Skadden

NFTs Give Rise to Innovative New Business Models and Revenue Opportunities

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Takeaways

- Most existing agreements covering the exploitation of intellectual property rights did not contemplate how NFTs should be treated.
- Drafting and negotiating agreements involving NFTs requires an understanding of both the underlying technology and business models, and the novel legal issues they present.
- Parties seeking to exploit the potential of NFTs need to consider the growing popularity of decentralized autonomous organizations (DAOs).
- Those marketing NFTs should be careful not to promote them as investments in ways that could run afoul of securities laws.

The dramatic increase in the use and adoption of non-fungible tokens (NFTs) in 2021 can be seen in the wide range of year-end reviews and lists in which they are featured. Rankings of these blockchain-based assets can be found in industries such as marketing/branding, sports, movies and television, music, art, gaming, fintech and cryptocurrencies. The impact of NFTs in these and other sectors is in its nascent stages, and their use and attendant legal issues will only multiply as companies that gave little thought to NFTs at the start of 2021 enter 2022 armed with business plans and NFT divisions.

The Nature of an NFT

An NFT is essentially a digital certificate stored on a blockchain that reflects certain rights, including ownership, associated with an asset — typically, a digital one. The unusual terminology comes from the fact that each NFT is unique, in contrast to other blockchain tokens, such as cryptocurrencies, that are fungible (*e.g.*, every bitcoin is the same, just like every dollar is the same). NFTs can also be associated with physical goods or experiences, acting as a digital password or key to authenticate the NFT owner.

While there is often just one NFT associated with a work, a creator could also make a limited-edition series of NFTs all tied to one work, such as special access to certain videos or music available only to a set of "superfans" who purchased the NFTs. They might also be used to generate tickets to attend an event or access real-world physical assets.

NFTs have been around for about four years, but it was only in 2021 that creators and rights holders began to capitalize on their potential. Today, most NFTs are bought and sold through third-party marketplaces that also provide the technology to mint new NFTs.

NFTs have a number of powerful features allowing for interesting and important innovations in the digital asset space:

- Since they are stored on a blockchain, NFTs are immutable and allow brand owners and creators to sell ownership of an "original" digital work even though that work can be easily replicated.
- Although designated as a token, NFTs are actually pieces of computer code so that, when created (or "minted"), they can be programmed to execute a variety of functions. Most importantly, they can be designed to allocate, efficiently and automatically, any revenue from the initial or secondary sale of an NFT to an unlimited number of stakeholders.
- Since most NFT transfers are recorded on a blockchain, whose transactions are transparent, holders can establish the provenance of a digital asset, and, in cases where one can identify the minting party, the authenticity of the NFT.

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Legal Issues Generated by NFTs

A threshold issue for many companies seeking to mint NFTs is whether they have the rights to do so. Not surprisingly, few contracts written before 2021 that allocate rights in intellectual property or publicity rights address the minting of NFTs. Companies are therefore trying to parse contract language and determine, often on a case-by-case basis, whether they alone have the appropriate rights to mint a specific NFT or need a license or consent from other stakeholders. This entails a determination of how an NFT should be characterized under existing contractual provisions. For example, is an NFT a type of merchandise or something different, and what intellectual property rights are needed to mint an NFT (*e.g.*, a derivative work right, a distribution right, a display right, a performance right)?

There have already been two high-profile disputes over just such questions. One pits director Quentin Tarantino against film company Miramax over the former's right to mint NFTs of script pages from his movie "Pulp Fiction." In another, Jay-Z and Damon Dash, co-founders of Roc-A-Fella Records, are in a dispute over Dash's attempt to mint and sell an NFT of his copyright rights to Jay-Z's debut album, "Reasonable Doubt."

We anticipate more such disputes over NFTs as creators, rights holders, and licensees test the interpretation of existing license agreements and the boundaries of their rights. Going forward, parties to new agreements involving the exploitation of intellectual property rights or name, image or likeness (NIL) rights will want explicitly to address which party or parties have the right to mint NFTs.

The minting of NFTs typically involves a collaboration between a traditional rights holder and a company with the technical know-how to write the computer code (or "smart contract") to mint an NFT onto a blockchain and to administer the storage aspects of digital work associated with the NFT (since the digital work itself is typically not stored on a blockchain). Drafting and negotiating these contracts requires a nuanced understanding of the technology and "tokenomics" underlying NFTs, as well as experience with the legal issues such agreements need to cover. For example, parties should address how to unwind a contractual relationship where the NFTs that were minted pursuant to that relationship nonetheless continue to persist on a blockchain.

Issues To Watch For

As NFTs continue to evolve in 2022, we expect to see a variety of new and expanding business models raising other legal issues that companies will need to consider. For example, in the second half of 2021, we saw the formation of an increasing number of decentralized autonomous organizations (DAOs) for the purpose of being involved in the NFT sector. DAOs extend the decentralization ethos underlying cryptocurrencies and decentralized finance to corporate governance, so decision-making authority is not concentrated in a small group such as a corporate board of directors or executive team. Rather, DAO governance is exercised through membership voting managed and recorded on a blockchain through "smart contracts." The legal status of DAOs and how they are organized will continue to evolve in 2022, and stakeholders engaged in the NFT ecosystem will likely need to decide whether and how to contract with them.

This past year also saw some NFT providers create business models that could raise securities law concerns. For example, some projects attached separate coin offerings to their NFT project that closely mirrored the types of "initial coin offerings" (ICOs) that the U.S. Securities and Exchange Commission found violated securities laws in 2017-18 when ICOs were common. Careful consideration should be given to any such coin offerings. In addition, NFT sales should not be promoted or marketed as investment opportunities in a manner that could raise securities law considerations.

Overall, we expect 2022 to be a growth year for NFTs, with the creator class, brand owners and rights holders continuing to innovate — raising novel legal issues along the way.