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# NFT Art – Your Top 40 Legal Questions Answered

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Non-fungible tokens were minted and sold under the radar until a relatively obscure artist sold an NFT for an immense sum. That seminal event invigorated interest in NFTs by artists, sales platforms and collectors. In this column, we undertake to identify and answer, in Q&A format, the top forty legal issues associated with this new medium of artistic expression.

## Copyright

1. How does copyright law apply to NFT art? NFTs do not change the operation of copyright. The underlying work is protected by copyright, which can be retained by the author or transferred to the holder of the NFT. This is similar to how a copyright in a conventional piece of art may be transferred to a third party. That said, copyright transfers must be in writing, and whether a smart contract is a writing for purposes of the Copyright Act is not a settled legal issue.

2. If the sales platform mints an NFT of digital art, does the smart contract need to specify who owns the copyright? Yes.

3. If a platform wanted to display an NFT image for public viewing, would the platform need the permission of the copyright holder, the owner of the NFT, or both? The answer will depend upon the terms associated with the NFT. A typical allocation of rights would be that the platform would need the permission of the copyright holder in the underlying work and not the permission of the owner of the NFT, but that allocation could change with the terms of the NFT. An artist could license the artist’s rights to a work exclusively to the NFT owner, which would require the platform to obtain the owner’s approval in order to display the work.

## NFT Minting

4. What are the risks of NFT minting? The answer might depend on who is minting the NFT. The creator could mint the wrong NFT, or could input the wrong content or omit information, and not be able to change any of this afterward. If a platform is transferring an NFT that has

already been minted, then there could be risks associated with the transfer (hacking, theft, counterfeiting, etc.). If the platform creates its own blockchain and mints NFTs to that blockchain, then there could be technical or structural risks.

5. If the platform mints the NFT art, will the art appear as having been generated by the artist, the platform, or both? The answer to this requires scrutiny of the smart contract deployed to mint the NFT. Typically, most marketplaces will require that participants mint only original content or content in which the participant has rights. If minting another's work, the participant could add information about the artist.

6. Will the NFT be held in the platform's wallet? The answer will likely depend on how the transaction is structured, as well as the smart contract deployed for the transaction. There might be tax consequences associated with temporarily holding an NFT.

## Smart Contracts

7. What is a smart contract? A smart contract is a computer protocol that digitally facilitates, verifies and/or executes the performance of a "contract" protocol.

8. Can a sales platform add terms to the NFT that govern how the sale will be conducted on the platform? Yes, it is common and recommended to impose terms applicable to the NFT purchase to affirm the legal enforceability of the protocol in the smart contract.

9. How does one embed a smart contract into the blockchain? Typically, a smart contract is deployed as a program on the blockchain, which is usually the Ethereum blockchain).

10. Could one settle a payment in fiat currency (rather than crypto currency) via smart contract? Answering with reference to currently available technology, the answer is probably not, because fiat currently payment settlements are recorded on private ledgers rather than on the blockchain. One could have the smart contract record on a distributed blockchain ledger, and then record that information in a traditional private ledger.

11. How would a smart contract handle a notyet-determined sales price? Smart contracts define rules and automatically enforce the rules through their deployment. As long as the rules are programmed into the protocol, and the smart contract ingests accurate data, the smart contract deployment will produce a certified output. Smart contracts also can be crafted to communicate with other smart contracts, which may increase the output possibilities. The platform's product development team should work with commercial lawyers versed in blockchain technology to assure that their smart contracts align with the parties' legal commitments.

12. If the platform is paid cash by a buyer, then how can the platform reconcile that payment with the automatic royalty embedded in a smart contract? Most likely the platform would need to include the confirmation cash payment as an input in the data feed to the smart contract in order to trigger payment of the royalty via the smart contract.

13. What is a sales agent's role in a smart contract where the platform does not mint the NFT and the smart contract already exists? This would depend on the protocol for the smart contract. One could program a smart contract to give the platform the temporary holding of an

asset as an intermediate step.

## Transfer of the NFT

14. If the sales platform does not mint the NFT or if, after minting, the NFT is not transferred to the platform, how can the platform be sure that title will transfer to the buyer? An NFT will not transfer payment to the seller until title to the NFT is transferred to the buyer on the blockchain.

15. Does the platform need to take title in order to transfer possession? No. As in the case of physical goods, the platform can conduct the sale process, notify the seller and the winner of the result of that process, and the seller can transfer the NFT to the buyer. The platform does need to have, however, the contractual ability to force the seller to fulfil its obligation to transfer possession.

16. Can a platform possess an NFT without owning it? While it is possible that an NFT could provide this capability in its terms, that would be highly unusual.

17. One reason why a sales platform takes possession of physical art is to make sure that the seller doesn't sell it to someone else. Is there a way to do this without taking title to the NFT? An NFT can have only one owner at a time, so the only way to be sure of avoiding the classic "double spending" risk is to own the NFT. That said, there may be other, better, ways to achieve this goal; e.g., by contract with the seller or the use of escrow accounts to guarantee transfer by the seller.

18. Can the platform add to the blockchain that the platform was involved in the sale as agent without taking title to the NFT? Yes. The platform can become part of the NFT's provenance in this way.

19. Is there any need for a platform to consider compliance with securities laws, commodity laws or banking laws with respect to its role in the transfer of funds in the sale process? Yes, but, depending on how the transaction is structured, it should be possible for the platform to avoid these issues by involving third parties that possess the correct regulatory qualifications. Because of unmanageable regulatory burdens, the platform will rightly wish to lawfully avoid characterization of its activities as securities brokerage or exchange operation or a money service business.

20. Are you sure about that? We heard that NFT art is a 'utility token' and that the SEC has no jurisdiction over utility tokens. SEC jurisdiction is unclear and the consequences of being secondguessed by the SEC are severe. Calling a token a "utility token" does not make it one. The function rather than the label is what matters. Consult with expert legal counsel.

## AML

21. What are the anti-money-laundering laws and related issues that pertain to NFT sales? The Global Financial Action Task Force published guidance in March 2021 that has an impact on decentralized finance markets and NFTs that should be considered. Some of the key AML considerations for a platform relate to enhanced regulations in the US, EU and UK that

expand AML requirements to dealers in art and antiquities. In addition, the platform should be considering the application of such regulations to crypto assets, exchange providers and wallet providers. Under these enhanced regulations, activity involving exchange, security, and utility tokens are brought within the AML rules. From a regulatory standpoint, this may include obtaining appropriate registrations and making required disclosures and interfacing with the applicable Financial Intelligence Units. From a compliance standpoint, this may include the development of policies and procedures (including Know-YourTransaction and Know-Your-Customer Procedures), risk assessments, training, suspicious activity investigation and reporting. As noted above, it is possible in some circumstances to avoid these sorts of obligations by partnering with an entity that has all the correct licenses and does all the necessary checking.

## Warranties

22. What warranties on NFTs should a sales platform provide? Platforms will want to minimize the warranties that they will make. If there is a warranty, it should be procured from the consignor, the creator or other providing party, as applicable.

23. What warranties related specifically to the NFT should a platform obtain from a seller? Warranties of title, authenticity, and continuing existence of the digital image, as well as non-infringement, and other standard warranties in the sale of goods, especially for art pieces and collectibles, should be procured from the seller.

## Confidentiality

24. Can the identity of a buyer of an NFT on the blockchain be kept confidential? There is no reason why a seller or a buyer cannot maintain the confidentiality of her, his or its identity, but so far most NFT marketplaces maintain the right to require an entity to prove its ultimate identity even while permitting the entity to transact business confidentially on the platform.

## Future Resale Royalties

25. How should the platform address artist-imposed future resale royalties (to the artist) in its sales agreements and conditions of sale? NFTs that provide for future resale royalties will automatically pay out future resale royalties to their creators when they’re sold. Royalty systems differ for each marketplace, though, such that this issue needs to be reviewed on a marketplaceby-marketplace basis.

26. Is this part of the NFT software code, such that any future buyer contracts to pay the artist the royalty? A transfers within the same blockchain will trigger a payment from the buyer to the artist.

27. Does the platform need to get involved in collection of these royalties or enforcement of the terms? No. It’s automatically handled by the blockchain.

28. How does an artist know when a transfer has occurred and thus a payment is due to the

artist? Because the artist is identified in the NFT, notification to the artist (and payment) is automatically handled by the blockchain.

29. How would the platform handle the royalty if the winning bidder paid in fiat currency rather than crypto currency? Initial sales will not incur a future resale royalty. If the platform brokers a “secondary market” sale within the same blockchain, then payment of the resale royalty should happen automatically, without the need for the platform to get involved. A buyer desiring to use fiat currency to make a purchase would need to deposit that money into a suitable crypto wallet to make the purchase.

30. If the NFT is transferred to the platform before sale, will that trigger the resale royalty or any other conditions in the NFT? What happens if there is no sale? The answers will depend on the conditions coded into the NFT, but it would be unusual for a transfer not to trigger conditions. Unless a separate agreement with the original NFT holder was negotiated, the platform would incur the condition obligations, even on no sale, if the NFT were transferred to the platform’s wallet.

## Sale Cancellation

31. What commercial laws apply to the sale of an NFT? There are significant uncertainties about what substantive law will govern the sale. UCC Article 2 governs only sales of tangible property. Digital art is not tangible. Courts sometimes apply Article 2 by analogy, but even then most provisions of Article 2 can be overridden by express contract terms. The alternative to Article 2, in the United States, is state common law, which again can largely be overridden by express contract terms. Furthermore, courts applying the UCC and the common law have increasingly applied principles of good faith, fair dealing, conscionability and commercial reasonableness to avoid results that seem (to the particular court) unfair or harsh. This suggests that sale contracts in the NFT art area should be drafted with extraordinary specificity and reasonableness.

32. Technologically speaking, what could happen that might require an NFT art sale to be unwound? Because the Ethereum blockchain is decentralized, it’s highly unlikely that there will be a total shutdown of the platform. Possible counterfeiting or hacking of smart contracts or wallets are genuine concerns. As with any work of art, we would expect that the principal concerns of a buyer would be that what it purchased was not the authentic, original work, or that multiple originals were or could be created. The usual supposition is that blockchain technology precludes these problems, but we would advise not indulging in that supposition in view of the rapidity of technological developments. We counsel protection against these risks.

33. For example, can the NFT be corrupted? This is a computer engineering question, not a legal one. The uniqueness of each NFT is said to be incorruptible, but again we counsel caution.

34. What happens if the platform that possesses the NFT files into bankruptcy? There are multiple risks associated with a platform going bankrupt. For example, a bankruptcy court could find that the NFT is or is not “property of the estate,” depending upon the applicable contract language between artists and the platform, with consequences either way. A court could also face challenges with valuing the NFT to the extent the platform requires debtor-in-possession financing throughout the case, which could put the platform at a disadvantage when negotiating with the DIP lender. The murkiness surrounding valuation can also pose

challenges to claims valuation and administration. Finally, given the opacity of the NFT market and the court's likely unfamiliarity with it in general, it is possible that a bankruptcy filing would subject the platform's directors, officers and other key principals to greater scrutiny than they would experience in a typical bankruptcy proceeding. Several platforms have gone into bankruptcy. Cred, Inc. is one that is currently in bankruptcy proceedings. Some of these risks can be managed by careful drafting of the sale contract. One bankruptcy risk of grave concern in this situation is that the bankrupt site's obligations to the buyer could be deemed "executory contracts" that could be rejected in the site's bankruptcy. Of note, licensees of copyrights are not given the protection against such treatment that the Bankruptcy Code gives to licensees of other types of intellectual property.

35. What are the mechanics of NFT sale cancellation? To delete an NFT, one would "burn" it to remove it from the blockchain. But this would remove the NFT entirely. If a sale were to be cancelled while preserving the existence of the NFT, then, if the new owner has already been recorded, one would need to execute a "cancellation" on the blockchain (potentially via smart contract) in order to change the record of ownership. This is primarily an issue to be dealt with in the terms of the contract.

36. If a buyer pays a USD purchase price in ETH, and if the sale is cancelled three years later and if ETH has become worthless, how will participants account for the change in value? We would draft the contracts such that the seller would be obligated to return the sale proceeds in the fiat currency of the relevant sales jurisdiction in an amount determined by using the exchange rate prevailing at the time of sale.

## Remedies

37. In the event of a dispute over the NFT, does the blockchain nature of NFT art mean that the current owner can pursue the artist rather than the sales platform? If the buyer is given cancellation rights, or warranties, then the contract should state precisely what the remedy will be. But under common law principles there could be questions about whether the remedy provided for is "reasonable," particularly in these circumstances.

38. Can a sales platform's terms and conditions of sale protect the platform from possible involvement in a dispute over the NFT? There are two scenarios to consider here: Either (1) the platform facilitates a transaction over an existing, public blockchain (e.g., Ethereum) or else (2) the platform uses a proprietary blockchain that it has created. In the former case, the platform is only tangentially involved and carefully drafted terms and conditions can limit its liability, likely making it immune from disputes about an NFT. In the second case, it is unlikely that the platform would be able to fully avoid being drawn into a dispute over an NFT minted on the blockchain, since it created the blockchain. Even in the latter case, though, it is likely that the platform's liability would be limited to structural issues pertaining to the blockchain.

## Insurance

39. What role does insurance play with respect to the sale of NFTs? Insurance coverage opportunities for NFTs will develop over time, but it will be bespoke coverage or no coverage for the near future.

40. Should a platform expand its liability insurance for risk of loss to the NFT as it usually would do with conventional art? No. We expect that the platform could eliminate or significantly reduce its liability for loss because there’s no tangible object and because the risk of loss due to custody issues should be minimized or eliminated through the use of blockchain -- or at least we would credibly argue that it is eliminated.

We hope that our answers to these forty legal questions will be useful to artists and to platform developers and operators, but this FAQ is not legal advice to anyone. As is evident from the variety of legal questions arising in the fledgling NFT industry, not one but several fields of law are implicated: copyright law, commercial law, technology transfer, securities, commodities, banking, insurance, tax and other specialties. Artists and platform teams should engage teams of legal counsel who are experts in these fields -- and who also are experienced with crypto assets -- to advise them regarding their particular circumstances and plans.



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