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Nonfungible Tokens and the Music Industry: Legal Considerations

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Nonfungible tokens (NFTs) have, in recent weeks, gone from a relatively obscure form of digital collectible stored on a blockchain to a virtual “gold rush” for artists, labels, and other music rights owners looking for ways to capitalize on new revenue streams. If the trend continues, the potential profits from artist NFTs—which were not typically baked into industry models—may further boost music catalog and publishing values for the benefit of artists, labels, and other music rights holders, and create opportunities for artists to generate new content and connect with fans.

In the rush to market, artists and other stakeholders should be careful and strategic in navigating the legal issues of “minting” and selling NFTs. This article sets forth key legal considerations that artists should

consider in developing and executing their NFT strategy.

What Are NFTs?

An NFT is essentially a digital certificate of certain rights associated with an asset—typically, a digital one—that is stored on blockchains, the decentralized computer networks that underpin most cryptocurrencies. “Nonfungible” simply means that each token is unique, to contrast it with other blockchain tokens—such as cryptocurrencies—that are “fungible” (e.g., every bitcoin is the same, just like every dollar is the same). The importance of NFTs is that even though digital works can be quickly and easily replicated, the NFT owner can claim rights in the “original” of that work. NFTs can also be associated with physical goods or experiences, with the NFT 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 create a limited-edition series of NFTs all related to one work, such as special access to certain videos or music available only to a set of “superfans” who purchased the NFTs. NFTs might also be used as a mean to generate tickets to an event. Today, most NFTs are bought and sold through third-party marketplaces that also provide the technology support to mint new NFTs.

A powerful feature of blockchains, and one that is essential to NFTs, is that because each “block” of transactions is cryptographically linked to the one before it, they are immutable—meaning that for all practical purposes, historical records of transactions cannot be altered. Thus, it is not possible to modify the NFT itself, such as by changing the owner or modifying what works are associated with that NFT.

While an NFT is stored on a blockchain, in many cases the work associated with the NFT is not. Instead, most NFTs include a metadata field with a pointer or link to an off-chain resource where the associated work is stored. Thus, while the NFT might

itself be immutable, the off-chain work may not have that same persistence.

NFTs in the Music Industry

The music industry already has embraced NFTs in highly creative ways, seeking to expand fan bases, connect with existing ones and generate new sources of revenue. This does not just mean providing access to music—artists have also created NFTs associated with digital art, physical goods, and live experiences. For example, in early February 2021, Mike Shinoda, co-founder of the band Linkin Park, dropped an NFT associated with a 37-second clip of an unreleased song accompanied by an animation titled “One Hundredth Stream.” Kings of Leon made headlines when it auctioned an NFT that included four front row tickets to one Kings of Leon headline show per tour anywhere in the world, a meet and greet with the band, tour merchandise, and use of an SUV limousine. And electronic music producer 3LAU has minted an NFT that can be redeemed for a custom song by 3LAU, in addition to unreleased music and a bonus physical, signed vinyl record.

Legal Considerations

What Rights Are Required to Mint an NFT?

A musical artist’s ability to successfully mint and sell NFTs requires a careful evaluation of the basket of legal rights owned by the artist, and those rights owned or granted to third parties—including music labels, publishers, and merchandise rights holders. In cases where the musical artist is combining their work with the creators of digital art or videos, the rights of those creators need to be taken into account as well. In addition, a musical work may have joint authors or be subject to exclusive licenses that impact who has the right to create an NFT. Knowledge of these rights is critical not only to avoid claims of infringement but also because most NFT marketplaces require robust representations that the person or entity minting an NFT has all appropriate rights.

Under U.S. law, a creator owns the copyright in a creative work upon the creation of that work and its fixation in tangible form, regardless of the medium. The copyright holder enjoys a “bundle of rights” with respect to the work: the exclusive right to reproduce, prepare derivative works of, publicly perform, and publicly display the work. This “bundle of rights”

can be held or licensed by the copyright holder in whole or in part, but critically, unless the rights are expressly assigned or licensed away, they remain with the copyright holder. The creator or “author” of a work is not necessarily the copyright owner. For example, employers hold the copyright in works created by employees, and commissioning parties hold the copyright in certain categories of works created by independent contractors if they are specified to be “works made for hire.” The boilerplate language in many record label deals is drafted as “work for hire” agreements.

Musical works present their own unique set of issues. Generally, each piece of recorded music has a compositional copyright in the music itself (the musical composition and lyrics) and a master copyright in the sound recording that is the particular expression of that composition as created by performing or recording artists. The master rights are held by the artist or, more typically, by a label. If a third party or musical artist that does not own the copyright in a piece of music wants to create a derivative work of a composition or a master recording, such as by combining a musical work with a video clip, they will require a “sync license” to use the composition and a master use license to use the master recording. Creating an audio-only recording of a composition requires a “mechanical license.”

When it comes to minting an NFT, the rights required will depend on what work is associated with that NFT. For example, an artist who creates a new music video clip that they want to “tokenize” as an NFT will need to be sure they have the appropriate rights and licenses to do so (including from any collaborating vocalists and musicians, or samples used in the sound recording and with respect to any songwriters and their publishers, as well as those of interpolations that may have been incorporated into the underlying musical work). Once a work exists, be it a new work created for purposes of minting an NFT or an existing work that a party would like to tokenize, one needs to consider what rights are required to actually create an NFT—in effect, who has the right to grant a purchaser with a digital “certificate of ownership” of an “authentic” version. Here, in addition to understanding the basic copyright ownership rights in the underlying composition, sound recording, and visual work, the minter of the NFT will also need to review any contracts attaching to that musical work, such as record label agreements, to determine which party has the legal right to mint the NFT.

Artists who have not yet signed with a label, or who are no longer subject to the terms of a label agreement, have maximum flexibility in the NFTs they can

mint for their master recordings, subject to obtaining grants of rights that may be held by joint owners or exclusive licensees.

New or emerging artists affiliated with a major or independent record label typically sign an exclusive artist recording agreement that grants the label exclusive rights to exploit a broad range of rights related to the artist's recording and album-related artwork for the life of the applicable copyright. Virtually, all label agreement forms include "catch all" language that is intended to capture exploitation of the relevant recordings or related artwork on future-developed technologies and platforms not in existence at the time the artist signed the label agreement. There is a reasonable argument that the minting of an NFT associated with a recording or artwork would be captured by such language.

Established artists, on the other hand, may have had more leverage with their label to carve out or "reserve" certain rights (e.g., merchandise) or have certain rights revert back to the artist after a negotiated period following expiration of their label agreement. Whether the artist or the label has the right to mint an NFT will often depend on the specific wording of the agreement and what type of asset or exploitation right one considers an NFT to be. Artists may seek to "engineer around" these clauses by minting NFTs that fall outside of the scope of rights that a label might have. For example, an artist may seek to capitalize on their name recognition and produce original nonmusical works such as digital art that are not tied to songs or an album. In these situations, the artist's representatives would be wise to conduct a review of their client's trademark registrations as well as the scope of any merchandising agreements that may be in effect.

We can expect that labels will be careful to explicitly address NFT rights in their agreements going forward. When negotiating these rights, the parties will want to take into account the fact that NFTs, as noted, can be associated with a wide range of digital works, or coupons for redemption of physical goods such as merchandise and experiences such as backstage meet and greet events offering direct contact with the artist. An NFT might also involve some use of the artist's name, image, or likeness intended to be granted in perpetuity. Merely allocating broad "NFT rights" to one party may miss some of these nuances. In addition, there are multiple different blockchains and NFT marketplaces, many of which do not interact with one another. The parties will want to take that into account when determining the scope of NFT rights and may want to consider the inclusion of blockchain-specific disclosures and risk factors.

What Rights Does the Purchase Obtain?

Purchasers of NFTs generally do not obtain any intellectual property ownership in the work associated with the NFT. This is no different from the way in which the purchase of nondigital assets operate. A purchaser of a painting, for example, does not obtain the rights to make posters of that work. Such rights would only transfer to the NFT holder through an explicit assignment, and most NFT marketplaces make clear that no rights are transferred. In some cases, the artists themselves make this clear when they offer their NFTs for sale.

A common misconception is that NFTs automatically provide a certification of authenticity. In reality, while an NFT allows one to view the blockchain address of its original creator, some independent means of verification is required to determine that the person or entity associated with that address is who they claim to be or has the appropriate rights in the associated work. Purchasers should make sure that there is some way to authenticate the creator of the NFT before they purchase.

Who Is Entitled to the Revenue Stream From the NFT?

NFTs are actually nothing more than pieces of computer code on a blockchain. This allows them to be configured such that each time the NFT is transferred to a new owner, a royalty or commission payment in the form of a cryptocurrency is automatically transferred to the digital wallet of one or more stakeholders (e.g., the artist, label, manager, etc.).

Which party is entitled to the profits from the initial sale of an NFT or a future revenue stream will depend on the terms of the contractual arrangement between the parties and how NFT rights are categorized in agreements that do not reference them explicitly. Established artists may have leverage to negotiate special negotiated "splits" with their label, particularly if the label wants to motivate the artist to create NFTs. In fact, some labels and other rights owners are eager to cut deals with artists to encourage them to create and drop NFTs (e.g., providing advance consent to a particular NFT or genre of NFTs, or agreeing to a negotiated split of the net proceeds).

The market for artist-label NFT profit splits is evolving, and artists should be strategic in developing and executing their game plan, including identifying key deal terms, with their advisers. Artists will also want to pay attention to how the label recoups its NFT-related costs, given that most marketplaces charge a fee for minting NFTs, and there may be other costs associated with storing and preserving

unique or valuable digital works associated with an NFT. Another consideration is whether the label is trying to charge other fees or otherwise “upcharge” the artist.

As noted, NFTs can be programmed to automatically transfer cryptocurrency to any digital wallet that is compatible with that blockchain. However, if the NFT revenue flow is handled this way, it means that all stakeholders will need to have a digital wallet and be able to accept the type of cryptocurrency that is generated by the NFT. Agreements will need to specify the type of cryptocurrency in which payments are to be made. In addition, because NFTs are immutable, one cannot go into an existing NFT and reprogram the royalty structure or change the digital wallet receiving payments. Agreements will need to account for this reality, and the parties may also want to have technical diligence performed on the NFT code to confirm the actions the code will execute match with the parties’ contractual terms. Labels, agencies, and managers—some of which are already setting up NFT “task forces”—can help an artist navigate these technical and legal elements.

Piracy and Infringement

Given the price at which many NFTs, especially those associated with musical rights, have been sold, it is no surprise that bad actors have entered the space offering NFTs in works for which they have no rights. For example, a number of digital artists have had some of their work minted as NFTs and listed for sale without their permission. Parties looking to enforce their rights, or who are contractually obligated to enforce them on behalf of a third party, may be able

to have the work associated with the NFT taken down from platforms where it is offered or from the file service where it is stored. However, since an NFT is immutable, once it is minted the NFT itself cannot be “taken down.” Rights holders may need to take comfort in the fact that an NFT without its associated work will likely lose its value.

Other Issues

Although beyond the scope of this article, music industry stakeholders should take into account a variety of other legal issues, including the tax treatment of an NFT sale or ongoing royalty revenue and whether losses from NFTs, such as for a technology failure or smart code bug, can be insured. In addition, NFTs could implicate state or federal securities law if, among other factors, they are offered as an investment opportunity (e.g., fractional interests in NFTs) with a promise that the NFT creator will promote the NFT to increase its value.

Key Takeaways

Optimizing an NFT in the music industry requires understanding the technology behind NFTs, an analysis of the legal rights held by the artist and third parties, understanding the terms imposed by NFT marketplaces, and ensuring adequate protections of the artist and the fan-purchaser. Artists and other stakeholders should consult with their advisers to navigate and understand these cutting-edge issues and the evolving landscape of what is considered “market” for the industry.

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