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Podcast

Tech Talks

NFT Primer: What Buyers, Sellers and Issuers Need to Know

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Announcer:
Welcome to Mayer Brown's Tech Talks Podcast. Each podcast is designed to provide insights on legal issues relating to Technology & IP Transactions and keep you up to date on the latest trends in growth & innovation, digital transformation, IP & data monetization and operational improvement by drawing on the perspectives of practitioners who have executed technology & IP transactions around the world. You can subscribe to the show on all major podcasting platforms. We hope you enjoy the program.

Julian:
Hello and welcome to Tech Talks. Our topic today is non-fungible tokens, commonly called "NFTs." You have probably seen articles about NFTs in the news. You probably have questions. We have answers. Some answers, anyway. Our panelists today are going to try to decipher these digital assets and explore a few of the legal issues surrounding them.

I'm your host, Julian Dibbell. I am a senior associate in Mayer Brown's Technology & IP Transactions practice. I'm joined today by my colleagues, Richard Assmus and Rohith George. Rich is an Intellectual Property partner in Chicago. Rohith is a Technology & IP Transactions partner in our Northern California office.

Let's start with some basics. Rohith, what exactly is an NFT?

Rohith:
In order to understand what an NFT is and how an NFT works, I think it might be helpful to start with a basic understanding of blockchains and cryptocurrencies. So there's a common misconception that when you hold an NFT or if you're holding Bitcoin, for example, that you're holding a file that's stored on your computer, like a JPEG that someone can send to you, that's saved on your computer, and then you can put it on a USB stick or send it to someone else over the Internet. That's actually not how either NFTs or cryptocurrencies work. It's actually more like our traditional banking system.

When I wire or ACH transfer a hundred dollars to you, Julian, from my bank to yours, my bank isn't sending a file containing electronic money over the Internet to your bank. What's happening is mainly a bookkeeping exercise. My bank credits (or removes) $100 from the ledger, my account, and your bank debits (or adds) $100 to your ledger. There are some more steps to that and there are middlemen involved like the automated clearing house, but that's the core of what happens.

A public blockchain transaction is essentially the same thing, except it's using a shared ledger that everyone can see. If I'm sending one Bitcoin to you, I broadcast my desire to complete that transaction and a network of computers around the world validate that transaction and include it in an update to that shared ledger. Once confirmed, the ledger gets updated, I have one less Bitcoin in my account and you have one more.

So if we understand that "owning" some cryptocurrency is essentially just checking the shared ledger to see how many are allocated to your account, then the primary difference between an NFT and a cryptocurrency is in the name: NFT stands for non-fungible token. While cryptocurrencies are fungible, like Bitcoin, meaning one Bitcoin is one Bitcoin, my one is not different than your one; NFTs are non-fungible, meaning that each token is unique.

But otherwise they're the same in the sense that an NFT is just a record that's stored on a shared ledger (or blockchain) that identifies who is the current holder of a token. When I want to send my NFT to you, I broadcast that desire and the ledger is updated; it gets removed from my account and added to yours.

Now you might ask, what does holding the token get me? And I think we'll get into that a little more later. But the token actually contains a link to some metadata, and the metadata contains all the attributes for that particular NFT. This may include, for example, the image for art. If that art was created by the artist and sold as an NFT to a buyer, and then resold and resold again, then you can track the provenance of that NFT all the way back to the original creator and you can provably say that you have the original.

So whereas previously on the Internet, where anyone can copy/paste anything, and there's no authoritative shared ledger to track provenance, there was no way to make something that's digitally, provably scarce. Now there's a way. So I think this is kind of the fundamental innovation for NFTs, creating the concept of verifiable scarcity on the Internet, which was previously impossible.

Julian:
Right, and that's a huge distinction from the way things worked before in the pre-blockchain Internet. For those of us who've been paying attention to blockchain and cryptocurrencies for a while, we've been hearing a little bit about NFTs for years, but lately it seems it's all you can read about or hear about. What's driving the intense interest in NFTs lately?

Rohith:
You're definitely right. NFTs have actually been around for quite some time. For almost as long as crypto has been around. But they've only really hit mainstream public consciousness over the last few years.

Cryptokitties, which were these digital cats that you could breed and trade, were kind of the first to hit some level of mainstream attention during the crypto boom of 2017. Then there was this artist, Beeple, who sold a piece, an art piece, in partnership with Christie's in 2021 for $69 million, which really caused an explosion of interest. Since then, there have been a number of attention-grabbing headlines about people spending ridiculous amounts of money on cartoon apes or cats or farm animals.

But, although the headline is about the cartoon ape, the real reason for the speculation is all around exclusivity. People aren't paying for the cartoon; they're paying for access to the exclusive club of people who hold that NFT. So as a result, what we're seeing is that companies that are focused on building brand and brand loyalty are diving into the space.

Collectibles and art, which are all about exclusivity, were kind of just the first wave. We've seen, for example, fashion brands as the next wave, with Dolce & Gabbana, Prada, Gucci, Nike and others jumping in. These brands have customers who thrive on exclusivity, whether that's holding a limited edition purse or a limited edition shoe, so it's a natural fit to sell or reward these customers with exclusive digital items that you can then attach perks to.

I think another area that's going to be big is in customer loyalty programs. We saw Clinique offer special edition NFTs. These NFTs gave the holders rights to receive free products for some number of years, and they offered these to members of their loyalty program. The members have to share "stories of optimism" on social media, which was a great way to both reward members and membership in the program while simultaneously marketing and incentivizing new users to join up to the membership program.

So, as you can imagine, building an exclusive tier of NFTs at the very top that rewards the most loyal of customers and can act as a significant motivating factor for your customers. And you might say, well, I can do that right now without the NFT. I can provide exclusive benefits to my customers. If I'm Visa or American Express, I already have loyalty programs that provide benefits to the top tier.

The main difference is that membership to that exclusive club is "owned" by the member and it trades freely on open marketplace, so if you're Nike and you've got a limited edition Air Jordan NFT that gives you a perk of being in front of the waitlist for every new Air Jordan, then that could be a very valuable NFT to some people. And if you're Nike, you can programmatically take a royalty every time that NFT is sold or resold, so not only are you building brand loyalty but you get a recurring revenue stream out of it too, which can be significant; I think bored apes, for example, which is one of the most prominent NFT collections, generates almost $150 million from just royalties on secondary transactions alone, and that's with very minimal overhead or costs. Because once you've created it, it's just trading by itself and you're collecting a royalty. So that's kind of a potential value proposition that we've seen a lot of companies have a lot of interest in.

Julian:
I'm interested in the association you mentioned with art and artworks. Rich, tell us a little bit about the connection between ownership of an NFT and ownership rights in artwork?

Rich:
Sure, Julian, and thanks. So, one of the first successful use cases for NFTs was in connection with digital art. Rohith had mentioned a couple of those examples, and NFTs have continued to be associated with art, including digital art and other copyrightable works. As Rohith explained, there are many other use cases, and NFTs have also been associated with physical goods (such as rare whiskeys), but the connection to artwork has persisted in the public mind.

And artwork in some ways is a good analogy for what part of what NFTs do, which, what Rohith has said, is to create digital scarcity. What I mean by that is that collectors prize, for example, original artwork – to give you an example, original Picasso paintings routinely fetch tens of millions of dollars at auction, sometimes hundreds of millions of dollars. Each of those works is unique, and the experience of viewing and owning an original Picasso or an original Rothko, or what have you, is considered in a different category than a print you can probably buy online for 20 dollars. So buying an NFT associated with a given digital artwork is loosely analogous to buying an original artwork.

That's not the only analogy for an NFT – another common analogy that people use is a signed copy of a book or signed copy of anything. You can conceive of the NFT as a signed copy of a work. So, for example, famously when the first tweet sold at auction for a tremendous price, what did the buyer get? In essence, what they bought was a signed copy of the first tweet. You can imagine how rare that might be: a signed copy of the Constitution, or a signed copy of some other historical document, or the signed copy of a first edition of a famous book.

However, none of these analogies are really perfect, and one of the ways that they breakdown, the places they breakdown, is when an NFT is conflated with the copyright in the work with which the artwork is associated. So, as Rohith explained, an NFT itself is simply a verifiable, unique entry on the shared ledger, a blockchain. Unless the underlying contract associated with that NFT grants any additional rights to the owner, the owner of that NFT does not have any rights to the underlying copyright, and certainly hasn't "bought" that copyright. Indeed, the owner of that NFT doesn't necessarily have any rights to exploit the underlying copyright.

Julian:
So then, I'm struggling here and I think some of our listeners probably are as well. As an owner of an NFT, if you don't get particular copyright rights under the associated contract, what do you get? What rights do you have in any associated artwork or other intellectual property when you get kind of a raw NFT?

Rich:
The answer to that is, you need to read the contract. So the answer is maybe you have rights, maybe you don't. You need to read the contract. And what I mean by that is that as a seller, you have to decide what rights you are selling or what rights you are licensing in connection with the NFT, if any, and write those provisions into the smart contract that governs the NFT. As a buyer, similarly, you will need to understand exactly what rights you are obtaining.

There are a great variety of models for these contracts – sometimes the owner of the NFT has the right to make certain non-commercial uses of the underlying digital artwork, that's essentially a non-commercial license to the art. In other cases, even certain commercial uses of the art is permitted, and in that sense you are buying not just the NFT, and not just the blockchain entry, but also certain license rights that go along with the NFT. In that instance, owning the NFT is more akin to a durable license to the underlying work that just happens to be traded on a blockchain. But to be clear, it's also possible that you have no such rights and that really, all you were buying is a verifiable entry that is associated loosely with the given artwork.

Julian:
So, let's say you're a company that's interested in jumping into this space. How would you go about issuing or selling NFTs?

Rohith:
I'll take that one. Well I think the first question is whether you should be issuing or selling NFTs. On one hand, it's not something that costs a lot of time or money to do. You or I can basically go online right now

and take a photo that we've taken and create an NFT associated with that photo. Very minimal effort is required. Now will anyone want to buy that NFT? I don't know about your photography skills but mine are nothing to write home about so probably not.

It's a similar question for companies. You can certainly create NFTs and sell or give them away to your customers and hope they provide some value both to you and your customers. And there are some companies that have taken that kind of haphazard approach. But most of the clients that are coming to us, and that we're working with, are taking a much more strategic approach to this.

They're using NFTs as passes to provide access to VIP experiences. They're using them to encourage membership in loyalty programs. You know, they're carefully considering how to balance exclusivity with the desire for broad marketing.

But yes, when they do decide to do this, I think there are a number of legal agreements to take care of. If you're having an artist design your NFT and a blockchain developer develop your smart contracts, you have some usual issues about papering those agreements in particular to make sure you hold all the IP rights you need going forward. As Rich mentioned, you have to prepare the license that accompanies the NFT. Is it going to be a very limited license to use the art that accompanies the NFT or are you providing full commercial rights. I think that Bored Apes is an example of one that provides full commercial rights with the NFT. It really depends on the goals of the company. So we help clients think through those types of details as they set these things up.

Julian:
And Rich, how have you been seeing IP issues arise in this space?

Rich:
So last year was really a breakout year for NFTs, but what we're seeing in 2022 is an explosion of interest in NFTs as a marketing tool. The use of NFTs in marketing is really a combustible mix of untested legal theories about how NFTs interact with copyrights, with trademarks and in some instances, rights of publicity. And we've already seen disputes in this area. I'll give you a few examples, and try to draw some non-digital analogies.

So one issue that has come up is whether an artist associated with a given work has any residual rights to mint NFTs related to that artwork. A version of this particular fact pattern is being litigated between the movie director Quentin Tarantino and Miramax over, among other things, pages of the original script to *Pulp Fiction*, a movie I am sure many of our listeners have seen. Tarantino sought to mint NFTs associated with digital images of these original script pages, and Miramax claims this violates their rights, including their copyright in the script.

I think it's interesting to think about what rights an artist would have in the non-digital world. For example, I think there is really no question an author could sell lawfully owned copies of a script—script that may be sitting in their basement that has their notes on it and they can sell that physical copy of that script. In that case, the author would not be transferring any copyright interests, just the physical object itself. I also think there is no question that an artist could autograph a lawfully owned physical item associated with a work – to take us to a bit of an old-fashioned example, if there was a DVD of the movie

Pulp Fiction, I think it is beyond question that the director could sign that copy of the DVD or the case to the DVD and then sell those autographed copies.

What’s different here is that the facts as they have been reported, the physical pages here aren’t being sold; instead, it’s the digital images of those script pages that have been associated with an NFT, including, in this case, the right to make certain, further uses of those digital images. And one question, therefore, is whether the artist here has retained any such rights to do that. Miramax contends that all those rights in the script were assigned to Miramax in connection with the production of *Pulp Fiction*.

Copyright isn’t the only way that IP issues can arise in NFTs. As an example, many of our clients are considering NFTs as marketing opportunities, and want to use their trademarks in connection with those NFTs, for example, by linking NFTs to virtual goods, branded virtual goods. This raises a host of trademark issues, including whether a brand owner’s rights will extend to virtual goods, and what trademark license an owner of an NFT might need or want in connection with a branded NFT. These issues are likewise ripe for dispute, and we have already seen litigation between brand owners and those trying to exploit those brands in connection with NFTs that are linked to virtual goods. Just to be clear about what I mean about a virtual good, it might be, for example, a branded whiskey bottle that doesn’t exist in the physical world, but exists in an implementation of a Metaverse. And so really, the fundamental question there is, how do brand owner’s rights extend to those virtual goods, which can often be linked to NTFs?

One additional issue is rights of publicity. That’s the right of an individual to prevent the commercial exploitation of their name or image or likeness in connection, with commercial activity. You might think of a right to publicity as only applying to celebrities, but we all have a right of publicity. And those rights of publicity can be implicated by an NFT, for example, that’s linked to a video file that features a recognizable person, whether that’s a sports hero or a movie star or some other celebrity that can be a politician. The question is, what rights are needed from that particular person to mint and sell that NFT? That really remains an open issue, and one that will need careful analysis in connection with marketing uses of NFTs that are linked in any way with celebrities or other recognizable persons.

Julian:
Rohith, what about legal considerations not necessarily related directly to IP? Are there any that a lawyer in this space should consider, and if so, what are they?

Rohith:
There are quite a few, actually. I think we talked about perks associated with the NFT. One of the big areas we try to help clients think through is whether the perks they’re offering in connection with the NFT start to cross the line toward becoming a security and start running afoul of securities laws.

If you’re a lawyer in the crypto space, you’re probably familiar with the Howey Test. This is a test created by the Supreme Court that determines whether certain transactions qualify as “investment contract” under securities law. And if they do qualify as investment contract, they’re then subject to certain disclosure and registration requirements.

The question is basically whether there’s an investment of money in a common enterprise with a reasonable expectation of profits that are derived from the entrepreneurial efforts of others. The most (can’t say all) current NFTs, like the ones associated with art, don’t meet this standard and don’t have to worry about this issue. But you have to be careful about the type of perks that you offer that are associated with your NFT.

If, for example, you allow holders of the NFT to share in revenue generated from the enterprise, then you're starting to veer closer to the SEC treating your NFT as a security. So we take a look at how you're structuring the NFT and the perks you're offering with it, and help steer the ship a little bit.

And really, securities issues are really only the tip of the iceberg. How you design the NFT is only limited by your imagination, so for a gaming NFT, for example, there may be state gambling issues that need to be considered. There might be state money transmitter issues. There might be KYC/AML requirements. More than we can probably get into on this podcast. But there are a number of legal considerations that really trigger their base, their stock base analysis based on the perks and utility that you are describing to your NFT that comes with it.

Julian:
Sounds like maybe we should regroup for another podcast down the line, maybe four, five years ahead. What do you think we would be talking about then? What do you guys see in the near future for this space?

Rich:
In the IP space, I think we are going to see courts and litigants and contractual parties grapple with the way IP laws apply to NFTs. The IP laws over the last twenty, twenty-five years have really tackled two huge changes in the market, one being the advent of the Internet and the second being the advent of social media, and each of those developments have required new thinking about trademark rights, copyright and about rights of publicity. So it's a well-beaten path to try to understand how IP rights will apply in a really completely new technology area. You can definitely make some analogies, but ultimately, those analogies are only so good in what you need to do in our view in analyzing these questions – is go back to the first principals with respect to each of these rights and how they should apply in an emergent area.

Rohith:
And my answer will be a little bit more about where I think NFTs in general are headed We touched upon some of the initial art collectibles, fashion, luxury brands, marketing, loyalty programs. We touched on a lot of things that are kind of associated with trying to breed or develop communities and expand committees, build on the exclusivity and scarcity concepts, but I think many things will be tokenized over the next five years. I think gaming is an area that is ripe for NFT-ification, because it's already happening. I think gaming NFTs are a simple next step in terms of whether your digital assets in games can be held or transferred or owned by you. I think events and ticketing are an easy next step. Whether your ticket for access to an event is represented as an NFT, whether you can resell that ticket programmatically and the event organizer can take a royalty and not worry about scalpers, because it's all built into the smart contracts themselves for transfer of tickets. Anything that is unique and currently requires middlemen to handle and to custody and to handle transfer, so for example, over time I think real estate deeds, there are things, held as ledgers, or records right now that require a manual verification between various databases and require middlemen in between to kind of manage the process that could just be intermediated through NFTs. So, you know, I think that there is a lot of space here for, a lot of design space I suppose, that I think we will see play out over the next four or five years. So we are only in the first inning in my opinion of what NFTs will be, where tokens will be, where cryptocurrency will be headed. I am admittedly

a bit of an enthusiast in this space so take my words with that in mind, but I'm truly excited for the potential here, for NFTs in particular, going forward.

Rich:
I should add that I play the skeptic to Rohith with respect to NFTs, but either way, there are going to be a lot of developments over the next couple of years.

Julian:
Lots to keep an eye on for lawyers, lots to think about. Thanks, Rich and Rohith, for helping us getting us started with that whole process. Listeners, if you have any questions about today's episode – or an idea for an episode you'd like to hear about anything related to technology and IP transactions and the law – please email us at TechTransactions@mayerbrown.com. Thanks for listening.

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