



Non-fungible tokens: Emerging issues in the emerging marketplace

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Why did a video highlight of a LeBron James dunk sell for more than \$200,000? And why did a JPG image by digital artist Beeple sell for \$69 million? The answer is that the digital files were authenticated by blockchain technology as “one of a kind” works of art. These types of authenticated digital assets, known as non-fungible tokens (NFT), are taking the world by storm.

What is a token?

Tokens are digital objects which represent the right to perform some operation. There are many different types of tokens, but the most common are utility, security, and currency tokens. Utility tokens are often unique codes or identifiers that provide their owner with access to a digital service. Security tokens, like physical securities, derive their value from an underlying asset and represent some kind of ownership in that asset. Currency tokens, such as Bitcoin, Ethereum, and Litecoin, are tokens that act as a storage of value and medium of exchange.

What is a fungible token?

A fungible token can be easily exchanged for another item or value because each token is equivalent, and all tokens have the same value. Bitcoin (BTC) is an example of a fungible token. If you borrow 1 BTC from a lender, you can pay the lender back with a different BTC, and the lender would be receiving the same value in return.

What is a non-fungible token?

In contrast, a non-fungible token is unique. It is one of a kind, and it has its own value. It therefore cannot be replaced by another NFT.

A digital piece of art that is “tokenized” with an NFT is also unique. While it is possible to make a copy of the artwork, the NFT makes it easy to determine that the copy is not the original. When an artist tokenizes his or her digital piece of art and creates an NFT, it can be certified as a one-of-a-kind copy, and thus the NFT achieves the same kind of subjective value as a physical piece of art.

How do NFTs work?

Any digital asset, or a right in an underlying asset, can be tokenized to make an NFT. When an object is tokenized with an NFT, its data is turned into a digital form that exists on a blockchain with unique digital information which will distinguish it from other NFTs.

Blockchains are essentially lists that record a series of events or transactions. Once an asset on the blockchain is sold, the data of the transaction constitutes a link in the chain. Each subsequent transaction is then added as a new link.

Blockchains are immutable, and the data entered into a chain is irreversible. This means that transactions on a chain for a digital asset cannot be modified or reversed. Also, as a decentralized network, a blockchain is typically open and anyone can view the history of the transactions for a digital asset themselves. These properties prevent assets on a blockchain from being pirated, stolen, or destroyed, and allow individuals to easily verify the uniqueness of the asset.

The NFT marketplace emerges

With the recent boom of NFTs in the art and collectibles spaces, a new NFT marketplace has emerged. The key players in the NFT marketplace are the creators, the buyers/owners, and the online platforms used to connect the two.

Creators are the individuals who produce the art. Creators first tokenize their art to create a unique NFT, which they can then sell on the marketplace, either over a platform or directly to the buyer. Typically, creators will have to make representations about their NFTs to post them for sale on online platforms. The creators may have to represent that they are the artist of the work, that the work is an original, and that the work is scarce. Buyers require these representations to ensure that their NFT is legitimate and rare, rarity being one of the most valuable qualities of these assets.

Importantly, when an artist sells a piece of NFT art, *it is not the actual underlying artwork that is being sold*. Rather, it is a copy of the art, with the NFT representing ownership of the copy. All title and interest, including intellectual property rights of the art, usually remain with the artist.

What the buyer can do with the NFT art will depend on the licence. The NFT licence, at its core, is a user agreement. Generally, these licences allow the owners to display the art in certain environments and to re-sell their NFT in the marketplace. Some licences might also allow for commercialization of the art, potentially up to a certain dollar amount. For example, if the owner purchases a digital image, the licence could allow the owner to print and sell t-shirts with the image on them. Other licences may not allow for commercialization of the art at all.

NFT licences also provide other rights and restrictions. Usually, a licence will prohibit any modification of the art, in order to protect the creator's intellectual property. The licence might also prohibit the buyer from using the art in connection with images of hatred, violence, or other inappropriate behaviour.

In order to make the purchase, a buyer must have an amount of Ethereum (a type of cryptocurrency) stored in a digital wallet. NFT purchases are executed using smart contracts, and each transaction is recorded on the blockchain. Once recorded, the buyer becomes the owner of the NFT and the asset is stored in their digital wallet. At present, proof of ownership of NFTs is stored mainly on the Ethereum blockchain.

These purchases can be facilitated by online sites which allow creators to post, and buyers to buy, NFT art. Platforms are used to promote a creator's NFT to a wider audience, and they are responsible for having terms of service that protect both creators and buyers, and also limit the platform's liability.

Key considerations

The emerging market for NFT art and collectibles presents new and exciting opportunities, but it also raises questions and concerns. Many of these questions will likely be answered by the terms of the NFT licence and the terms of service of the platform. However, individuals must remember that this is still a developing area and that new issues will continue to come up. Some of the key considerations are as follows:

- **What can the buyers/owners do with their NFT art?**

Those who are looking to buy NFT art should determine the rights they will receive with respect to their purchase. These will likely be governed by the NFT licence or the terms of service of the platform on which the art is purchased.

- **How does copyright apply to NFT art?**

All intellectual property rights in the art (including copyright) will usually remain with the creator. Therefore, the owner of the NFT will not normally own the copyright in the art. However, any copyright owners do have the right to sell or assign their copyright, so it is possible to purchase the copyright in the underlying work (albeit at a higher price).

- **How are uniqueness and scarcity guaranteed?**

As with any collector's item, uniqueness and scarcity are the two most important attributes that make NFT art valuable. NFT art will only attract demand if uniqueness and scarcity are guaranteed. Creators will have to make the necessary representations for buyers to trust that they are getting a one-of-a-kind product.

Platforms may also bear responsibility for holding artists who sell on the platform to these representations. Platforms should consider vetting or having an approval process for their artists to make them more trustworthy to the buyer.

- **How should platforms alter their terms of service to address the liabilities associated with blockchain?**

All online technology carries its own risks, blockchain technology included. Data inaccuracies, transmission errors, and reporting problems are all possibilities when dealing with assets that exist and trade completely online. The novelty of NFTs also makes the prices of these blockchain assets extremely volatile, and regulatory regimes are continuously coming up with new regulations and policies concerning crypto-technology that could affect the development of the NFT marketplace.

Accordingly, platforms must take the above into account and consider how best to limit their liability through disclaimers and limitation clauses. Part of this consideration will be how liability can be apportioned among the multiple marketplace participants, including third-party services such as digital wallets, which participants will have to use.

- **What must platforms do to comply with record-keeping laws?**

Each jurisdiction will likely have its own record-keeping laws that apply to businesses which sell goods to consumers. One of the main advantages of blockchain technology is that every transaction is recorded on the blockchain. Platforms will have to consider whether having a record on the blockchain is sufficient to meet their record-keeping requirements.

Conclusion

The NFT marketplace is exploding, and surprisingly large amounts are being paid for NFT artwork. These prices, together with the uncertainty of a new technology, raise potential legal liability issues for art creators, buyers, and marketplaces. An important part of addressing these issues is to carefully consider the licences, terms, and conditions associated with NFT art transactions.

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