

NFTs: A Primer on the Trending Crypto Phenomenon

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On March 22, 2021, Jack Dorsey, Twitter's CEO, sold his first tweet as a Non-Fungible Token (NFT) for approximately US\$2.9 million. Shortly after, Sophia the robot, an AI humanoid by Hanson Robotics, was trending on Twitter after she announced she would be auctioning a jointly created digital artwork in the form of an NFT – the first sale of its kind.

So, what does this all mean, and why should it matter to you? NFTs are an exploding crypto phenomenon with players from different industries, including the music, art, fashion, gaming, and sports industries, which sometimes intertwine. By way of example, avatar company Genies recently announced its partnership with Billboard Chart-topper Shawn Mendes and NFT seller OpenSea to drop one-of-a-kind collectible NFTs.

This overview article seeks to explain what an NFT is, the innovative technology behind NFTs, what an NFT transaction may look like, why NFTs are making headlines, and some important legal considerations to keep in mind as the NFT evolution progresses. Before diving into a more detailed discussion on NFTs, it is important to lay out the basic building blocks that make up this innovative technology.

NFTs: 101

At a high level, a **non-fungible asset** means a unique asset that cannot be easily divided or substituted for something similar (unlike a fungible asset such as currency, where by way of example, a \$20 bill holds equal value to two \$10 bills). An **NFT** is a digital asset certified by a unique digital **token**: a unit of cryptographic information that can be exchanged for or represent a good, service, or other form of value. That token can be owned, collected, and traded. While this article will focus on digital artwork, NFTs now include video game assets, music, sound bites, and collectibles (e.g., NBA's Top Shot), to name a few.

Each NFT is a digital certificate, kind of like a stock certificate, that is stored on a blockchain (i.e., the Ethereum blockchain).

Blockchain is a decentralized, transparent, and secure digital record of data. It is a public ledger that cannot be manipulated because it is stored on a shared network of computers, which prevents any single entity from being able to invalidate or manipulate the record. As a result, the ownership history of each token can be easily tracked and verified. This technology is how cryptocurrencies, such as Bitcoin, work and spurred the birth of NFTs.

Taking the digital art world as an example, blockchain technology allows artists to release digital art as NFTs while providing an avenue to authenticate their unique nature and ownership history. While the content of an NFT may be technically duplicated, the original digital token remains unchanged, signifying its authenticity. This is similar to the physical world where a buyer can easily purchase prints of Jean-Michel Basquiat's 1992 piece, *Untitled*, online for \$15 to \$20, yet the original piece last sold for US\$110.5 Million in May 2017.

While NFTs are a relatively new phenomenon, art collection and the economic principles of supply and demand are not. If we pick up on the example above, Basquiat's *Untitled* is the only *one* of its kind that was, in fact, painted by Basquiat himself. The value of such a work stems from the artist's direct involvement with the piece, the period the piece was created in, and the rareness of the piece. While demand for Basquiat's work is high, since *Untitled* is a one-of-a-kind, its supply is limited, and it is valued accordingly. Whereas postcards designed by Basquiat are more widely available which is reflected in their value. NFT creators can similarly control the number of NFTs created from a particular work and impact the market accordingly.

The Marketplace: How to Sell and Buy

Once an NFT is created, the author can sell it, license its use (e.g., to a gallery), and even control the conditions of how the digital art is used or displayed. They can also require a portion of subsequent sales be remitted to them.

Cassels

WHO: Anyone can upload a digital asset to a marketplace in order to create an NFT. However, NFTs will often gain value from the author's reputation or the significance of the subject-matter.

WHERE: There are numerous online marketplaces that allow users to upload their digital art, add it to the blockchain, and place the art for sale. Marketplaces range from sites that are open to all users such as Rarible and OpenSea, to curated sites such as SuperRare and Nifty Gateway – the latter are more analogous to specialized art dealers who display and sell select works, which often sell at a higher average price point. By way of example, popular painter and NFT artist FEWOCiOUS sold more than \$4 million worth of NFTs through two curated art drops on Nifty Gateway.

HOW: In order to sell or purchase NFTs, interested parties will usually need to invest in a digital wallet and a cryptocurrency to fuel their account. Most marketplaces accept Ether (a popular cryptocurrency that works on the Ethereum blockchain), WX, or Flow. Some marketplaces like Nifty Gateway will also allow users to connect a credit card directly to its website.

Once a user is ready to upload their digital art they will typically create an NFT marketplace account and select (i) a description for their digital art (optional); (ii) perpetual royalty rates (more on this below); and (iii) the number of tokens (i.e., copies).

Typically, an artist will also have to pay a “gas fee.” Gas fees are processing fees for the computing energy required to create and validate the unique token on the blockchain (i.e., tokenization). The token then works as a certificate for the asset tied to it. Most marketplaces will similarly require sellers and buyers to pay a “gas fee” for each transaction. The value of “gas” will vary based on supply and demand and will even vary depending on the time of day.

The potential for artists to receive a share of the proceeds from the reselling of their work is another exciting aspect of NFTs. While a patchwork of artist resale rights exist around the world, with NFTs, an artist can simply program a resale royalty into their NFT to receive a commission *beyond* the first point of sale. Enabled by the blockchain technology, this royalty could theoretically continue in perpetuity. This is a welcome perk to many artists who will be able to continue to be compensated for any future sales of their art, especially if the art or artists increase in popularity. Some NFTs even allow for ongoing monetization (e.g., owners of video game items can monetize virtual structures like casinos or receive dividends from digital racing tracks).

Legal Considerations

It is important to note that once a buyer purchases an NFT, they will obtain ownership rights over the asset and will be able to resell it. They do not, however, obtain all of its intellectual property rights. Just like with the purchase of a traditional art piece, buying the original work will not automatically provide the owner with copyright *unless* the purchase includes an assignment of copyright.

A copyright owner (i.e., the NFT's author) may instead choose to simply grant the NFT owner a license to use the NFT in certain contexts. By way of example, NBA Top Shot's Terms of Use provide buyers with a “non-exclusive, non-transferable, royalty-free license to use, copy, and display” the NFTs in certain limited contexts. Alternatively, an author may also choose to license the NFT to digital galleries without opting to sell the asset itself. As with other works, NFTs will certainly give rise to interesting intellectual property questions around authorship (particularly when artificial intelligence is involved), infringement, and whether certain uses are permissible.

Further legal implications are likely to include security law considerations as NFTs expand in scope. Namely, in certain scenarios, the substance of an NFT may trigger the tokens being traded to be deemed a security (i.e., considerations such as the manner of sale, the number of tokens, if services are being offered, or if the token offers security-like benefits such as promising liquidity). If deemed a security, each NFT transfer would need to follow regulatory guidance, which may trigger unique considerations across different jurisdictions.

In each instance, we will likely see the terms and conditions under which NFTs are sold evolve over time to deal with these questions.

The Future of NFTs

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Due to the fluid and evolving nature of the crypto world, it is difficult to precisely predict how future crypto technology will unfold. Despite this uncertainty, it seems NFTs are here to stay. As our world becomes increasingly more reliant on the digital sphere, NFTs fill an untapped demand for a legitimate digital art space for both buyers and sellers.

The traditional art community is also catching on. The coveted auction house Christie's recently partnered with popular NFT artist Mike Winkelmann – more commonly known as Beeple – to auction off his crypto art to a traditional art audience. Beeple's piece sold on March 11, 2021 for almost US\$70 Million – making it the highest crypto art sale in history. It is then no surprise that the market cap for NFTs went from US\$41 million in 2018 to approximately US\$338 million in 2021. What is even more telling, is the flexibility of the future of NFTs and the myriad of possibilities for assets to be tokenized. For example, NFTs can technically be used to certify official documentation such as birth certificates or ownership licenses.

While the lines between traditional and crypto art continue to blur, players in the industry such as musicians, artists, collectors, dealers, galleries, and marketplaces will need to account for NFTs' cultural and legal implications. Particularly, copyright, licensing, and intellectual property considerations such as ownership rights will be at the forefront of this quickly-evolving industry.

This publication is a general summary of the law. It does not replace legal advice tailored to your specific circumstances.