



Navigating the Uncharted Legal Territory of NFTs

- Many businesses are exploring NFTs as a way to capitalize on intellectual property and reinforce relationships with fans and customers.
- Those weighing whether to “mint” NFTs need to look closely at existing agreements, which may not clearly address who has the right to create an NFT. There is already some litigation over the issue.
- Creators should also be aware that, if an NFT is marketed as an investment, it may fall under the securities laws, and trading NFTs based on inside information may be illegal in some circumstances.

Over the last two years, non-fungible tokens, commonly known as NFTs, have entered the mainstream as global brands, entertainment companies, sports leagues and others have created (or “minted”) NFTs of a variety of digital works, in many cases attached to “real world” benefits.

If your company is presented with an opportunity to take advantage of NFTs, you will need to understand in broad terms what NFTs are, the existing legal framework surrounding them and the unresolved legal issues they pose.

What Is an NFT?

To understand NFTs, one has to start with blockchain technology. A blockchain is a peer-to-peer decentralized network of computers that allows transactions to be validated and then transparently recorded in a master ledger. Importantly, there is not a

single blockchain; rather, there are multiple blockchains, not all of which can interact with one another.

Because each new block of transactions on a blockchain is cryptographically based on the previous ones, blockchains are immutable; for all practical purposes, records cannot be altered. Blockchains therefore provide a powerful technology to create and perpetually store immutable records of the ownership of digital goods.

These ownership records are NFTs, each of which have a pointer to the specific digital good they represent. That distinguishes them from other types of digital assets on a blockchain, such as cryptocurrencies, which are all the same — *i.e.*, fungible.

A key feature of NFTs is that, despite the term “token,” they are in fact programmable pieces of computer code. This allows developers to

design an NFT that, for example, pays royalties automatically every time an NFT is sold.

How Are NFTs Being Used Commercially?

Although we are at the nascent stages of the evolution of NFTs, as creators and rights holders explore how to exploit this technology, NFTs have already been put to use by a number of different types of business:

Digital art and music. In their simplest form, NFTs can be associated with digital creative works, such as art or music. NFTs allow creators to market their works to, and engage directly with, fans, who can use the NFTs to signify that they own an official copy of a work and not a digital copy.

Brand-driven NFTs. Global brands have embraced NFTs as a means to engage with their consumer bases. In these cases, NFTs are often collectibles that also “reward” consumers with access to benefits or promote new products or services. For example, Coca-Cola auctioned NFTs that were virtual images of iconic Coca-Cola merchandise, such as a virtual custom-designed Coca-Cola Bubble Jacket. Proceeds from the auction went to Special Olympics International.

Fan engagement. Traditional intellectual property rights holders, including entertainment companies and sports leagues, are using NFTs to create and market digital collectibles as a means to build fan engagement for both existing and new fans. For example, the National Basketball

Association and Disney have each released a number of different types of collectible NFTs to engage with their respective fans.

Gaming. Gaming companies are looking at ways NFTs can be used to allow players to own in-game assets, such as “skins” a character might wear, and potentially trade them or transfer them to other games.

Future uses. There are also experiments using NFTs as a source identifier for both tangible and intangible goods and services. This might include school transcripts and professional certificates; proof of identity; and ways to record ownership of specific tangible assets. For example, BlockBar sells collectible liquors and wines obtained directly from producers and mints NFTs that correspond to a specific bottle stored with BlockBar, assuring authenticity and allowing the owner to take delivery or sell the bottle.

Legal Issues Presented by NFTs

Businesses considering NFT opportunities need to understand the existing framework of intellectual property law that applies to them, and the fact that there are certain unresolved legal questions surrounding them. Here are just a few of them, and we limit our discussion here to U.S. law.

Who Has the Right To Mint an NFT?

Anyone minting an NFT needs to determine whether they have the appropriate rights to the underlying



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digital work. Given that NFTs have only recently come into use, most existing contracts involving the creation of, and rights to, digital goods make no reference to NFT rights. Therefore, for the time being, to assess who has the right to mint an NFT one must rely on a standard intellectual property analysis, and also examine existing agreements to see if there are clauses that could be construed to encompass NFTs. Already, there has been some litigation over who has the right to mint certain NFTs. For example, the director Quentin Tarantino is in litigation with Miramax over his right to mint NFTs consisting of digital images of portions of the handwritten version of the *Pulp Fiction* screenplay.

What Rights Are Being Acquired in the Underlying Work?

The purchaser of an NFT does not normally acquire intellectual property rights and, in particular, copyright rights, in the associated work. In this respect, purchasing an NFT is no different from purchasing a piece of physical art. Just because you bought a David Hockney painting does not mean he can't paint another identical painting and sell it to someone else. While the buyer of a painting owns

the physical work, they typically do not acquire any intellectual property rights in the work itself.

While most NFT issuers only grant purchasers the right to use and display the work underlying the NFT for personal use, some issuers are starting to grant limited or broad commercial rights allowing purchasers to exploit their work.

It is important to draft NFT license agreements to define carefully the rights the issuer wants to grant, and to make sure those terms are binding on all subsequent purchasers.

Which Jurisdiction's Laws Apply?

All legal issues surrounding NFTs are complicated by the fact that it may not even be clear which jurisdiction's laws should apply. One must factor in that NFTs are offered on a decentralized blockchain ecosystem, and are paid for in cryptocurrencies and can be effectuated without either party revealing any geographic-identifying information such as a shipping or billing address. As the use of NFTs and blockchain technology expands, in the U.S., we expect it will take a series of court decisions to establish a framework for resolving these issues.

Could the NFT Be Considered a Security?

Those who offer, sell or purchase NFTs need to be attuned to potential securities law issues. Under the Supreme Court's so-called "*Howey* test," an "investment contract" (and thus a security) exists where there is

(1) an investment of money, (2) in a common enterprise, (3) where profits are reasonably expected to be derived from the managerial or entrepreneurial efforts of others. The doctrine takes its name from a 1946 Supreme Court decision interpreting securities statutes from 1933 and 1934, long before the existence of the internet, blockchains and NFTs, but the legal standard remains the same.

Courts have held that an asset may not be an investment contract when it is acquired primarily for personal use rather than as a passive investment. Moreover, where the profits sought by purchasers are based on their own efforts or market forces of supply and demand, the asset may not be treated as a security.

In practice, this means the determination is very fact- and circumstance-specific, so each potential NFT transaction will need to be assessed to determine if the investment contract criteria might apply.

Most cases involving the *Howey* test have involved underlying assets that are not securities. But in deciding if there was a reasonable expectation of profits based on the managerial efforts of others (*i.e.*, the creator or promoter), courts have also looked to the manner in which the underlying asset is promoted to purchasers — including any promises made by the seller. Companies will therefore need to consider not just the NFT itself but all the circumstances surrounding its offer and sale.

The Risk of Insider Trading Issues

Businesses considering involvement in the NFT market also need to be aware of the risk of insider trading in NFTs, which was highlighted by several recent prosecutions and enforcement actions. Companies may want to create NFT trading policies to head off potential problems.

On June 1, 2022, Nathaniel Chastain, a former project manager at the largest NFT marketplace, OpenSea, was arrested on federal charges of wire fraud and money laundering. According to the indictment, Chastain used confidential information he learned in his job about which NFTs would be featured on OpenSea's homepage. He then allegedly bought those NFTs, knowing they would likely rise in price when featured, and sold them for a profit. The prosecutor stated that Chastain's arrest "demonstrate[s] the commitment of this office to stamping out insider trading — whether it occurs on the stock market or the blockchain."

Similarly, on July 21, 2022, the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) each brought insider trading charges against a former Coinbase product manager, his brother, and a close friend for using material non-public information to purchase a variety of non-NFT cryptoassets prior to announcements by Coinbase that these assets would be listed on the company's cryptocurrency trading platform.

While the SEC's claims alleged that the traded digital assets were securities, the DOJ's charges did not because, like the OpenSea charges, they were based on alleged violations of the wire fraud statutes.

These cases underscore that those dealing with NFTs may possess confidential information that affects the value of an NFT, and that trading on such information could be unlawful. Accordingly, companies that issue NFTs or are involved in any activity that could affect the value of

an NFT should consider implementing NFT trading policies. Even if the liability risk to the company itself (as opposed to its employees) may be low, companies could nevertheless face reputational harm if an employee engages in wire or securities fraud by trading NFTs based on the company's confidential information.

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