

NFTs and Rights Clearance: Due Diligence, Transfer of Rights, NIL, Terms of Service

TUESDAY, APRIL 19, 2022

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Today's faculty features:

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Meet the Speaker



Andy Lee

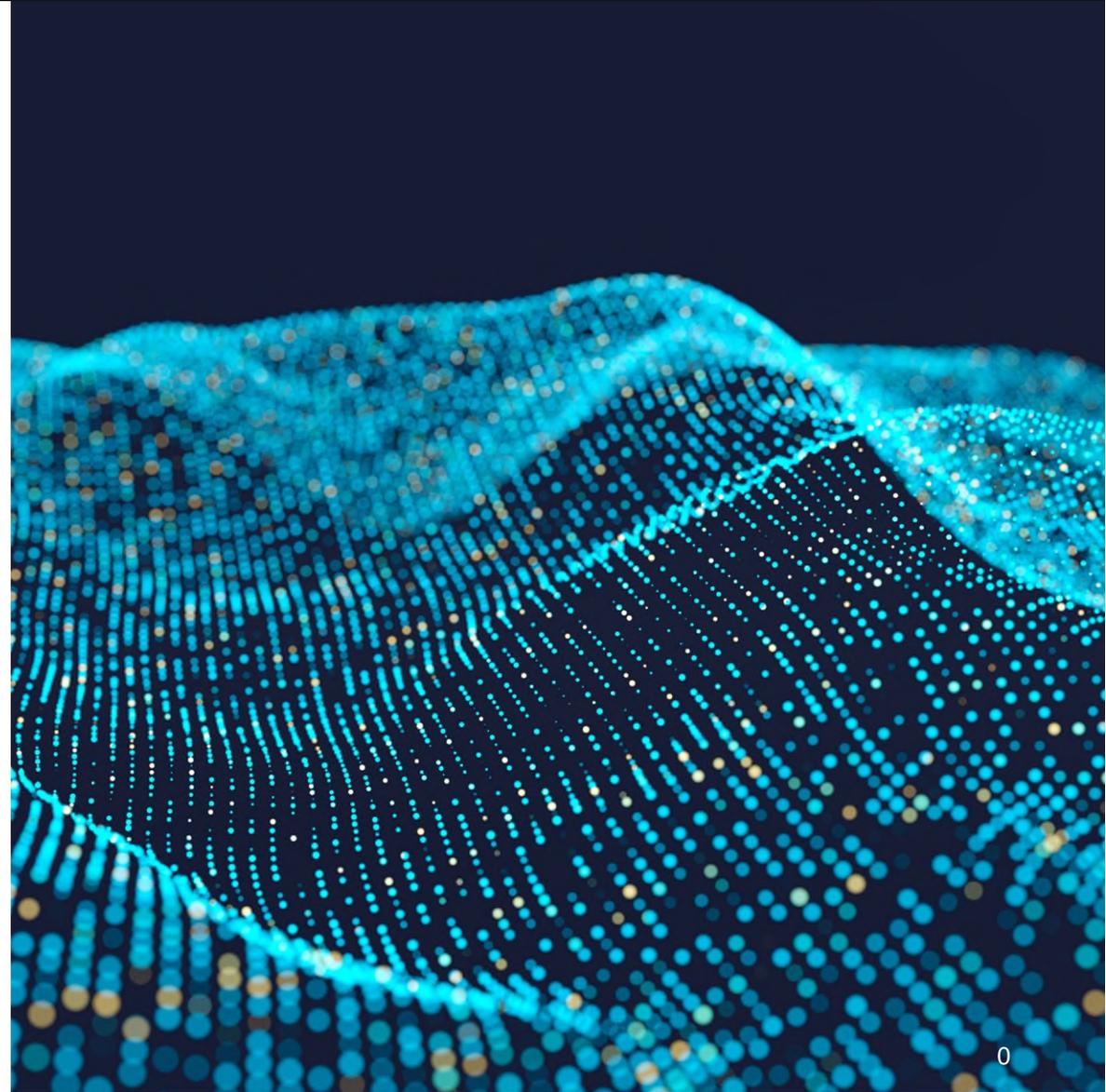
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Andy Lee helps to lead Foley & Lardner LLP's NFT Task Force and has more than 20 years of experience working in-house and serving as an outside advisor to the sports, technology, media, and entertainment industries.

His NFT practice includes advising prominent artists, musicians, platforms, and investors in connection with partnerships, regulatory compliance, IP issues, platform launches, and NFT drops.



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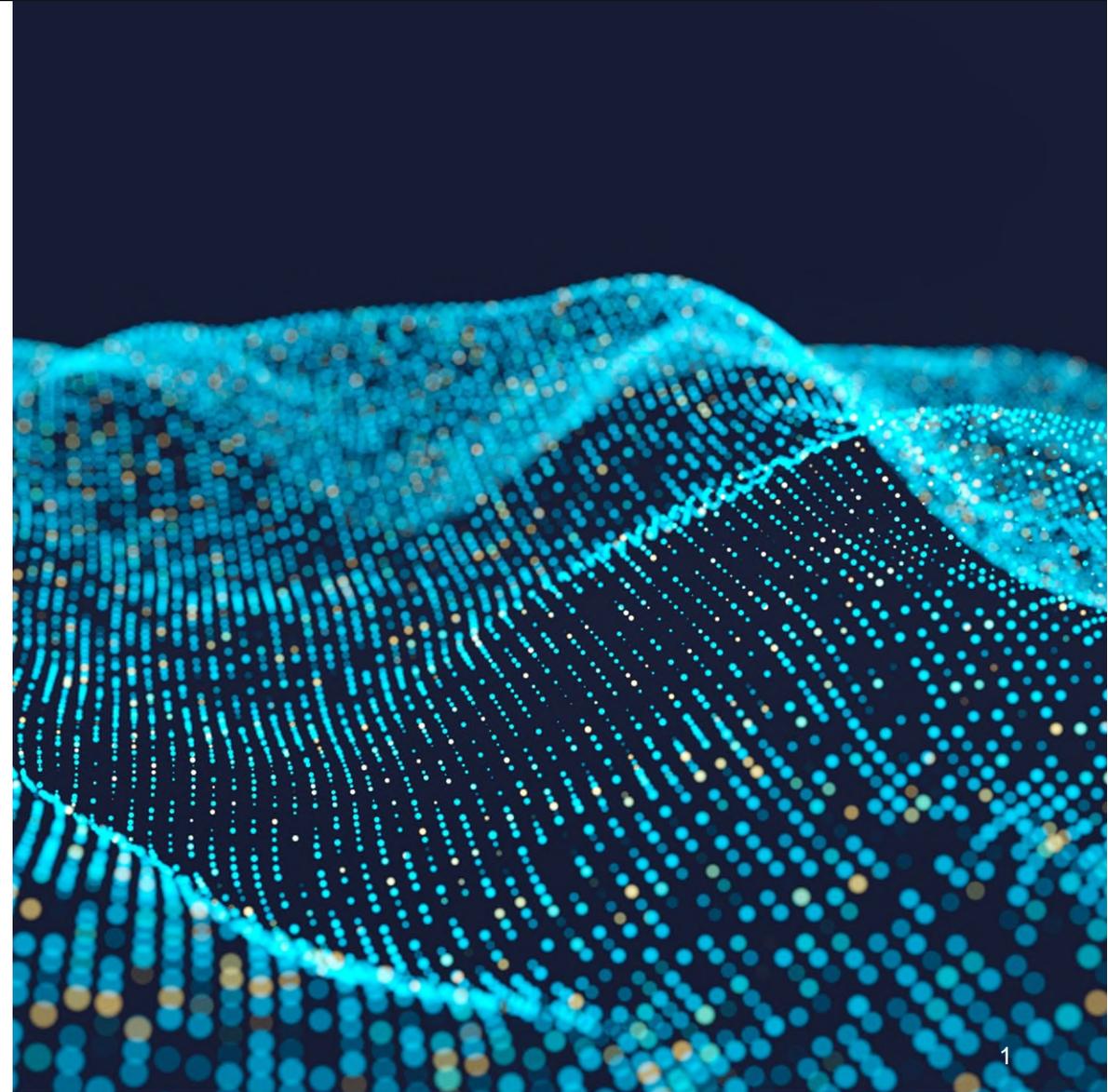
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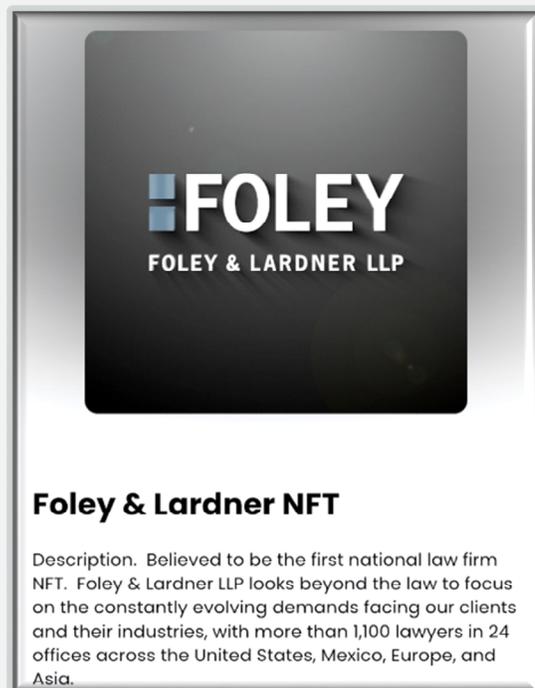
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What is an NFT?



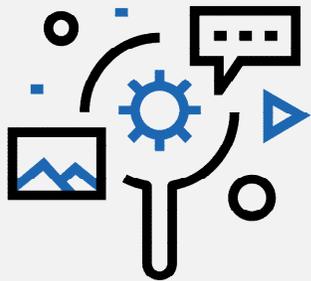
Above is an NFT that was created by Foley & Lardner LLP team members during a live demonstration of the technology.

- NFT is short for **Non-Fungible Token**.
- NFTs are non-fungible because they are unique tokens (representing digital assets) that cannot be interchanged with other tokens.
- When an NFT is minted (created) the NFT is recorded onto the blockchain. Due to the nature of blockchain, NFTs contain immutable data stored across a distributed ledger. This means that no one can unilaterally modify the record of ownership associated with an NFT, nor can anyone make another copy of an NFT.
- Each NFT is unique, incorruptible, unfalsifiable, and indestructible, eliminating the need for outside authentication of assets like artwork or other collectibles.
- Primary Types of NFTs: PFP, Utility, Security & Governance

Why Are They Such a Big Deal?

- NFTs have transformed the creator economy by enabling creators to benefit from resale transactions after the “first sale.” Popular NFTs are more than just images, including community features, “real-life” benefits, and “air drops.”
- NFTs are already important in the growing metaverse (virtual reality world). Last summer, **Coca-Cola** minted a virtual puffer jacket NFT (listed for \$2.4 million) which can be worn in Decentraland, an open-access 3D VR platform. In September 2021 and April 2022, Foley & Lardner LLP assisted the Utah Jazz in the launch of their Jazz NFT program, JAZZXR, which combines the franchise’s first-ever digitally designed non-fungible token (NFT) with access to a unique live experience with Jazz icons.
- The market for NFTs has exploded over the last year, with trading volume reportedly topping \$15 billion in October:
 - Christie’s Auction House sold an NFT by the artist **Beeple** for \$69 million.
 - DJ and crypto-enthusiast **3LAU** sold 33 music-based NFTs for \$11.7 million.
- Over the summer, **OpenSea** (an NFT marketplace) raised \$100 million with a \$1.5 billion valuation; recent reports are that the company is now fielding investment offers based on a \$10 billion valuation.
- **Coinbase**, a cryptocurrency exchange platform, recently announced that it will be launching its own peer-to-peer NFT marketplace, where users can mint, purchase, showcase, and discover NFTs.

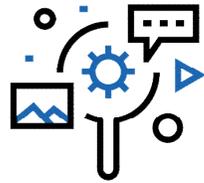
NFT Project Genesis Events



- Legal Analysis
- Corporate Formation
- Documentation

Case Study:

Fractionalization in the Music Industry



- Emerging trend towards using NFTs to fractionalize rights in music and other creative, revenue-generating assets.



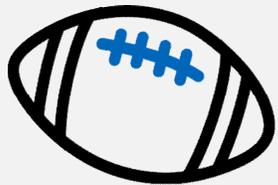
- Efforts to create platforms for artists to use NFTs to monetize their music directly, through fans and without record labels standing in the middle.



- Selling fractional shares of the copyright to a song, or just a share of the royalty/revenue streams from the song, as NFTs.

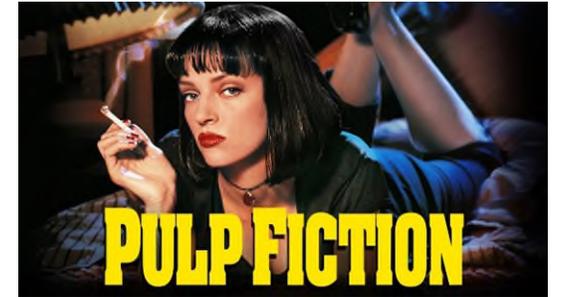
Case Studies:

Collectibles in Sports, Media, & Entertainment



Miramax v. Tarantino

Miramax suing to stop Quentin Tarantino from selling NFTs that include images of his original 'Pulp Fiction' screenplay.



Friel v. Dapper Labs

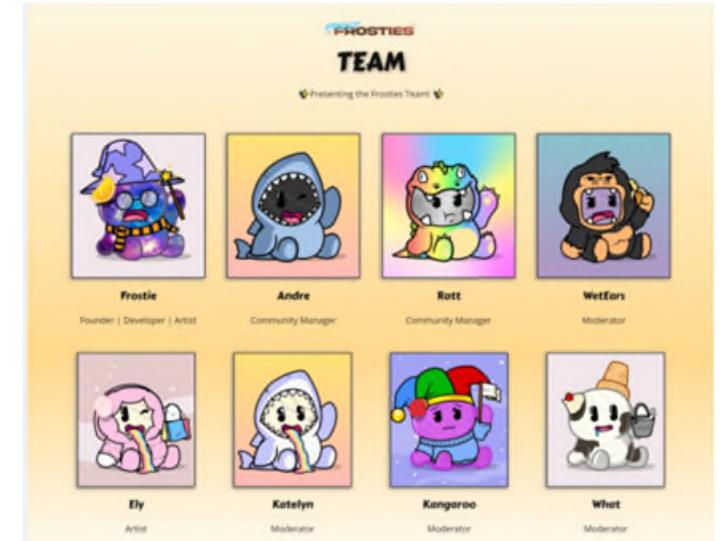
Class action lawsuit asserting violation of securities laws in connection with the issuance of the NBA Top Shots.



“Rug Pull” Charges: USA v. Frostie & heyandre



- Fraud and money laundering charges in connection with alleged “rug pull” NFT projects.
- Grand jury subpoenas to Discord, Coinbase, Charter Communications, Citibank, GoDaddy, T-Mobile, and PayPal led authorities to the defendants based on IP addresses.



- The Frosties NFT project promised various utility functions for its NFTs, such as giveaways, holder rewards, future mint passes, staking, metaverse gaming, breeding functions, and other things.
- The 8,888 NFTs sold out in 48 minutes and 356.56 ETH allegedly was transferred out of the project through various wallets to the defendants.
- The project was shut down within hours and the defendants allegedly began planning a second rug pull.

Where Are Things Heading?

- **Biden Administration Executive Order**

Four main policy concerns: (1) consumer & investor protection, (2) global market stabilization, (3) mitigation of illicit & dangerous activities, and (4) maintaining U.S. primacy in global finance and technology, while directing federal agencies to submit reports and make recommendations over the next year.

- **SEC Scrutiny or Guidance**

Growing public perception of NFTs as investments, actions by bad actors, plus evolving structures of NFT issuances will lead to SEC scrutiny and/or guidance.

- **Smart Legal Contracts**

Types of “smart legal contracts” in NFTs are likely to evolve to encompass transactions more sophisticated than collectibles with secondary market commissions.

- **NFT Bubble**

If (when) the NFT bubble bursts, a flurry of litigation and legislation will follow, which may shape the NFT landscape over time.

- **Web3**

Decentralization is the future — DAOs and less “sexy” NFTs as well as blockchain technology in general will become more prevalent and begin to influence day-to-day life.

- **Evolution of the Law**

Existing areas of law will need to be adapted and applied to NFTs and other blockchain technologies.

Meet the Speaker



Daniel Barsky, Partner

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Daniel Barsky is an intellectual property attorney in Holland & Knight's Miami office. Mr. Barsky regularly represents clients in intellectual property (IP), information technology (IT) and data-related licensing and transactional matters, including mergers and acquisitions (M&A), private equity transactions, joint ventures, and multilateral and multinational licensing agreements.

Mr. Barsky's clients call upon him to navigate complex transactions involving IP, IT and data assets. He assists and advises clients with navigating the complexities of transactions involving intangible assets such as patents, trademarks, copyrights, trade secrets and data, brand licensing and distribution agreements, blockchain technology such as cryptocurrency and non-fungible tokens (NFTs), software and technology licensing agreements, and transition services agreements.

NFT Structure – Required Elements

- To understand the rights implicated by NFTs it is important to understand what comprises an NFT.
- ERC-721 is the most popular NFT standard at this time (exists on the Ethereum chain).
- ERC-721 has only a handful of requirements:
 - **Token ID**: a unique identifier for each token within a specific contract, generated upon the creation (minting) of the token, and does not change over time;
 - **Contract Address**: a blockchain address that can be viewed from anywhere using a blockchain scanner (the smart contract will be viewable at the Contract Address); and
 - **Token Owner**: which blockchain address owns a particular token.
- A single smart contract (Contract Address) can spawn multiple NFTs, but each NFT will have a unique Token ID. There will be only one of each combination of Contract Address and Token ID.

NFT Structure – Required Elements

- That's it!
- On the basic requirements of the ERC-721 NFT there are no intellectual property issues – no patents, copyrights, trademarks, or trade secrets.
- The real issues arise when you start addressing the optional elements of an NFT and implications associated with the underlying items associated with or represented by the NFT.
- Any NFT can be located and inspected with only two pieces of information: the Contract Address (which allows a user to locate and read the smart contract that underpins the NFT) and the Token ID (which
- The optional elements of an ERC-721 NFT become important when evaluating ownership rights, rights clearance, and investments and transactions.

NFT Structure – Optional Elements

- Will focus discussion on ERC-721 (there are other NFT standards, both on other blockchains and on Ethereum itself).
- The ERC-721 standard allows for a number of optional functions of an NFT, such as:
 - **Token Controller**: the owner of an NFT can specify a single other address to control that specific NFT;
 - **Account Operator**: an account (wallet) holder can specify one or more Operators for all tokens held by that account (wallet);
 - **Name**: a description of the token type defined by a specific smart contract;
 - **Symbol**: a short name for all NFTs issued under a specific smart contract (like a stock ticker symbol);
 - **Token URI**: a function that returns a Uniform Resource Identifier for each token. Unlike a Token ID *this can change over time*.
 - **Total Supply**: the number of tokens allowed by a specific smart contract.
- There are other, technical optional functions (that get even deeper into computer coding than we already are...)

What operations are permitted?

- There are only three operations (transactions) that are permitted for ERC-721 NFTs:
 - **Transfer Token**: gives ownership of the NFT to another account (wallet);
 - **Approve Address**: sets or removes the NFT Controller; and
 - **Set Approval for All**: adds or removes an Operator.
- There are no other operations that are performed – or even permitted – with an ERC-721 NFT!
- Note there are some pretty obvious missing functions/features missing from the standard, such as:
 - Liens/Security Interests;
 - Fractional Ownership; and
 - Derivatives.

Types of Rights at Issue

- Given that there are only three mandatory elements for a typical NFT they can be used for a variety of purposes across the major categories of intellectual property:
 - Patents;
 - Trademarks/Service Marks;
 - NIL/publicity;
 - Copyright; and
 - Trade Secrets.
- The structure of, and limitations to, NFTs create a number of issues that need to be addressed.
- But keep in mind that there are multiple NFT standards, and new standards may be created in the future to address some of these issues.
- Key takeaway? ***Know the standard that governs the NFTs at issue and understand that standard.***

What an NFT is Not...

- **The underlying asset itself.** Think of an NFT like a record of a deed for real property, not the real property itself. The recorded deed shows the world who owns the real property (ownership), the chain of title for the real property (transfer history), and can include additional language such as restrictions, easements, and future conveyances (akin to smart contract language). But the recorded deed is not the real property itself, just like an NFT is not the underlying asset itself.
- **Limited in number.** While NFTs are non-fungible, they are not limited in number like some cryptocurrencies, such as bitcoin. The only limits on NFT creation are the creativity of individuals and the computational limitations of a chosen blockchain.
- **Representative of a unique asset.** Each NFT itself may be unique but the underlying asset an NFT represents may not be unique. For instance, outside the technical limitations of a chosen blockchain, there is nothing to prevent an artist from creating one million NFTs representing one million copies of the same piece of art.

NFT – Key Rights Considerations

- What are you actually getting?
 - Ownership?
 - License?
- It is critically important to check the underlying asset – the smart contract.
 - Knowing the address of the smart contract is critical because it allows a full review of the smart contract.

Case Study – The Bored Ape Yacht Club



Case Study – The Bored Ape Yacht Club

- Let's take a look at the Smart Contract for a popular NFT – The Bored Ape Yacht Club...

```
1  /**
2   *Submitted for verification at Etherscan.io on 2021-04-22
3   */
4
5   // File: @openzeppelin/contracts/utils/Context.sol
6
7   // SPDX-License-Identifier: MIT
8
9   pragma solidity >=0.6.0 <0.8.0;
10
11  /**
12   * @dev Provides information about the current execution context, including the
13   * sender of the transaction and its data. While these are generally available
14   * via msg.sender and msg.data, they should not be accessed in such a direct
15   * manner, since when dealing with GSN meta-transactions the account sending and
16   * paying for execution may not be the actual sender (as far as an application
17   * is concerned).
18   *
19   * This contract is only required for intermediate, library-like contracts.
20   */
21  abstract contract Context {
22      function _msgSender() internal view virtual returns (address payable) {
23          return msg.sender;
24      }
25
26      function _msgData() internal view virtual returns (bytes memory) {
27          this; // silence state mutability warning without generating bytecode - see https://github.com
28          /ethereum/solidity/issues/2691
29          return msg.data;
30      }
31  }
32  // File: @openzeppelin/contracts/introspection/IERC165.sol
33
34
35
36  pragma solidity >=0.6.0 <0.8.0;
37
38  /**
```

Case Study – The Bored Ape Yacht Club

- That doesn't look like a traditional contract...
- So what is it?
- “Smart Contracts” are not classical contracts in the lawschool sense.
- Smart Contracts are snippets of code that perform certain functions (in this case, minting a Bored Ape Yacht Club NFT).
- The Bored Ape Yacht Club Smart Contract is written in a programming language named Solidity, which is required for ERC-721.

```
63  pragma solidity >=0.6.2 <0.8.0;
64
65
66  /**
67   * @dev Required interface of an ERC721 compliant contract.
68   */
69  interface IERC721 is IERC165 {
```

Case Study – The Bored Ape Yacht Club

- The entire Bored Ape Yacht Club Smart Contract is 2,021 lines of code.
- **Nowhere** in any of those lines of code is intellectual property or intellectual property ownership addressed.
- To determine what rights are involved, who owns which rights, and the relationships between the seller of the NFT, the buyer of the NFT, and any third parties who may also hold rights in a component of the NFT you need to find and analyze documents exogenous to the NFT, the Smart Contract for that NFT, and often times outside the blockchain itself.
- We'll discuss these issues a little later in the program.

NFTs and Patents

- There are multiple ways NFTs interact with patent rights:
 - New technologies (such as new NFT standards) could be patentable (subject to compliance with 35 U.S.C. § 101 and *Alice*).
 - Patents could be ‘tokenized’ and traded as NFTs on the blockchain.
 - Use of patent-related NFTs to track patents.
 - Use of NFTs to fractionalize patent ownership.
- There are many questions and pitfalls:
 - It is unclear what utility using NFTs and the blockchain to track patents holds: the USPTO’s patent assignment database is online, freely available, easily searchable, and regularly updated. In some ways this is a solution seeking a problem.
 - Fractionalization of patent ownership could result in securities concerns.
 - U.S. patent applications are normally kept secret for at least 18 months after filing; items on the blockchain are open and freely viewable.
 - Publication of inventions on the blockchain can implement timing considerations for filing new patent applications.

NFTs and Trademarks/Service Marks

- Some key considerations for trademarks and service marks as NFTs on the blockchain:
 - Rights clearance on the blockchain and metaverse.
 - What are the specific goods and services classes that should be used for the metaverse?
 - When does use of a brand as an NFT constitute “use in interstate commerce” sufficient to support a mark application?
 - Interoperability.

NFTs and NIL/Publicity

- NFTs present interesting opportunities for name, image, likeness (NIL) rights and rights of publicity.
- NFTs make it easy to mint a person's NIL into tokens for sale and trading, such as use as trading cards.
- Key consideration = ensure that the person has properly granted permission for use of their NIL in a token.
- When representing an individual negotiating NIL and publicity tokens it is important to negotiate, and properly document, exactly what use is approved and what use is not.
- Policing appropriate use can be problematic.

NFTs and Copyrights

- Copyright is one of the key areas where NFTs interact with intellectual property law.
- There are multiple considerations:
 - Who owns the original artwork (if any) involved in the NFT? Were those rights properly assigned to the entity that minted the NFT?
 - What rights are transferred from the creator of the NFT to the purchaser? Are there any limits on those rights?
 - Is the NFT itself subject to copyright protection?

NFTs and Trade Secrets

- Trade secrets and NFTs probably do not mix well.
- There is an inherent tension between trade secrets and blockchain: one derives its value from not being generally known to the public while the other derives value from being fully public and open to inspection.

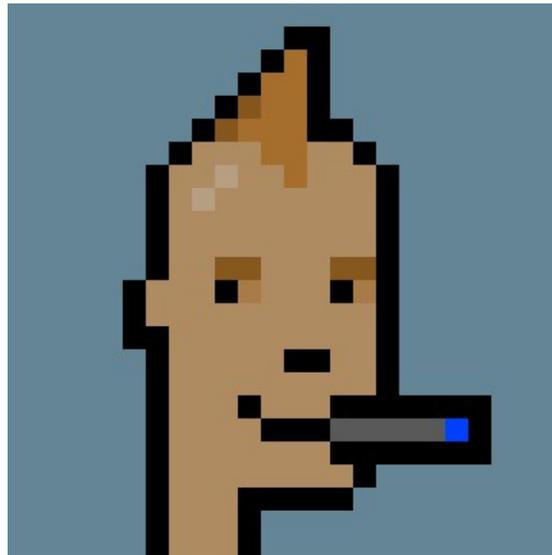
NFTs **Do Not** Alter Intellectual Property Law

- It is critical to remember that NFTs do not alter intellectual property law!
- If the law requires that transfers of ownership be recorded (such as at the United States Patent and Trademark Office or United States Copyright Office) then simply transferring an NFT will **not** satisfy the requirement of the law.
- NFTs also do not alter work-for-hire law and how ownership of intellectual property transfers from a creator to the purchaser.
- A number of issues can arise between the official chain of title (as shown by various intellectual property offices) and the unofficial chain of title (as shown by the blockchain).

Considerations in Transactions

- NFTs raise a number of new and unique issues to consider in transactions.
- One of the key issues is figuring out what rights are implicated in any transaction (whether buying, selling, or making an investment).
- Figuring out who owns what can be much more difficult than it would first appear.
- Why? The blockchain is supposed to make ownership easy to determine!
- True, but, practical considerations mean key steps in an ownership chain are often not documented (or not documented well), steps were skipped, and overall general sloppiness in the 'origin story' of an NFT.

Case Study - CryptoPunks



Case Study - CryptoPunks

- CryptoPunks were launched in June 2017.
- In May 2019, someone made the following post in a Discord channel:

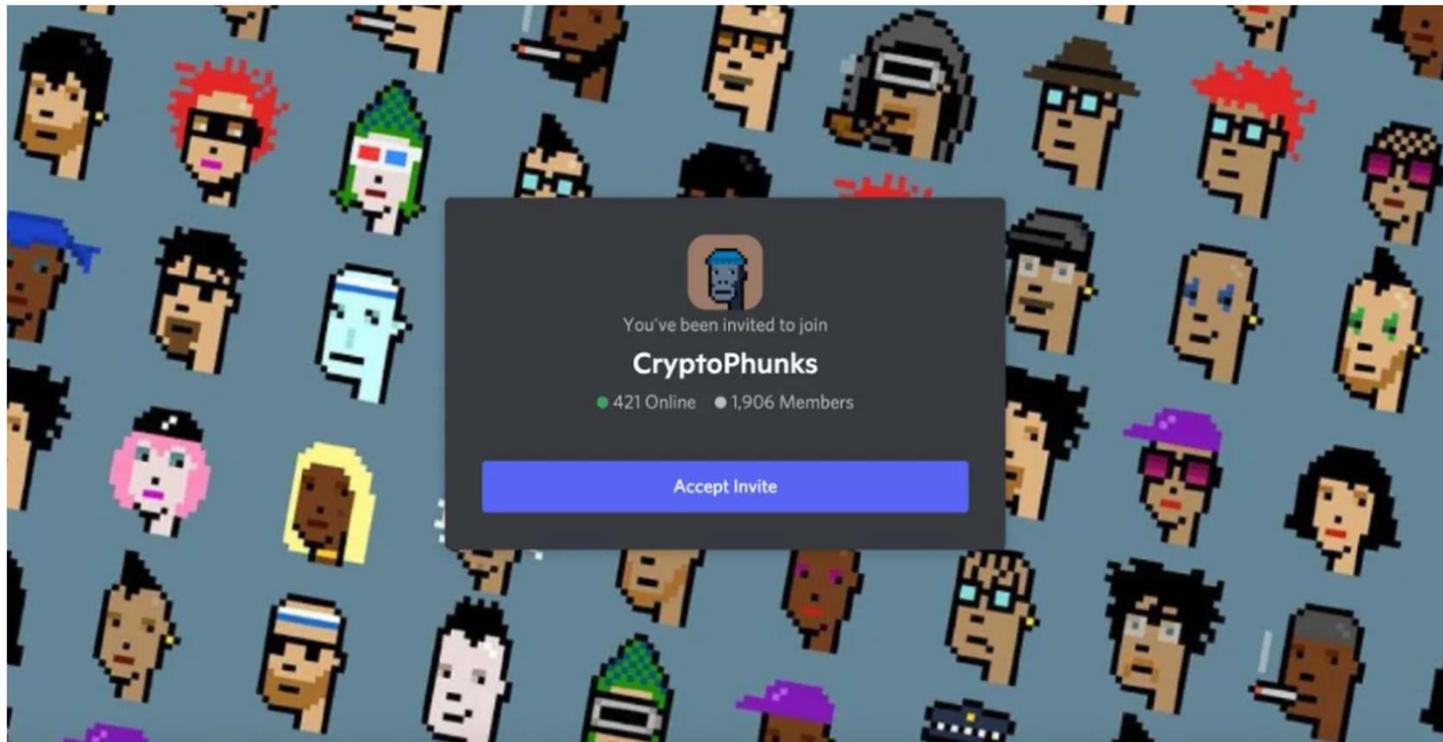


Case Study - CryptoPunks

- Almost two years after launching the collection, someone (who purports to be the creator of CryptoPunks), makes a unilateral decree that the license terms to CryptoPunks has been changed.
- Was that Discord post sufficient to change the license terms in CryptoPunks? And what were the license terms before the post?
- It is not clear! Nobody is certain as to the original license terms of the CryptoPunks NFTs.
- The original license terms were not placed on the blockchain.

Case Study - CryptoPunks

- Why did this become a problem?



Terms and Conditions in NFTs

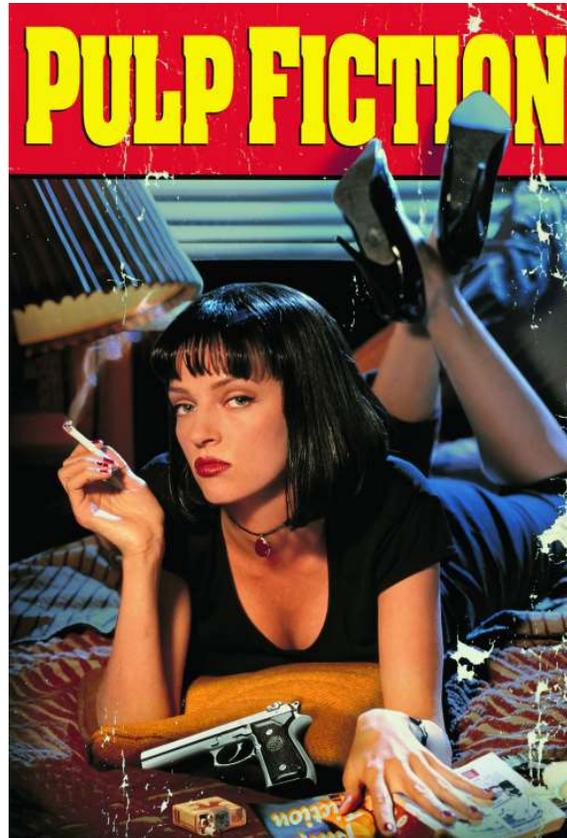
- It is important to review terms and conditions (and any other documents that you might be able to find) when reviewing an NFT deal.
- Often, the terms and conditions do not match public perception...

OWNERSHIP

i. You Own the NFT. Each Bored Ape is an NFT on the Ethereum blockchain. When you purchase an NFT, you own the underlying Bored Ape, the Art, completely. Ownership of the NFT is mediated entirely by the Smart Contract and the Ethereum Network: at no point may we seize, freeze, or otherwise modify the ownership of any Bored Ape.

ii. Personal Use. Subject to your continued compliance with these Terms, Yuga Labs LLC grants you a worldwide, royalty-free license to use, copy, and display the purchased Art, along with any extensions that you choose to create or use, solely

Other Issues – Rights Allocated Before NFTs Existed



Considerations for Artists and Creators

- Artists/creators need to consider how to address IP rights in NFTs in similar ways
 - Sell all or some of the rights?
 - Sell none of the rights and give a license instead?
 - Segment rights for different purposes?
 - Seek payment on all resales?

Artists and Creators

- Resale Royalty
 - With NFTs that track ownership and transactions on the publicly available blockchain, artists and creators can continue to be compensated when their work is sold and re-sold
 - This can be automatically done with Smart Contracts that trigger payment automatically when art is re-sold
 - Resale percentages vary widely between 5% and 20%

Securities Issues

- What is a security? Stocks, notes, bonds, “**investment contracts**”
- *SEC V. W.J. Howey Co.* – test for determining what constitutes an “investment contract” (the “**Howey Test**”).
 - (1) an investment of money
 - (2) in a common enterprise
 - (3) with the expectation of profits
 - (4) derived from the entrepreneurial or managerial efforts of others.

Securities Issues

- *Friel v. Dapper Labs, Inc.* – S.D.N.Y. – 1:21-cv-05837
 - Class action complaint alleging that defendants “promoted, offered, and sold securities” by selling NBA Top Shot Moments NFTs without registering the NFTs as securities
 - Complaint alleges that Dapper Labs created its own blockchain and its own “Flow Token” cryptocurrency
 - Dapper Labs allegedly partnered with the NBA to create NBA Top Shot built on the Flow blockchain
 - NBA video highlights are minted as NFTs (called “Moments”), creating a unique digital asset recorded on the Flow blockchain created by defendants
 - The owner of a Moment does not acquire intellectual property rights or rights to the underlying highlight

Securities Issues

- *Friel v. Dapper Labs, Inc.* – S.D.N.Y. – 1:21-cv-05837
 - The Complaint alleges that the Moments are investments because they constitute an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others
 - The Complaint alleges that investors purchased a Moment and could only sell Moments to purchasers on the same marketplace, but investors could not get their money out
 - Case is still in the pleading stages (Operative Complaint filed on December 27, 2021)