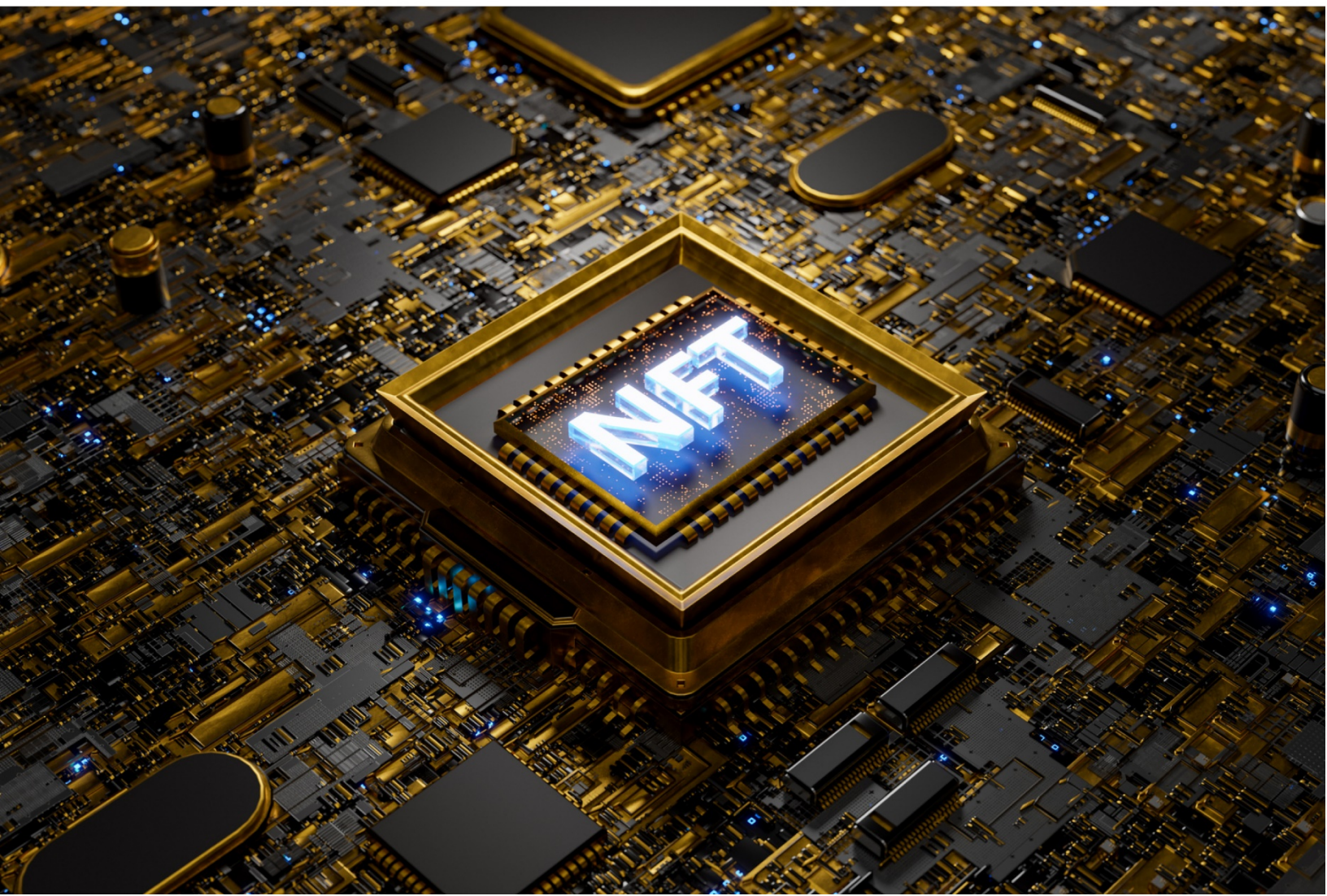


Morgan Lewis

# NON-FUNGIBLE TOKENS

## WHAT'S IN STORE FOR 2022



*2021 was a banner year for non-fungible token sales, which are projected to climb even higher in 2022.*

Selected by Collins English Dictionary as the 2021 Word of the Year, non-fungible tokens (NFTs) are unique blockchain-based digital assets that are associated with images, artwork, videos, games, or other creative content. Although NFTs have been gaining steam in the arts and sports industries, they are expected to expand into a broad set of industries this year. The gradual adoption of a crypto economy and broader acceptance of virtual ownership means tech entrepreneurs and investors alike are increasingly turning toward digital assets in preparation for a future in the metaverse.

For the most part, NFTs are still in their infancy, with a small, but growing, marketplace of buyers and sellers. However, NFTs have the potential to become mainstream as more brand-name companies enter the arena and proliferate their use for collecting, betting, trading, exhibiting, and gaming, among other uses. With \$41 billion in NFT sales in 2021 according to the latest data by Chainalysis, compared with total sales valued at less than \$100 million in 2020, this market is poised to be a new revenue source for many companies looking to monetize existing intellectual property.



As with any emerging, fast-paced technology, the global legal, enforcement, and regulatory framework is playing catch-up to developments and new market entrants. In this forward-looking piece, Morgan Lewis lawyers look at various industries that are being disrupted by NFTs and address various considerations relating to intellectual property (including copyright, trademark, and patent); data protection and privacy; tax; and state and federal law.

## THE NFT REVOLUTION

While NFTs are becoming more prevalent in other industries, their popularity is exploding in the sports and arts worlds. Collectors are shifting their investments from physical memorabilia and traditional art mediums to NFTs in order to claim unique ownership of a moment in sports history or a digital piece of artwork. There is a long, deep-rooted history among sports fans and art patrons of buying exclusive physical “tokens” of a favorite player, moment, or piece of art—and NFTs are a digital extension of the same.

From a legal perspective, the NFT world is a licensing world. While gaining access to NFT technology is relatively easy, given the various third-party service providers available, the ability to source and sell content legally is a complicated matter. **Turning something into an NFT and commercializing it is not an intuitive legal process.** For example, content used to create NFTs is often covered by copyrights or is subject to agreements that could have very well been drafted prior to the NFT age. It would be wise for a buyer/collector to have a legal review of previous agreements to determine whether the various parties have the rights to sell or buy a particular style of NFT. Otherwise, one may end up paying their profits out of pocket to various rightsholders.

New technologies that leverage digital assets—such as the various metaverses being imagined, 3D printing, and other technologies that either display or leverage digital art—increase the demand and may impact the value for collectible NFTs. It may not be too far in the future when having a collectible NFT video of a sports moment playing or an art gallery-like viewing in one’s “metaverse house” will be commonplace.

Looking to 2022, sales of sports NFTs are poised to grow even larger as individual pro and college athletes are launching their own collections separate from the actions that teams and leagues are undertaking. According to research from Deloitte, **NFTs for sports media are anticipated to generate more than \$2 billion in transactions in 2022**, approximately double the value from 2021. Limited edition video clips of sport moments or player cards will continue to be the most popular and lucrative products, with the NFT value depending on the athlete’s prominence, event significance, and consumer demand.

The collection of illustration art, in particular, lends itself particularly well to NFTs—and is seeing a surge in continued interest. In the golden era of illustration art, legends such as Frank Frazetta produced book covers, calendar art, and comic books by painting original art that is now highly sought after and extremely valuable. Such artists sold many of their original pieces of art as a source of supplemental income. Over the years, as production cycles have shortened and budgets have shrunk, artists were forced to abandon the creation of physical art in favor of more efficient digital means, meaning that their supplemental income from selling their original paintings evaporated. NFTs provide artists who specialize in digital art the opportunity to monetize the originals in the same manner as the golden-era artists.

Following on their success in the sports and arts worlds, fashion, beauty, and luxury brands have entered the NFT arena as a way to tap into a digitally focused consumer base and potential new revenue source. Particularly for retailers, NFTs offer the opportunity to drum up excitement and brand interest over exclusive access to items or collections, presales, and new product launches, and to build a deep community bench. More recently, there has been an emergence of retailers launching ecommerce marketplaces dedicated to NFTs and establishing cryptocurrency partnerships. With more mainstream consumer companies exploring NFTs, other industries and consumer products are primed to be disrupted, including real estate, virtual real estate, live entertainment shows, music, and video games, among others.

## **EXPECTED CONSUMER PROTECTION ACTIONS**

It is anticipated that state attorneys general will conduct at least preliminary inquiries, if not full investigations, as to whether the marketing and promotion of some NFTs violate state and federal consumer protection laws prohibiting unfair or deceptive acts and practices (UDAP). All 50 state attorneys general (plus the District of Columbia), as well as key federal enforcement agencies such as the Federal Trade Commission and Consumer Financial Protection Board, have this broad and ill-defined consumer protection authority.

**Attorneys general will likely collaborate with their federal counterparts to the extent that NFTs are to be treated as investments, securities, or other vehicles.** At a recent meeting of state attorneys general, several pointed to what they saw as an enforcement vacuum; they also noted that the transactions for NFTs may be circumventing state sales and use tax laws, thus depriving states of needed revenue.

In a typical scenario, a small group of attorneys general would combine in a multistate investigative task force with one or more of them issuing administrative subpoenas or civil investigative demands for documents and perhaps testimony. They would pick a few subject issuers or other market participants based on consultations and proceed. They might work directly with or in concert with relevant federal agencies and would share documents and information.

It is still far too early to determine how many resources would be devoted to such an effort and the vigor with which any inquiry might be pursued. However, it is important to note that many state attorneys general have appropriated additional resources during the past administration and those resources are still available for matters an attorney general wishes to pursue.

State UDAP laws can be a moving target. There are few, if any, rules. The process is opaque, and the compulsory process is broad. The potential penalties for violations are calculated not on loss but on the number of violations. Penalties can be statutory and also may include restitution and disgorgement.

## **COPYRIGHT LAW PITFALLS**

Before engaging in the purchase, sale, or creation of NFTs, it is important to consider potential copyright issues. Does the creator and/or seller of an NFT have the right to tokenize the underlying work? If the subject of the NFT is an exact copy of a copyrighted work or is altered in such a way that it constitutes a derivative work without authorization, then the owner of the copyrighted work that is linked to the NFT may assert copyright infringement. This can be asserted on the argument that even if the content is stored separately from the NFT token, a copy was likely made to generate, display, and/or promote the token, or some other exclusive right of the copyright owner was violated.

It is also important to note that the transfer of an NFT alone likely does not transfer any copyrights. A transfer of a copyright must be expressed in writing and signed. Thus, if the seller of an NFT does not expressly say somewhere that a copyright right will transfer, then there is really no chance that any copyright will convey. Without copyright ownership or an applicable license, the purchaser of an NFT may have far less ability to enjoy the content linked to the NFT than one may have thought.

**When it comes to NFT sales, active parties should be aware how the first-sale doctrine may apply,** which states that the legitimate owner of a copyrighted work, such as a book or CD, may sell that individual item without infringing copyright. If an NFT is intended to transfer some type of item physically off the blockchain, such that the original owner will no longer have possession of the item, such an NFT may, in some circumstances, be less likely to

infringe, even if a photo of the product is linked to the NFT to show exactly what is for sale. On the other hand, if the NFT is associated with copyrightable subject matter of a third party separately from an offer to sell a physical item, the creator of the NFT may be more likely to infringe copyright as noted above.

Another interesting copyright consideration is to what degree the subject of an NFT was created using artificial intelligence (AI). If the content of an NFT is created exclusively or perhaps primarily using AI, with little to no creative input from a human author, there is an argument that such content may not be registrable at the US Copyright Office, and the copyright could potentially be unenforceable in the United States for that reason. Accordingly, promoting an NFT as wholly computer-generated may have unintended consequences for the purported copyright owner.

### *Miramax v. Pulp Fiction*

In one of the first complaints to be filed concerning NFTs and copyright law, Miramax Films sued filmmaker Quentin Tarantino after he announced his intention to auction off scanned pages from the original screenplay for *Pulp Fiction* in the form of NFTs. Miramax alleges that Tarantino's rights pursuant to his contract did not extend to NFTs and, therefore, he is infringing upon Miramax's copyright by creating derivative works in the form of NFTs. In this case, contract interpretation will be key to the outcome, unless the parties reach a settlement. The complaint alleges that Tarantino conveyed all right, title, and interest in the copyright to the film, and all elements of the development and production thereof, to Miramax, but acknowledges that he reserved the right to various other adaptations, including "print publication (including without limitation screenplay publication, 'making of' books, comic books and novelization, in audio and electronic formats as well, as applicable), [and] interactive media." The question is whether the court will side with Miramax that the creation of the NFT itself is an unauthorized derivative work of copyrightable elements of the movie that he had transferred to the studio, or if the NFT is simply a link to a scan of a screenplay that Tarantino has a reserved right to sell. If the latter, as noted above, the first-sale doctrine may come into play in Tarantino's defense.

For owners of copyright rights in music, software, video, artwork, and other content, NFTs would appear to provide a new means to distribute authorized copies in a highly efficient manner that can also be collectibles or that have added benefits, creating even more value to the traditional exclusive rights provided by copyright. It can only be anticipated that new benefits of NFT ownership will be offered or created, such as being invited to a special event, and new technologies will be introduced to facilitate proof of NFT ownership to receive those benefits, both in the metaverse and the real world.

## **TRADEMARK RIGHTS ENFORCEMENT**

Trademark rights are also implicated if NFTs use marks and trade dress without the consent of the brand owner. For example, unauthorized virtual versions of well-known designer handbags have appeared as NFTs and have sold for significant amounts. Many luxury brands are focusing on the metaverse as a potentially significant new market for virtual versions of their goods. Each unauthorized brand-related NFT will need to be considered to evaluate what trademark or other rights may have been infringed. One proactive step that brands can take is to review their trademark portfolios and consider whether their registrations are likely to be sufficient to cover their goods in the metaverse. In some countries, NFTs based on branded goods likely will be considered within a natural zone of expansion for the trademark owner and infringing, but in other countries a more literal scope of registered trademark rights may be key to enforcement in the virtual world.

With respect to the Miramax case and *Pulp Fiction*, if the court determines that Tarantino's reserved contractual rights permitted him to sell NFTs of the screenplay, the case may turn on whether his use of the *Pulp Fiction* trademark and other branding elements were nominative fair use (i.e., permissible) or trademark infringement. Miramax has alleged that the use is an infringement. In NFT marketplaces, as in traditional markets, the key trademark questions will generally be the same: is the use of the trademark likely to cause confusion? Does use of the branding suggest an endorsement, sponsorship, or affiliation that does not exist?

Looking ahead to the next celebration or holiday season, you very well may give or receive an NFT of brand-name apparel or accessories in addition to the real thing.

## **PATENT PROTECTION**

Numerous companies have filed for patent protection over NFT-related disclosures, with about 100 applications filed with the US Patent and Trademark Office and 23 granted patents to date using the term "non-fungible token." While the underlying NFT technology is now well known, these NFT patents aim to cover improvements to this core technology or ways NFTs can be used to improve existing systems.

### *RTFKT and 'Nikeland'*

For example, Nike has been granted a slew of patents related to digital assets including "cryptographic digital assets associated with articles of footwear or digital design files representative thereof." (US Patent No. 10,505,726 B1; *see also* US Patent No. 11,032,072 B2; US Patent No. 11,113,754 B2.) These patents claim to build on past blockchain-based NFTs plus, for instance, use of a middleware server to keep track of and provide unique owner identifications. This may differ from earlier systems that could simply rely on a user's preexisting blockchain address.

And such patents may be seeing real-world use. Late in 2021, Nike [acquired RTFKT](#) (pronounced "Artifact"). RTFKT "leverages the latest in game engines, NFTs, blockchain authentication and augmented reality to create one of a kind virtual products and experiences," Nike wrote in a press release. Prior to the acquisition, [RTFKT sold more than 600 pairs of NFT-linked virtual sneakers](#) for more than \$3.1 million. RTFKT sneaker NFTs may land soon in the [Roblox-based 'Nikeland'](#).

However, **as NFT patent filings become more commonplace, and when NFT patents are asserted in court, applicants are likely to see pushback** on Section 101 grounds. 35 U.S.C. § 101, as articulated in a string of Supreme Court cases leading to *Alice*, outlines what qualifies as patentable subject matter and prohibits patents that claim laws of nature, natural phenomena, and abstract ideas. Assessing eligibility under *Alice* first requires a determination of whether the claim is directed toward an abstract idea or other ineligible subject matter, and, if so, second, a determination of whether they are saved by an inventive concept. Thus, claims for exchanging financial obligations to manage settlement risk (an abstract idea) were not patent-eligible merely by being implemented on a generic computer (no inventive concept).

Is using the blockchain or NFTs an inventive concept? The answer is unclear. Bitcoin and its underlying blockchain technology are barely a decade-old, and few would have predicted in 2008 that it would form the basis of a multitrillion-dollar economy. Early pioneers developing a roadmap to tokenizing traditionally physical or nonscarce digital goods may have a strong argument that their work in this space was "inventive." But as blockchain and NFTs gain an increasing foothold in public consciousness and understanding, reliance on a "blockchain" or "NFT" for patent eligibility may not be much better than a generic computer.

## **PRIVACY AND INFORMATION SECURITY REGULATION**

NFTs will be impacted by the ongoing and significant trend toward greater attention to and regulation of data privacy and information security issues, including providing individuals with more rights and control over their data. The European Union's General Data Protection Regulation (GDPR), California Consumer Privacy Act (CCPA), and Virginia Consumer Data Protection Act (VCDPA) all provide the right to the erasure and correction of collected personal data, but the immutable nature of the blockchain poses an obstacle to companies' ability to execute those rights.

Another legal consideration is that the common law right of publicity prevents the unauthorized commercial use of an individual's name, likeness, or other recognizable aspects of one's persona. The right of publicity grew out of the right to privacy torts, specifically from the tort of "invasion of privacy by appropriation." With NFTs, this right could be at issue. Selling an NFT would almost certainly be considered a commercial use and selling an NFT depicting a person without that person's consent would likely be deemed a violation of that person's rights of publicity unless a defense applies. These and other issues emphasize how critical it is to consider data privacy and information security issues as part of the initial planning and design of NFTs and NFT platforms.

## **TAX CONSIDERATIONS**

The US Internal Revenue Service (IRS) has not issued NFT-specific tax guidance. Tax law inexorably lags behind technical innovation, but NFTs present a significant regulatory challenge due to the varying intellectual property rights and divergent transactions involving any particular NFT. Absent NFT-specific guidance, taxpayers and authorities will need to apply existing tax laws to NFT transactions on a case-by-case basis.

The IRS issued cryptocurrency guidance in Notice 2014-21, a few years after Bitcoin began to gain traction (later supplemented by Rev. Rul. 2019-24). The notice treats cryptocurrency as "property" (rather than currency) for federal income tax purposes. Although cryptocurrency and NFTs both utilize blockchain technology, the notice's application is limited to "convertible virtual currency"—virtual currency with an equivalent value in real currency or that acts as a substitute for real currency. Many NFTs are commonly purchased with cryptocurrency, and the notice generally requires purchasers of goods or services to realize taxable gains or losses on the exchange of virtual currency.

**The tax characterization of an NFT transaction must be determined on a case-by-case basis.** As in prior instances where technological or financial innovation has outpaced the tax law, taxpayers and the IRS will likely analyze the tax characterization of an NFT transaction by analogizing to existing law or guidance applicable to similar transactions. For instance, an NFT transaction could be characterizable under the "computer program" regulations as a sale, license, or lease (Treas. Reg. § 1.861-18). Many aspects of these regulations, primarily finalized in 1998, are now outdated. Proposed regulations were issued in 2019 and provide some updates particularly for "cloud transactions," but NFTs are not specifically addressed (Prop. Reg. §§ 1.861-18, 1.861-19).

NFT creators and investors that engage in sales or exchanges of NFTs should expect to recognize taxable income, gain, or loss under general federal income tax principles. An individual NFT creator may be subject to ordinary income tax rates on an NFT transaction because self-created properties are treated under the Internal Revenue Code of 1986, as amended, as noncapital assets. Alternatively, the NFT creator may have ordinary royalty or rental income if the transaction is characterized as a license or a lease. Some NFTs may be treated as "collectibles" under Code Section 408(m)(2), which is defined to include "any work of art." If the NFT is a collectible for Code Section 408 purposes, a 28% tax rate may apply as opposed to the

preferential 20% rate on capital assets held for more than one year. A 3.8% net investment income tax may also apply.

Individual traders and dealers in NFTs (e.g., parties regularly engaged in NFT sales or exchanges) would not be able to avail themselves of preferential capital gains rates and would instead be subject to ordinary income tax rates on NFT sales and exchanges.

**Gain or loss from NFT transactions must be reported on federal income tax returns, but there is currently no NFT-specific reporting mechanism.** IRS Form 1040 includes a line inquiry about virtual currency exchanges, which is applicable to NFT sales or exchanges (or any sales or exchanges) involving cryptocurrency.

Additional potential NFT tax issues include state, local, and non-US tax considerations; sourcing of NFT-related income; withholding and other cross-border transaction implications; and NFT charitable contribution deductions.

## **CONCLUSION**

As the proliferation of the cryptocurrency and broader digital asset industry continues to spread into everyday life, the quick expansion of NFTs comes as no surprise. The rise of NFTs has pushed into the spotlight questions about ownership, how an item is valued, and the interplay between the physical, digital, and virtual worlds. New methods and means of monetization, new technology, and new definitions and proof of ownership have left this budding industry with little regulation, policy, or oversight. The lack of legal guidance surrounding the buying and selling of NFTs, as demonstrated above, crosses into numerous areas of law such as intellectual property (including trademark, copyright, and patents), data protection and privacy law, tax, and other state and federal laws, among others. Complex legal issues will formulate around the commercialization and ownership of NFTs, and legal disputes, such as *Miramax v. Pulp Fiction*, may become more prevalent.



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