returns on their investments. But those who are entering the market now with the expectation of quick and substantial profits should proceed with caution, and be sure to understand and be comfortable with the risks of buying and owning NFTs.

Understanding NFTs

Typically, when people think about ownership of an artwork, they imagine the physical possession and display of a tangible work of art — buying a painting and hanging it on a wall. However, an NFT is different.

It is not a physical asset — and it is not the digital artwork itself. So what is it, and what is the buyer actually purchasing?

An NFT is a unique digital token that typically has a digital image, song, video or other media attached to it. The digital token comes with a unique code or metadata, and within that code is the reference to the actual image, either with a link or thumbnail to the underlying digital asset.

To create an NFT, an artist "mints" his or her digital artwork by uploading the art to an online marketplace using blockchain technology, and attaching an NFT to it. The NFT will then be verified and included in a blockchain.

In that regard, NFTs accomplish something truly innovative: the minting process effectively turns a digital image into an "original," creating scarcity and value in a space where it has traditionally been difficult to do so, and the NFT holds it out for the world to see.

Practically, when a purchaser buys an NFT, he or she will see an image of the underlying digital asset in his or her digital wallet, but nothing else. The token itself does not appear in the wallet; it is data that will be recorded on a blockchain and will reference the name of the artist, the name of the work and the means to access the image.

The artist can also add specific terms — a popular one is a resale royalty, automatically payable to the artist upon a resale. Simply put, an NFT is code on a blockchain, and is used to record ownership and subsequent transfers of a specific artwork, but it is not the underlying digital asset or image.

The underlying file or image is stored on a platform or server outside of the blockchain, and the NFT owner does not have — and will not have — control or exclusive ownership of the server or platform hosting the file. In practical terms, the purchaser will not be able to restrict others' access to the artwork.

In fact, the marketplace will display an image of the underlying digital or physical asset to all marketplace participants; the image is meant to be widely accessible to anyone. On OpenSea, a popular marketplace for minting, selling and purchasing NFTs, all users can view the digital image along with other basic information, including the name of the current owner.

NFTs constitute a new medium of art that challenges traditional notions of what art is, and what ownership of a work of art means. This is not the first time this has happened: Video art, conceptual art and digital art have all posed similar challenges.

In thinking about purchasing or creating an NFT, there are a number of legal issues to consider.

Contract Law and NFTs

Traditionally at auction, a buyer purchases a work of art subject to the conditions of sale included in the catalog for the purchased lot. The conditions of sale provide, among other things, that the buyer will pay the purchase price and receive physical possession of the object.

NFTs challenge that very notion. Just like at auction, the purchase and the sale of an NFT is governed by the terms and conditions of the marketplace, or the conditions of sale of the auction house. However, for NFTs, there are no industry standards about the accessibility of the underlying asset over time.

In fact, when Christie's sold Beeple's "Everydays: The First 5000 Days," the auction house gave no guarantees to the buyer that it would be able "to receive, access or view the lot and/or digital asset."

Right now, there are many NFT marketplaces, and most of them are relatively new. But as time goes on, the marketplaces themselves, or the platforms they use to store digital artwork, may break, become obsolete or simply go offline, resulting in the underlying image being no longer accessible, or even lost.

As the NFT market continues to develop, the issue of who is responsible for maintaining the digital file, and who is responsible for a buyer's continued access to such file, will need to be addressed.

The challenge of upgrading artwork to a new format or platform has been dealt with in other fields by video and conceptual artists. For instance, some artists using video as a medium have agreed to update the physical device used to display their work. In other instances, upon a sale of the work, the owner of a video or film work must pay to upgrade the format — e.g., from a video cassette to a USB drive.

In the case of NFTs, the marketplace terms or the metadata within the NFTs could require that the artwork be uploaded to a new server or platform, or that the server or platform hosting the artwork be maintained. But this solution only works if there is an underlying copy of the minted work stored safely somewhere else, and the artist is available and willing to ensure continued access to that specific underlying digital file.

Alternatively, the digital file could be decentralized, using blockchain technology, with a link calling it from a decentralized server. The InterPlanetary File System — a file application meant to hold and store images on a blockchain — was meant to do just that.

The "gas fees" — i.e., the costs of computing energy required to process and validate the transaction placing the image on a blockchain — are one of the hurdles of a decentralized file system. But they are not the only one.

Recently, when the images called from the InterPlanetary File System did not load, there was no one to call to fix the problem — because no one is actually responsible for this in a decentralized system.

Intellectual Property and NFTs

The intellectual property questions raised by NFTs come in two baskets. First, who can create an NFT from a copyright standpoint? Second, what are an NFT buyer's rights with respect to his or her use of the image?

Minting and the Artist's Rights

Collectors may want to create an NFT out of artwork they purchased, but will run the risk of being sued for copyright infringement under the Copyright Act, or of a claim by the artist under the Visual Artists Rights Act, or VARA.

Under the Copyright Act, creators of an original work of art retain the copyrights in the underlying work of art for a period lasting the artist's lifetime plus 70 years after the death of the artist. The copyright holder typically will own a bundle of rights, which include, among others, the exclusive right to reproduce the work, prepare derivative works and display the work publicly.

Minting will require the consent of the artist — or other copyright holder — because the process itself will likely be viewed as creating a derivative work, and because the image is meant to be used and displayed on the marketplace indefinitely.

In practice, marketplaces have embraced that approach, because they were primarily used by digital artists themselves to create scarcity and value, and the marketplace terms and conditions typically require NFT creators to represent that they are the copyright holders to the minted artwork, or at least that they have permission from the copyright holder to display the art.

Under VARA, owners of a visual work of art may not unilaterally change the medium in which a work of art is created without running the risk that the artist disavows authorship. An alarming example came from the minting of "Morons (White)" by Banksy.

A blockchain company purchased the Banksy print and proceeded to burn it, but only after they had turned it into an NFT, changing the artwork from a physical artwork to a digital artwork. Banksy did not react. But other artists may take a different position.

Courts or regulators will have to address whether NFTs are just a new platform or medium to buy or sell artwork, or whether minting a token of an artwork constitutes a copyright infringement or a modification of the work under VARA, when claims will inevitably arise.

Buyer's Rights in the Underlying Image

Most NFTs recently sold at auction are digital images, and those NFTs do not come with any intellectual property rights. From an intellectual property perspective, NFTs should be no different than physical artworks, with artists retaining their intellectual property rights to the underlying artwork under the Copyright Act.

Traditionally, the owner of a physical artwork has the right to publicly display the work, but cannot reproduce the artwork without the permission of the copyright holder, unless it falls within the statutory exceptions.

For physical artworks, the distinction between display and reproduction is usually simple: An owner can hang the artwork on their wall, or loan it to a museum, but generally cannot freely reproduce pictures of the artwork to the larger community.

For digital images however, the display of artwork will almost certainly require the owner to transfer, download, copy or print a copy of the artwork. Certain marketplaces have addressed the issue specifically granting a nonexclusive and nontransferable license to use, copy and display the digital image for personal use.

However, the rights a subsequent purchaser will acquire are unclear, especially since the NFT may be transferred and sold on a different marketplace. There are no standard terms or uniformity in the rights granted by marketplaces to purchasers.

In fact, a marketplace may be silent on such terms and conditions — or may narrowly define the rights the buyer will have with respect to the underlying digital work. As usual, the devil is in the details, and reading the fine print is essential, especially as the price of NFTs soar.

Outside of the marketplace architecture, digital artists can also choose to contractually grant specific rights to an NFT buyer with respect to the use, display and reproduction of a digital artwork. When Beeple sold "Everydays: The First 5000 Days," he announced that he would work with the purchaser — MetaKovan — to allow him to physically display the work.

However, this raises other questions with respect to the relationship between the physical and the digital work. Is the physical work a new artwork separate from the NFT — and if so, what happens to the physical object when the NFT is sold to a new buyer? Will the subsequent NFT buyer also acquire the same licensing rights as the seller received?

The answers to these questions will have an impact on the value of NFTs. But courts have not addressed any of these questions, and probably will not for at least a few more years.

Taxation and NFTs

The extravagant prices at which NFTs have sold have created impressive profits for some collectors. They may see their purchases as investments.

For example, MetaKovan, who purchased various Beeple NFTs, sold fractional interests in those NFTs to investors interested in owning a share of a Beeple NFT. The way that NFTs are traded, and the limited rights of ownership and possession that buyers obtain, certainly would support the impression that artworks are being purchased as investments.

However, it is not yet clear how those gains will be taxed. For NFTs where the underlying asset is art or is a collectible, will the gains achieved when they are sold be taxed at the higher capital gains rate charged on art and collectibles?

AML and OFAC Compliance and NFTs

NFTs are usually sold on a marketplace. To complete a transaction, the marketplace requires that a user's account be linked to a digital wallet holding cryptocurrency.

Most marketplace users have a handle or pseudonym, allowing them to remain completely anonymous to the other marketplace participants. Thus lack of transparency, coupled with high prices for the sale and purchase of NFTs, have already caught the attention of anti-money laundering regulators.

Wallets converting traditional currency into cryptocurrency are subject to the Anti-Money Laundering Act, and all marketplace transactions are subject to compliance with U.S. Office of Foreign Assets Control regulations. Penalties can be severe for businesses and individuals engaging in money laundering — even unwittingly — or entering into transactions in violation of OFAC rules.

But it is unclear whether wallet services have had the time and manpower to put the appropriate protocols in place to submit reports, keep records, verify users' identities and handle the other compliance tasks that traditional financial institutions undertake. And the information that a buyer or seller would need to ensure his or her own compliance is simply not yet made available to them in the marketplaces.

Conclusion

At the moment, NFTs are a prime example of the innovator's dilemma. Marketplaces and NFTs are using disruptive technology that entails some level of financial risk and legal uncertainty, because the law has not yet had a chance to catch up to blockchain technology and its byproducts.

But with the value attained by some NFTs, the market is more likely to attract regulation and taxation — and also lawsuits.

Actors from all fronts — legal, financial and technological — will shape and iterate on the technology as new challenges arise. The technology will evolve and mature; new versions will be rolled out, changing the art market and other markets in ways we may not be able to foresee today.

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