# NFTs: Legal Risks from "Minting" Art and Collectibles on Blockchain

Our firm represents clients in some of the world's most significant disputes relating to blockchain, cryptocurrency, film, music, and artworks, and has been closely monitoring the exponential growth in the non-fungible token (NFT) art and collectibles market. This article discusses potential legal issues in the space.

## What are NFTs?

An NFT is a digital file on a blockchain that shows who owns a unique piece of digital content.[1] Theoretically, any digital content can be minted into an NFT: photographs and other works of digital art, songs, tweets, even memes. NFTs of NBA player highlight videos are sold through the "Top Shots" online marketplace. NFTs can also be used for items that exist only inside video games (for example, rare character skins, or clothing that can be worn inside Fortnite or Pokemon Go). For purposes of this discussion, each of these is deemed to be a work of art.

NFTs are "non-fungible" because unlike other cryptocurrency, such as Bitcoin or Ether tokens, NFTs are not interchangeable with one another. Rather, NFTs are unique, although there may be multiple "editions" of a particular artwork or collectible available for sale, each evidenced by its own NFT.

An important distinction between traditional works of art and works attested to and sold using NFTs is that the "work" must be either a work created in a digital medium (such as the digital collage that the artist Beeple recently sold for $69 million) or a digital image of a physical work (such as a painting or sculpture). Expect to see new forms emerge. Nike has patented a system in which a customer acquires a virtual version of a shoe. An NFT can thus be ***tied*** to a physical object but it is not the object itself.

When someone "mints" an NFT, they create a file that lives on a blockchain that cannot be edited or deleted. Because the file exists on a blockchain, it can be viewed publicly, meaning the item's provenance is public and verifiable. Typically, NFTs are minted on Ethereum blockchain, although NFTs can also be minted on other blockchain systems (for example, Top Shot NFTs are minted on the Flow blockchain).

NFTs first gained notice as part of the brief CrypoKitties craze in 2017, which allowed buyers to buy and trade digital versions of kittens. The market for the digital kittens rose steeply for certain rare items and then quickly fizzled, but NFTs have remained, and their use has dramatically increased recently. Some in the cryptocurrency and art fields have pointed to NFTs as a game changer for commerce and art. Other industries, from the NBA to sneaker makers, have also taken notice. Mark Cuban, for example, reportedly told USA Today recently that NFTs "could turn into a top 3 revenue source for the NBA over the next 10 years."

Importantly, NFTs can include smart contracts that can specify the rights of the buyer and seller and—unlike most traditional art sales in the United States—can require that the creator or first seller of the NFT receive a certain percentage of the NFT's resale, ***each*** time the work is resold. Marketplaces, including Rarible, OpenSea, SuperRare, and Nifty Gateway, have sprung up

[1] A blockchain is a list of linked records, wherein each block contains a cryptographic hash of the previous block, a timestamp, and transaction data.

for selling and reselling, NFTs. The extent to which a secondary market exists depends on the item, and the item's popularity.

## NFTs and Art

The growth of NFTs in art has been fueled by its unique attributes. NFTs can allow artists to better monetize their work by selling NFTs directly online without middlemen. Access to a readily accessible online resale market could also mean that works gain value quickly. And unlike the traditional U.S. art market, artists may benefit from the rise in value of their work by incorporating commission requirements in the smart contracts that accompany NFTs (for example, the SuperRare NFT marketplace requires that creators receive a 10% commission when artwork continues to trade on the secondary market).[2]

Some hope that NFTs will open up a new revenue source for artists, including underrepresented artists, either by allowing artists who traditionally do not sell in galleries to sell directly to buyers online, or by allowing artists to sell something in addition to their tangible works. For example, an artist could sell an NFT of the digital image of a painting or sculpture to one buyer, while selling the physical work to another buyer, allowing the artist an additional opportunity to profit from the work.

NFTs are not without potential negatives. As the market for NFTs has exploded, and as buyers have shown an appetite for bragging rights regarding ownership of the NFT associated with popular or even iconic works, some artists have complained that their work has been tokenized into an NFT without their permission. Many NFTs being offered for sale have also been based on other popular works, such as comic book characters, and some have questioned the extent to which the minter of the NFT has profited off the underlying work without the permission of the underlying artist or copyright holder. Many have criticized NFTs for the massive amount of electricity consumed by the blockchain system.

While artists and others debate these concerns, the markets for NFTs have been expanding and rising in price dramatically, particularly in recent months, with well-known artists and musicians, tech leaders, and auction houses participating the market. Christie's sale of a digital collage consisting of 5,000 works by the artist known as Beeple (aka Mark Winklemann) was Christie's first sale of an NFT, and ranks as highest price ever for an artwork that exists only digitally. (It also marked the first time Christie's accepted Ether cryptocurrency as payment.)

Other recent high-profile NFTs include 10 digital works by the recording artist Grimes, including a video that sold for nearly $389,000. Grimes' works in toto reportedly sold for approximately $6 million, most of which came from two works which sold hundreds of copies. The band Kings of Leon announced this month that it would sell its latest album for a limited period—two weeks—for $50 as a bundle of a vinyl album and an NFT. After the two week period, Kings of Leon will press no more copies. A market has also emerged for tweets packaged as NFTs, including a sale for charity purposes of a screen shot of Jack Dorsey's first tweet from 2006 (bidding for which had reportedly reached $2.5 million within a few days).

Many NFTs have been based on another work that already exists in another form. For example, a print by street artist Banksy that reportedly sold for $33,000 at Christie's in December

[2] https://help.superrare.co/en/articles/4792372-2-4-copyright-on-superrare (last accessed March 18,2021).

was destroyed by fire on video, and the video was reportedly then sold on the OpenSea NFT marketplace for more than 10 times what the buyer paid for the physical print. The seller claimed that by burning the physical artwork, the NFT's value was no longer tied to a physical piece but resided solely in the NFT. A number of other Banksy-inspired NFTs have also been sold, although Banksy has said he is not affiliated with the items or the sales.

## Legal Issues Arising From NFTs and Art

*Potential Claims by Holders of Rights in Underlying Works*

Artists have already made clear on social media that their works have been "minted" into NFTs and offered for sale without their permission. Online marketplaces appear to have developed procedures to address the potential for infringement (for example, OpenSea's Terms of Service invite rights holders to submit complaints, and state the site "will take down works in response to formal infringement claims and will terminate a user's access to the Services if the user is determined to be a repeat infringer.").[3]

Rights holders, however, may resort to litigation. The artist or other rights holders might opt to bring a claim against the sellers or creators of the NFTs for copyright infringement. Who gets to sue will depend on who owns the copyright: the artist or the owner of the physical work. Unless the artist expressly conveyed the copyright to someone else in a signed writing, the artist is the person with the right to sue for infringement of the right to prepare derivative works, such as digital images.

The copyright ownership issue can become even more complex. Potential claims might arise where artists who initially created the work under an employment arrangement with someone else then attempts to create digital works based on the original work using NFTs. The original work may constitute a work for hire, as defined in 17 U.S.C. § 101, in which case the employer (or commissioning party) —not the artist—owns the copyright and the right to base derivative works on it. This is often the case in the creation of comic book characters and related artwork, motion pictures, and some recorded music. In a letter publicized in several media outlets last week, DC Comics warned its freelancers not to sell NFTs of works based on DC Comics characters, for example. Depending on the terms of the artist's employment agreement or freelance contract, the rights holder might have claims for breach of contract. That will likely involve questions of copyright preemption.

There will also be disputes over whether the NFT constitutes fair use. Some of the issues that will have to be resolved include whether the NFT involves a creative work of expression, copies an entire physical work, and has the potential to deprive the copyright owner of revenue from the exploitation of the work. But this has not been tested. Though no such case appears to have yet been decided regarding sales of NFTs in the United States, rights holders might argue that such appropriation of their work is a copyright violation under existing law. Such disputes would look to the fair use standard articulated in cases such as *Blanch v. Koons*, 467 F.3d 244 (2d Cir. 2006).

[3] OpenSea Terms of Service effective March 16, 2021, *available at* https://oDensea.io/tos (last accessed March 18, 2021).

Such claims might also involve complex disputes about whether the NFT itself or in its creations violates rights granted to the artist under the 1990 Visual Artists Rights Act, codified in section 106A of the Copyright Act. That statute protects the rights of visual artists to the attribution of their work, protects them from being attributed to works they did not create, and prohibits any intentional distortion, mutilation, or other modification of any work of "recognized stature." For example, the individuals who burned the Banksy print and minted an NFT of the video might be subject to liability. They might also argue that they are protected by the fair use defense because they transformed Banksy's work into a new work or that the burning and creation of the video constituted a commentary on Banksy's underlying work.

Similarly, artists have voiced concern about works that appear to be very similar to their works, even if they are not exact copies. This is not surprising given that digital artists often borrow from other sources to make memes and other works. SuperRare's online copyright explainer page, for example, notes "it's clear that the crypto art movement has continued the practice of reappropriating unoriginal content, often with a symbolic, transformative, or meme-worthy purpose."[4] The site warns that "[a]rtists should never mint a work containing copyrightable elements of another's work unless they are authorized by the copyright owner or a valid fair use defense applies."[5] As in *Cariou v. Prince*, which involved allegations that the artist Prince's appropriation works were too close to the underlying Cariou photographs, artists and other copyright holders whose works are used to create similar works may also sue the sellers or creators of NFTs based on their works for infringement. Such disputes might involve, for example, animations of other existing artworks, or collages that incorporate another work. Determining whether such NFT works constitute fair use will require a "context-sensitive inquiry" of the statutory fair use factors, including consideration of whether the use of the underlying work is transformative, and of whether the NFT artist "had a genuine creative rationale for borrowing" the underlying work. *Blanch v. Koons*, 461 F.3d 244, 251, 255 (2d Cir. 2006).

Name-and-likeness rights constitute a further set of rights that may be infringed by the creation and sale of NFTs. Sports figures, recording artists, and actors may have retained these rights and be able to invoke state statutes and common law to obtain injunctions and damages against those creating and selling works in which their name, likeness, or voice is used without their consent.

*Potential Claims by Buyers of NFTs*

Because NFTs are a barely developed area of commerce, it is possible that some NFT holders may allege they misunderstood the extent to which they acquired rights when they purchased an NFT. The scope of what is acquired may be defined in a contract or a marketplace's terms of service. But those terms may state (or fail to state) that others may still be able to download, view, or listen to the work that was minted into the NFT. They may also state (or fail to state) that the buyer cannot profit from use of the underlying video clip or image. For many NFT sales, the buyer does not acquire the copyright in the underlying work. SuperRare, for example, warns that that buyers do not have a copyright interest in the underlying artworks and that artists do not lose copyright protection over works when they are sold, unless the parties

[4] https://help.supeiTare.co/en/articles/4792372-2-4-copyright-on-sunerrare (last accessed March 18,2021).

[5] *Id.*

expressly agree in writing to convey a copyright interest.[6] Depending on the circumstances, the terms might also state that other versions, or editions, of the same NFT can be sold. If the buyer believes the scope of what the buyer was acquiring was not fully disclosed, or was misrepresented, and if the value has dropped, the buyer may bring a claim for fraud or seek rescission of the contract. Depending on the specific contracts, a buyer who believes a seller of an NFT violates the contract terms might also bring a claim against the seller or creator of the NFT. For example, if additional copies of a work were sold although the contract called for the work to have been a limited edition NFT, the buyer might sue the seller for breach of contract.

Buyers of NFTs who claim to have been misled about whether they were buying from the artist themselves, or buying authentic works by a particular artist, could also bring claims against the seller for fraud or breach of contract. Although blockchain verification should significantly reduce the ownership risks associated with buying a particular NFT, it will not necessarily eliminate the typical authenticity issues associated with physical works of art. Forgery of physical works is possible because talented forgers have been able to replicate the appearance of the original artists' works; digital creators will attempt to do the same with NFTs. For example, an NFT may depict images by a particular artist and be sold as a creation of that artist, even though the artist had no role in its creation and did not authorize the use of images. Buyers should therefore conduct the same level of authenticity and provenance diligence before buying an NFT that they would before buying a physical work of art.

Given the fast-moving market and steep prices for recent NFT sales, buyers may also become concerned about market manipulation. "Wash trading" is a form of market manipulation used in fungible token markets, predominantly to pump up perceived trading volume of a cryptocurrency exchange, making it more attractive to potential traders and users. Just as in other markets, NFT markets may suffer from manipulation schemes that fabricate perceived demand, giving rise to potential fraud and other claims.

To protect themselves, buyers interested in getting into the NFT market should familiarize themselves first with the terms of what they are buying, and the scope of what will be conveyed. They should also do as much due diligence as possible about the seller and the site. This includes checking the Terms of Use, which may often include arbitration provisions.

The potential for account hacking and loss of NFTs through theft is also an emerging concern. The weekend after the highly publicized Christie's sale of the Beeple work, Twitter users began tweeting to claim that they had lost NFTs in their Nifty Gateway accounts, with one Twitter user claiming to have lost more than $150,000 worth of the collectible tokens. Nifty Gateway responded on Twitter that its "analysis of prior events still indicate that the account takeover was limited in impact, none of the impacted accounts had [two-factor authentication] enabled, and access was obtained via valid account credentials."[7] Users of NFT marketplaces should review the Terms of Use to evaluate what options they may have in the event of a hacked account and whether they are sufficient.

Insurance coverage will also become an important issue, especially in the case of hacking the blockchain. Any buyer of NFTs needs to review relevant policies of asset insurance, such as homeowners and fine art policies, to be sure this asset is covered and not subject to any exclusions.

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[6] https://help.supeiTare.co/en/articles/4792372-2-4-copvright-on-superrare (last accessed March 18,2021).

[7] https://twitter.eom/niftygateway/status/l 372533666207916039

There may also be disputes with the underwriter over the value of the asset and whether the purchase price is sufficient evidence of the insurable value, given the immaturity of the market.

Regulatory Issues with NFTs

Although beyond the scope of this article, NFTs also raise regulatory issues. Sellers and buyers should be aware that NFTs may be subject to compliance and trade regulations, anti-money laundering and bribery laws, and other rules. Because the buyer or seller of an NFT could be anywhere in the world, participants in the NFT market should evaluate whether they are in compliance not only with U.S. law, but also other global and regional laws. Areas to consider include whether blocked persons may be attempting to use NFTs to evade sanctions. In October 2020, the Office of Foreign Asset Control (OFAC) issued an advisory warning that high-value artwork transactions "may play a role in blocked persons accessing the U.S. market and financial system in violation of OFAC regulations" and stating that OFAC does not believe the artwork exemption in the "Berman Amendment" to the International Emergency Economic Powers Act (IEEPA) and the Trading with the Enemy Act (TWEA) "allow[s] blocked persons or their facilitators to evade sanctions by exchanging financial assets such as cash, gold, or cryptocurrency for high-value artwork or vice versa."[8]

Parties to transactions should also consider financial reporting rules. Late last year, the Financial Crimes Enforcement Network (FinCEN) proposed rules to clarify recordkeeping and reporting rules for financial institutions regarding cryptocurrency, which would decrease the reporting threshold from $3,000 to $250 for transactions that begin or end outside the United States.[9] FinCEN issued a notice on March 9, 2021, encouraging financial institution reporting of suspicious activity relating to trade in antiquities and art.[10]

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If you have any questions about the issues addressed in this Client Alert, or if you would like a copy of any of the materials we reference, please do not hesitate to contact us:


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[8] https://home.treasury.gov/system/files/126/ofac_art_advisory_10302020.pdf.

[9]https://liome.treasury.gov/news/press-releases/sm 1216; *see also* https://publicinspection.federalregister.gov/2020-28437.pdf; https://www.federalregister.gov/documents/2020/10/27/2020-23756/threshold-for-therequirement-to-collect-retain-and-transmit-information-on-funds-transfers-and.

[10]https ://www. fmcen.gov/sites/default/files/2021 -03/FinCEN%20Notice%20on%20Antiquities%20and%20Art_508C.pdf.