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ARTICLE SERIES

EXAMINING THE LEGALITY OF NON-FUNGIBLE TOKENS (NFTS)

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Inception

$69,000,000 (sixty-nine million US Dollars). That is how much the first Non-Fungible Token ("NFT") was sold at an auction house [1] The creator of the NFT, 'Beeple' (Mike Winkelmann), is now one of the most expensive artists in the world. Recently, he also sold a video in the form of an NFT for $6,600,000 (six million, six hundred thousand United States Dollars) [2].

These few sales and other mega-purchases [3] have created an NFT hype that has spread across the globe, with NFT and Blockchain critics already speculating that another 'Dotcom Bubble [4], has arrived. In Nigeria, creatives are already taking advantage of the NFT wave, with Jason Osinachi selling two NFTs for $16,227 (sixteen thousand, two hundred and twenty-seven US Dollars) and $23,633 (twenty-three thousand, six hundred and thirty-three US Dollars) respectively [5] and the renowned rapper, M.I Abaga, revealing that his next album will be an NFT [6].

However, with the attraction NFTs have garnered, legal questions have begun to follow. In this article, we will examine NFTs as well as their legal implications, and conclude with what role the law is meant to play in this new world of digital collectibles.

NFTs Explained

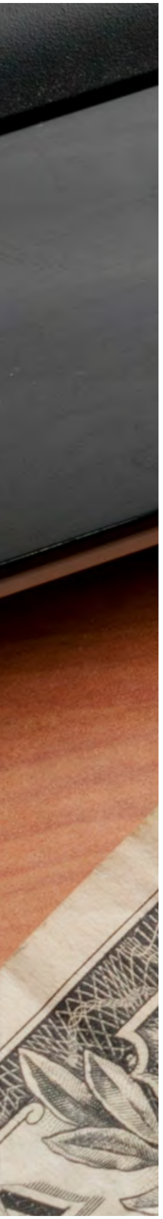
Ethereum.org, a public, open resource for Ethereum [7] describes a Non-Fungible Token as a method or way to identify something or someone in a unique way [8].

NFTs are 'Non-Fungible' because they cannot be used to buy goods or services the way cryptocurrency can be used.

The Token standard which is used to create the NFTs [9] , ERC-721, is a smart contract which exists on the Ethereum blockchain and allows creators to ascribe different values and functionalities to the smart contract through the use of Application Program Interfaces ("APIs"). The functionalities added to the smart contract are what makes it an NFT.
If the smart contract has various functionalities such as; the capability to transfer tokens from one account to another, get the current token balance of an account, get the owner of a specific token and can give out an output such as an image, video, GIF or, tweet, then it can be called an NFT [10].

Such functionality described above, gives creators the ability to include whatever they want to add to the digital asset and then store it on the blockchain.

[1]"First NFT artwork at auction sells for staggering $69 million" by Jacqui Palumbo for CNN Style, accessed on 6 April 2021 https://edition.cnn.com/style/article/beeple-first-nft-artwork-at-auction-sale-result/index.html **[2]**https://niftygateway.com/itemdetail/secondary/0x12f28e2106ce8fd8464885b80ea865e98b465149/100010001 **[3]** "Internet cats, Beeple and CryptoPunks dominate Top 10 NFT Sales" by Robert Hoogendoorn for DappRadar, accessed on 6 March 2021 https://dappradar.com/blog/internet-cats-beeple-and-cryptopunks-dominate-top-10-nft-sales#:~:text=%20Top%2010%20NFT%20Sales%20%E2%80%93%20March%208-14,400%20ETH%20%28%20see%20the%20owner%29%20More%20 **[4]** According to Investopedia, the dotcom bubble was a rapid rise in U.S. technology stock equity valuations fuelled by investments in Internet-based companies in the 1990s. the bubble burst in the early 2000s and heavily impacted several companies focused on technology and the internet leading to their unfortunate demise. **[5]**"How Nigeria's leading crypto artist makes and sells NFTs" by Alexander O. Onukwue for Tech Cabal, accessed on 6 April 2021 https://techcabal.com/2021/03/19/osinachi-nigeria-nft-crypto-art-artist/ **[6]** "The Next Wave: NFT's honeymoon is over" by Alexander O. Onukwue for Tech Cabal, accessed on 6 April 2021 https://techcabal.com/2021/04/05/the-next-wave-nfts-honeymoon-is-over/ **[7]** The blockchain which a lot of NFTs are created on
[8] "ERC-721 NON-FUNGIBLE TOKEN STANDARD" by Ethereum.org accessed on 6 April 2021 https://ethereum.org/en/developers/docs/standards/tokens/erc-721/ **[9]** An asset built on top of an existing blockchain, which has the ability to replicate such functionality or assets. You can read our article on Cryptocurrency and Initial Coin Offerings here for a better understanding of what Tokens are. **[10]** "ERC-721 NON-FUNGIBLE TOKEN STANDARD" by Ethereum.org accessed on 6 April 2021 https://ethereum.org/en/developers/docs/standards/tokens/erc-721/



Most platforms that display NFTs for sale make the process of creating an NFT simpler for creators by asking them to ‘Mint’ the image, video or digital material they wish to make an NFT. The process of Minting is simply using codes to add the digital content as a Token on the Ethereum blockchain. Consequently, the creative is prompted to get a wallet and purchase Ethereum. After the creative has gotten a wallet with a unique address, the creative must ‘sign’ the digital work which will link the creator’s wallet and address to the artwork as the original creator, and if the functionality of collecting royalties is added to the Smart Contract, the creative’s wallet will be credited with royalties upon transfer of the work from one person to another every time a transfer occurs. A ‘gas fee’ (which is the cost of adding the digital material on the Ethereum blockchain and adding functionalities to the smart contract which will hold the digital information the creator has uploaded) will be paid. Once the work has been Minted (added to the blockchain) it will be treated as an NFT and cannot be edited or deleted [11]

Individuals who access the platform which the NFT is hosted on can now purchase it with Ethereum or the Coin native to the blockchain the NFT was built on. Once an individual purchases an NFT, they buy the digital file on a blockchain that shows that they own the unique piece of digital content [12]

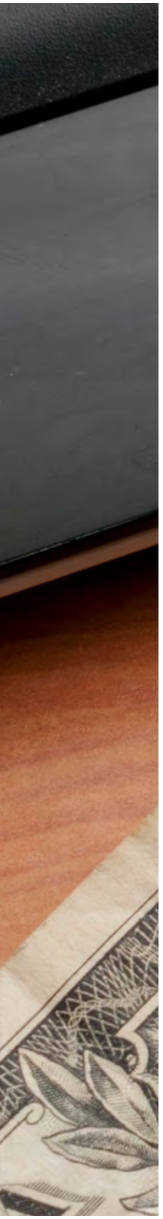
Why NFTs are in demand

So why are individuals buying digital files? Dragan Boscovic, Professor of Computing, Informatics and Decision Systems Engineering at Arizona State University, believes that:

“The issue is that perceptions of what the buyer is paying for are not easily framed in legal terms. NFT marketplaces do not always accurately describe the value proposition of the goods they are selling. The truth is that the value of any NFT is speculative. Its value is determined by what someone else is willing to pay for it and nothing else[13]"

Professor Bosocvic states that turning something as fleeting as a tweet into an NFT which people will pay millions for (ask Jack Dorsey how much he sold the first tweet [14] requires making it unique and creating a method to prove ownership [15].

[11] “A Complete Guide to Minting an NFT” by Samantha Ayson for Foundation, accessed 6 April 2021 https://help.foundation.app/en/articles/4742869-a-complete-guide-to-minting-an-nft#:~:text=Minting%20an%20NFT%20is%20how%20your%20digital%20art,tokens%20that%20get%20%E2%80%9Cminted%E2%80%9D%20once%20they%20are%20created.
[12] “NFTs: Legal Risks from “Minting” Art and Collectibles on Blockchain | Quinn Emanuel Urquhart & Sullivan, LLP” Krypt0 Knight accessed 6 April 2021 https://krypt0knight.com/2021/03/nfts-legal-risks-from-minting-art-and-collectibles-on-blockchain-quinn-emanuel-urquhart-sullivan-llp/
[13] “How nonfungible tokens work and where they get their value – a cryptocurrency expert explains NFTs” by Dragan Boscovic, Research Professor of Computing, Informatics and Decision Systems Engineering, Arizona State University, for the Conversation accessed 7 April 2021 https://theconversation.com/how-nonfungible-tokens-work-and-where-they-get-their-value-a-cryptocurrency-expert-explains-nfts-157489
[14] “Jack Dorsey sells his first tweet ever as an NFT for over $2.9 million” by Taylor Locke for CNBC, accessed 7 April 2021 https://www.cnbc.com/2021/03/22/jack-dorsey-sells-his-first-tweet-ever-as-an-nft-for-over-2point9-million.html [15] “How nonfungible tokens work and where they get their value – a cryptocurrency expert explains NFTs” by Dragan Boscovic, Research Professor of Computing, Informatics and Decision Systems Engineering, Arizona State University, for the Conversation accessed 7 April 2021 https://theconversation.com/how-nonfungible-tokens-work-and-where-they-get-their-value-a-cryptocurrency-expert-explains-nfts-157489



These aforementioned characteristics help in ascribing value to the NFT, but ultimately the value is determined by the buyer.

Uses of NFTs

NFTs are not only used for artworks but can be used for a myriad of things such as; creating virtual land [16] (with people paying over $500,000 to obtain a piece of the digital real estate [17] and to obtain abilities and items such as outfits in video games [18].

In fact, one of the earliest applications of NFTs was in a video game called Crytpokitties where players trade ‘Cryptocats’ or ‘Cryptokitties’ which are smart contracts existing on the Ethereum blockchain which permit the transfer of the Cryptokitties at a set sum [19] EvenAmerica’s National Basketball Association (“NBA”) is leveraging on NFTs by collaborating with Dapper Labs to create NBA Top Shots, moments captured in digital format of players performing exceptional feats during NBA matches [20].

Crypto-enthusiasts predict that the NBA could generate over $500,000,000 (five hundred million United States Dollars) in revenue from the sale of their Top Shots since people already buy trading cards of players for exorbitant prices and Top Shots function like trading cards in digital format with the added advantage of the players on the cards being in motion, [21].

However, with great wealth, comes great legal scrutiny and questions have started to pop up about some of the legal obligations and issues surrounding NFTs.

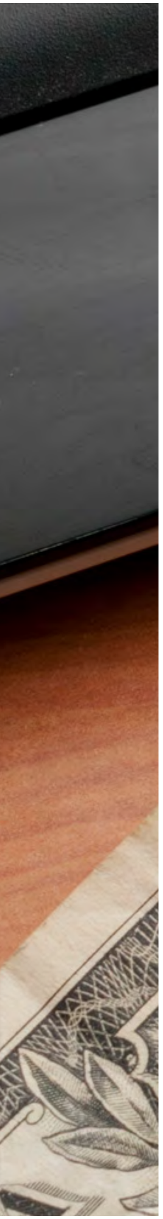
Legal Considerations

There are several legal issues arising since the NFT wave began but we will only focus on those that are currently having a detrimental effect on the creators and buyers of NFTs.

Ownership of the NFT

Nelson Rosario, founder of Smolinski Rosario Law, succinctly captures the dilemma with the ownership of NFTs.

[16] “Users Pay $1M for Digital Land as 2017 ICO Finally Opens Virtual World” by Benjamin Pirus for the Coin Telegraph” https://cointelegraph.com/news/users-pay-1m-for-digital-land-as-2017-ico-finally-opens-virtual-world
[17] “Take a look at the digital 'Mars House' that just sold for over $500,000 - the world's first crypto real-estate sale” by Grace Kay for Business Insider India, accessed 7 April 2021 https://www.businessinsider.in/tech/news/take-a-look-at-the-digital-mars-house-that-just-sold-for-over-500000-the-worlds-first-crypto-real-estate-sale/articleshow/81918167.cms
[18]“Today’s Top 5 NFT Crypto Games” by Thomas Delahunty for NewsBTC accessed 7 April 2021 https://www.newsbtc.com/news/company/todays-top-5-nft-crypto-games-leading-nft-games-of-2020/
[19] “Cryptokitties Are Still a Thing. Here's Why” by Rakesh Sharma for Investopedia accessed 7 April 2021 https://www.investopedia.com/news/cryptokitties-are-still-thing-heres-why/
[20] “THE NBA ON NFT-Top Shot is playing the long game in the NFT craze” by Elizabeth Lopatto for the Verge accessed 7 April 2021 https://www.theverge.com/22348858/nba-nft-top-shot-dapper-labs
[21] THE NBA ON NFT-Top Shot is playing the long game in the NFT craze” by Elizabeth Lopatto for the Verge accessed 7 April 2021 https://www.theverge.com/22348858/nba-nft-top-shot-dapper-labs



“An NFT is not that different from any other crypto purchase in that you are buying control over information in an entry in a ledger”

What he means is that NFT buyers do not actually own the NFTs. What they own are blockchain receipts (digital files) that act like a receipt for the purchase they are made and not the actual NFT [22].

For instance, the Term of Use in the NBA Top Shot specifies that buyers have a ‘non-exclusive, non-transferable, royalty-free licence to use, copy, and display’ the NFTs in certain limited contexts and they do not own the Top Shot [23].

Thus, even though some rights are transferred to the buyer such as the ability to resell the NFT at any time, the creator may still obtain a royalty fee from every sale, thus limiting the ownership rights of the buyer.
Consequently, potential buyers are advised to look at how their ownership rights may be impacted when they are about to purchase an NFT.

Ownership of Intellectual Property

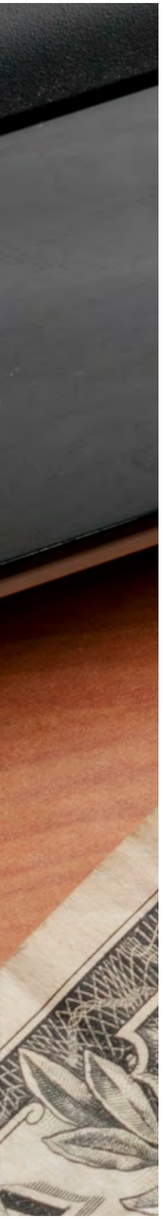
Buyers may believe that once they acquire an NFT, intellectual property rights (IPRs) are automatically transferred as well but it is not that simple. Generally, when a buyer buys an NFT, he does not obtain the original work and IP experts are positing that what the buyer obtains is a copy of the work [24].

Also, most of the creatives do not explicitly state that they have ceded their intellectual property rights to the buyer. Since most of the creatives still collect royalties from every transfer of the NFT, the inference drawn is that what they give to the buyer is a licence to use the NFT and not a transfer of the copyright.

This point is supported with how the NBA Top Shot sells its NFTs. It sells them alongside a Licence template which creators can use which clarifies that the buyer of the NFT receives:

- a personal licence to use and display the art associated with the NFT, as well as
- a commercial licence to make merchandise that displays that art associated with the NFT, a license subject to a $100,000 gross revenue per year limit [25]

[22] “The NFT craze will be a boon for lawyers” by Leigh Cuen for Tech Crunch accessed 7 April 2021 https://techcrunch.com/2021/03/29/the-nft-craze-will-be-a-boon-for-lawyers/
[23]“NFTS: A PRIMER ON THE TRENDING CRYPTO PHENOMENON” by Any Obando for Cassels accessed 7 April 2021 https://cassels.com/insights/nfts-a-primer-on-the-trending-crypto-phenomenon/
[24] “NFTs: What Are You Buying and What Do You Actually Own” by Ghaith Mahmood for the Fashion Law accessed 7 April 2021 https://www.thefashionlaw.com/nfts-what-are-you-buying-and-what-do-you-actually-own/
[25] “NFTs: What Are You Buying and What Do You Actually Own” by Ghaith Mahmood for the Fashion Law accessed 7 April 2021 https://www.thefashionlaw.com/nfts-what-are-you-buying-and-what-do-you-actually-own/



Kings of Leon, a rock band that recently released their album as an NFT, stated emphatically that the buyer only has a licence to display the album for personal use and cannot use it for commercial purposes or in films or music [26].

Decentraland, a platform where individuals can buy digital real estate as NFTs, states in its Terms of Use that Metaverse Holdings Ltd owns all IPRs on the site meaning that buyers cannot use the IPRs connected to the NFTs for commercial purposes [27]. Also, because most NFT transactions are cross border, there will most likely be a conflict of IPRs and Laws in different jurisdictions as to how the IPRs are interpreted and applied to the NFT in question. Potential buyers have to carefully read whether the creator is transferring copyright or other IPRs to any buyer or simply licensing the NFT to them, and should take into consideration the IP laws of the different jurisdictions.

Copyright Fraud

On social media, graphic artists have voiced serious concerns about how their works are

taken from their social media accounts or their portfolios and are 'Minted' as NFTs. SuperRare, an NFT platform, notes that

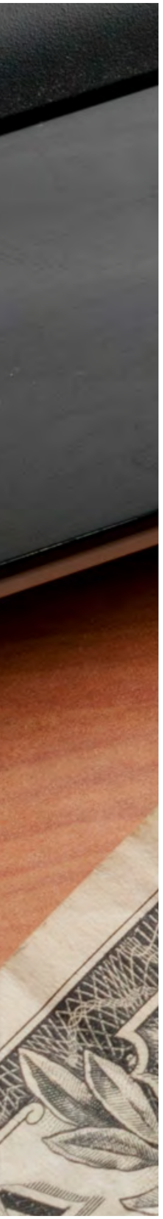
"it's clear that the crypto art movement has continued the practice of reappropriating unoriginal content, often with a symbolic, transformative, or meme-worthy purpose." The site warns that "[a]rtists should never mint a work containing copyrightable elements of another's work unless they are authorized by the copyright owner or a valid fair use defense applies [28]

However, even with the warnings, it is hard for artists to trace individuals who have Minted their work because the address that will be identified as the original creator of the work is anonymous since the transaction is on a blockchain. Also, Minting the work makes it difficult to edit or watermark. There may also be disputes over whether the minting of someone else's work of art and turning it into an NFT is fair use.

Some of the questions that may come up include:

- Does the NFT involves a creative work of expression?
- Does it copy an entire physical work?

[26] "NFTs: What Are You Buying and What Do You Actually Own" by Ghaith Mahmood for the Fashion Law accessed 7 April 2021 https://www.thefashionlaw.com/nfts-what-are-you-buying-and-what-do-you-actually-own/
[27]"LEGAL IMPLICATIONS OF NON-FUNGIBLE TOKENS (NFT)" by Pramod Chintalapoodi for CHiP Law Group accessed 7 April 2021 https://www.chiplawgroup.com/legal-implications-of-nfts/
[28] "NFTs: Legal Risks from "Minting" Art and Collectibles on Blockchain | Quinn Emanuel Urquhart & Sullivan, LLP" Krypt0 Knight accessed 6 April 2021 https://krypt0knight.com/2021/03/nfts-legal-risks-from-minting-art-and-collectibles-on-blockchain-quinn-emanuel-urquhart-sullivan-llp/



- Does the NFT have the potential to deprive the copyright owner of revenue from the exploitation of the work [29]

Even though there has not been any recorded dispute regarding whether Minting an art work is fair use in the courts of law, it is expected that individuals who hold such intellectual property will not see such action as fair use since the sale of an NFT version of their work may make a lot of profit. Due to the anonymity of blockchain transactions and the cross-border nature of NFT transactions, artists may find it hard to prevent the reappropriation of their work. However, it is worthy to note that since the NFT craze began, some artists have deleted their works from their social media accounts and made their online portfolios private.

Classification of NFTs for Regulatory and Tax Purposes

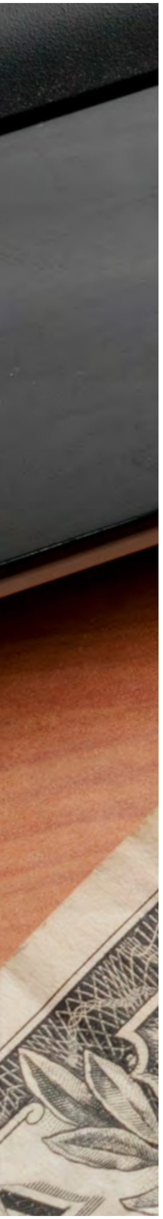
Ordinarily, once the creator finds a buyer who pays for the NFT, the creator has earned income which will be subject to income tax and if the buyer sells it for a higher price,

it should be classified as property which should attract capital gains tax upon the resale of the NFT.

However, if the NFTs are offered to the public, with the promise that its value may increase and the holders can sell it at a profit, and the NFT is being promoted by celebrities or individuals, it may be an investment more than a digital work of art at that point [30]. In this case, the NFT may be classified as a security and may be subject to security rules and regulations as well as the various taxes that accompany securities. But the question remains whether they will be classified as securities in the instance mentioned above.

Consequently, due to the ability of NFTs to be used for various things, regulators will be faced with the dilemma of properly classifying them for tax purposes and also to understand whose purview they fall under for regulation and control. Potential buyers of NFTs should see whether they are going to be subject to compliance and trade regulations, anti-money laundering and bribery laws, and other relevant rules [31]

[29] "NFTs: Legal Risks from "Minting" Art and Collectibles on Blockchain | Quinn Emanuel Urquhart & Sullivan, LLP" Krypt0 Knight accessed 6 April 2021 https://krypt0knight.com/2021/03/nfts-legal-risks-from-minting-art-and-collectibles-on-blockchain-quinn-emanuel-urquhart-sullivan-llp/
[30] "Will NFTs be Deemed Securities Subject to the U.S. SEC Laws and Regulations?" By Max Dilendorf Esq. Gleb Zaslavsky, Esq. and Bari Zahn for Yahoo! Finance accessed 7 April 2021 https://finance.yahoo.com/news/dilendorf-law-firm-nfts-deemed-175600150.html
[31] "NFTs: Legal Risks from "Minting" Art and Collectibles on Blockchain | Quinn Emanuel Urquhart & Sullivan, LLP" Krypt0 Knight accessed 6 April 2021 https://krypt0knight.com/2021/03/nfts-legal-risks-from-minting-art-and-collectibles-on-blockchain-quinn-emanuel-urquhart-sullivan-llp/



Conclusion

Whether NFTs are regarded as a financial bubble, it is evident that NFTs will redefine the way creatives have access to the ultimate consumers of their work and even how they can make money off future sales.
With the 'multi-potentialite' nature of NFTs, the law has to be ready for any surprises innovators may bring with the use of NFTs.

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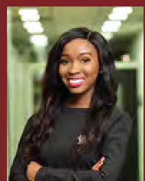

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