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Media, Entertainment and Technology Litigation Update – Non-Fungible Tokens (NFTs) – April 2021

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Each month, Gibson Dunn's Media, Entertainment and Technology Practice Group highlights notable developments and rulings that may impact future litigation in this area. This month we focus on the increasingly popular digital asset known as non-fungible tokens or "NFTs" and related issues in the entertainment space and beyond.

Issue: Non-Fungible Tokens (NFTs)

Summary: NFTs have gone mainstream in what some have called a new "gold rush." An NFT sold for almost $70 million at a Christie's auction last month, NFTs of basketball video highlights have generated hundreds of millions of dollars in sales on the NBA Top Shot platform, and NFTs even were the subject of a skit on a recent episode of Saturday Night Live. Some consider them a fad or a bubble, citing the almost $600,000 sale of an image of an animated flying cat with a pop-tart body that anyone can download from the internet for free. But in one form or another, NFTs are here to stay. Even if the market matures and interest wanes in some unconventional pieces of digital art, NFTs will continue to offer a significant potential revenue stream for artists and entities in the film and television, music, and online gaming industries, among many others. We highlight below some of the emerging legal and policy issues related to NFTs, which include intellectual property law, profit participation issues, securities law, and even climate change.

What do the music group Megadeth, former University of Iowa basketball player Luka Garza, and New York City track and field center The Armory have in common? In the span of 24 hours earlier this month, each of them entered the rapidly expanding NFT market. They joined a number of artists and entertainers who have led the charge in selling NFTs. As film studios and other entities with large content libraries consider following suit, they will need to consider a number of deeply rooted legal issues against a relatively new technological backdrop.

I. Background

There are widely varied understandings of NFTs and related issues concerning tokens and blockchain technology. While many of our readers are familiar with these terms, a brief introduction is helpful to frame the issues that follow.

A. What are NFTs and What is the Blockchain?

An NFT, or "non-fungible token," is a unique unit of data stored on a public ledger of transactions called a blockchain. The unique data could represent an image, an electronic deed to a piece of property, or a digital ticket for a particular seat at a sporting event. In contrast to these "non-fungible" tokens, cryptocurrencies such as Bitcoin and Ether—just like U.S. dollars, British pounds and other "fiat" government-issued currencies—are

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fungible; one penny in your pocket has the same intrinsic value as the penny under your couch cushion.

Today, NFTs generally reside on the Ethereum blockchain, which also supports, among other things, the cryptocurrency Ether—the second largest cryptocurrency in terms of market capitalization and volume after Bitcoin. While other blockchains can have their own versions of NFTs, right now Ethereum is the most widely used (though NBA Top Shot uses the Flow blockchain).

But what is a blockchain? As noted above, it is an electronic database or ledger showing a history of transactions. Each transaction is represented by an entry into the electronic ledger and multiple ledger entries are ordered in data batches known as "blocks" to await verification on the network. New blocks are added after the current block reaches its data limit. The blocks are connected using cryptography: each block contains a "hash" (a sort of coded electronic signature linking it to the previous block), which is how the blockchain gets its name.

A key feature of the Ethereum blockchain that distinguishes it from a database one might have at a business or law firm is that the blockchain is decentralized across a community of servers. Data is not stored in any one location or managed by any particular body. Rather, it exists on multiple computers simultaneously, with network participants holding identical copies of the ledger reflecting the encrypted transactions.

That is why blockchains are touted as both verifiable and secure. It is similar to the tracking details showing each step in a package's journey from the shipper to its final delivery destination. Unlike the tracking details provided by a shipping company, however, on the blockchain no one person can alter that record to change the encrypted data without the network's users noticing and rejecting the fraudulent version. And if any one computer system fails, there are duplicate images of the tracking details on the blockchain ledger available on other computers around the world.

B. What Do You Get When You Buy An NFT?

While an NFT is unique, it is important to keep in mind what that unique digital item actually is. In most cases the NFT is a digital identifier recording ownership, not—to borrow an example from the above—the actual image of the pop-tart cat. What amounts to your "receipt" is reflected in the blockchain, but the image file itself resides elsewhere.

This has to do with blockchain storage limitations and costs. The digital image itself theoretically can be stored in metadata on the blockchain, but in the vast majority of cases it is hosted on a regular website or the decentralized InterPlanetary File System (IPFS). The identifier is logged on the blockchain, but if the image is taken down from its non-blockchain location—say, because it violates someone's copyright—the NFT could end up being a unique digital path to a closed door (even if there may be seemingly identical "copies" of the digital asset elsewhere). The immutable purchase record would remain on the blockchain, but the original image might not be viewable.

Almost uniformly, the NFT transfer conveys an interest in a licensed copy while copyright ownership of the underlying image or song is not transferred. The NFT may be in a limited edition and it may have some additional perceived value because it is officially authorized by the copyright holder or originated from the address of the copyright holder. But while the underlying copyright can be transferred when the NFT is sold or licensed, typically it isn't. The terms and conditions of an NFT platform may reveal the limits of what actually is being transferred and how it might be used.

Under NBA Top Shot's terms, for example, the purchaser who obtains a license to a "Moment" cannot use it for a commercial purpose, modify it, or use the image alongside anything the NBA considers offensive or hateful. An NFT platform that controls the image

file is able to remove that file from its platform.

* * *

Monetization strategies for NFTs are constantly evolving, so one cannot generalize and say that all NFTs fall in one legal bucket or another. An NFT can be fair use of a copyright or it can violate it. An NFT likewise could be a simple collectible or it may be offered in such a way to convert it into a security subject to myriad regulations and disclosure requirements. It depends on the NFT. But as the market evolves, complicated questions will need to be answered by NFT creators, platforms, and, potentially, courts.

II. Intellectual Property

Any NFT platform must be particularly focused on the intellectual property rights underlying the NFTs stored, sold, or licensed on the platform. A single NFT may include various copyrightable elements, including a video clip and any accompanying music. Whereas the platform may be able to invoke a statutory liability protection with respect to some potential claims—like defamation—certain intellectual property claims are not precluded.

Specifically, Section 230 of the Communications Decency Act of 1996 shields certain online service providers from liability for hosting content that someone else created. In particular, Section 230(c)(1) states that "No provider or user of an interactive computer service shall be treated as the publisher or speaker of any information provided by another information content provider."

To the extent Section 230 applies to a particular NFT platform, the law's broad protection still has carve-outs. Among other things, it does not apply to "any law pertaining to intellectual property." Courts have different interpretations of the scope of Section 230's reference to "intellectual property." In *Perfect 10 v. CCBill*, 488 F.3d 1102 (9th Cir. 2007), the Ninth Circuit ruled that Section 230 permitted claims under federal intellectual property laws but preempted state intellectual property claims alleging a violation of the plaintiff's right of publicity. In *Atlantic Recording Corp. v. Project Playlist, Inc.*, 603 F. Supp. 2d 690 (S.D.N.Y. 2009), a Southern District of New York court reached the opposite conclusion, holding that the "intellectual property" carve-out extended beyond intellectual property claims under federal law to include state-law claims.

Whether or not an NFT platform would be subject to potential liability for violating someone's state-law right in her or his name and likeness, federal intellectual property law still would apply. And offering an NFT that potentially infringes a copyright could result in liability for the platform if, for example, it does not take the necessary steps under the Digital Millennium Copyright Act. That risk is heightened for some platforms given how easy it is to tokenize someone else's work. Speculators can turn any digital image into an NFT that they can then try to sell, even if the original creator does not agree to that use or even know about it.

Studios and other intellectual property rights holders will need to be especially vigilant in protecting their intellectual property—and NFT platforms likewise will need to promptly remove content if a copyright owner notifies it of an infringement—as the market for small pieces of content expands.

III. Profit Participations

Especially in the current NFT environment, it is not difficult to imagine the potential value of tokenized iconic moments from movies and television. Of course, there would be a number of contractual issues for a rightsholder to navigate, which would vary from deal to deal. Valuable clips might come from movies dating back long before the advent of NFTs, the internet, or even computers. The relevant agreements certainly would not address

NFTs, but even analogous provisions might be difficult to identify. Agreements may refer to “clips,” for example, but typically a clip is used to promote the full program or film rather than to be monetized on its own.

Depending on what it depicts, an NFT might not be a “clip” at all. Again using NBA Top Shot as an example, a “Moment” is not just a short video excerpt showing a pass or dunk; it is a package of on-court video, still photographs, digital artwork, and game information. Contracts would need to be analyzed to determine if the NFT should be categorized as a clip, a derivative production, merchandising, promotional material, or something else, with potential consequences on the calculation of gross receipts and any corresponding rights to profit participations or Guild royalties.

Exclusivity provisions in film or television licenses to third parties might bar or limit a studio from “minting” an NFT from a work in its library. Other considerations might also limit a rightsholder’s willingness to enter the NFT space. With vast libraries of well-known and high?quality content, however, studios are better positioned than most to take advantage of the increased interest and marketability of discrete portions of a film or program.

IV. Securities Law

Particularly in light of the SEC’s increased focus on cryptocurrencies, including its recent lawsuit accusing Ripple Labs Inc. and two of its executives of engaging in an unregistered “digital asset securities offering,” anyone involved in marketing an NFT should give careful consideration to whether the NFT is a security under U.S. law.

This should be of particular concern to the celebrities marketing their own NFTs. Several years ago, in response to celebrity endorsements for cryptocurrency Initial Coin Offerings (ICOs), the SEC warned that “[a]ny celebrity or other individual who promotes a virtual token or coin that is a security must disclose the nature, scope, and amount of compensation received in exchange for the promotion.”[1] A failure to do so would be “a violation of the anti-touting provisions of the federal securities laws.”[2] The same principle would apply to NFTs, with the key question being whether an NFT is a security. This issue has significant bearing on the NFT platform as well. If an NFT is a security, the offeror must follow securities law disclosure requirements and restrictions on who may invest.

The term “security” in U.S. securities laws includes an “investment contract” as well as other instruments like stocks and bonds. Both the SEC and federal courts often use the “investment contract” analysis to determine whether unique instruments, such as digital assets, are securities subject to federal securities laws.

To determine whether a digital asset has the characteristics of an investment contract, courts apply a test derived from the U.S. Supreme Court’s decision in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). Under that *Howey* test, federal securities laws apply where

1. there is an investment of money or some other consideration,
2. in a common enterprise,
3. with a reasonable expectation of profits,
4. to be derived from the efforts of others.

Again, it would depend on the NFT, but transactions that resemble a fan buying a collectible likely would not be securities under this test. The notion that an NFT is non-fungible also makes it less likely to be a security.

Nevertheless, the NFT market is a creative one. Many NFTs, for example, are configured through the “smart contracts”—which are essentially computer programs—to automatically pay out royalties to the digital artwork’s original creator with every future sale of the NFT on that platform; the artist could package those royalty rights for sale to potential investors.

NFT issuers also can sell fractional interests in NFTs or groups of NFTs. As prices for some NFTs climb into the stratosphere, this approach becomes more appealing to potential buyers who want a piece of the NFT but are unwilling or unable to pay for the whole thing. According to recent statements by SEC Commissioner Hester Peirce, however, doing so increases the likelihood that the NFT would be deemed a security under the *Howey* test.[3] That likelihood grows where the NFT issuer or a third party claim to be able to help increase the NFT's value.

V. Climate Change

A major issue that has arisen related to NFTs— and cryptocurrency generally—is their believed effect on the environment. Articles abound comparing the energy consumption of the Ethereum blockchain to entire countries. An analysis by Cambridge University asserts that what it calls the "Bitcoin network" uses more energy than Argentina.[4] NFTs thus have proven somewhat controversial, with one online marketplace for digital artists dropping its plans to launch an NFT platform after backlash that included an artist labeling NFTs an "ecological nightmare pyramid scheme."[5]

Some contend that these ecological concerns are exaggerated and misleading, noting that NFTs themselves do not cause carbon emissions. As one platform wrote in a recent blog post, "Ethereum has a fixed energy consumption at a given point of time."[6] The carbon footprint of the Ethereum blockchain would be the same if people minted more NFTs or stopped minting them altogether. But even the post acknowledges that "[i]t is true that Ethereum is energy intensive."[7]

The crypto energy consumption issue relates to how blockchain technology currently operates. To validate a transaction—and engender trust in a system that is not backed by any central bank or other government authority—the blockchain network relies on a method called "Proof of Work." The hashing function described above that allows the blocks to be chained together requires complex mathematical equations that only powerful computers can solve. "Miners" must solve these equations to add a new block to the chain. As incentive to solve the mathematical puzzles, the miner receives a reward of new tokens or transaction fees.

The energy costs to complete the hash functions under the Proof of Work model can be high, with miners using entire data centers to compete to solve the puzzles first and garner the reward. To mitigate any environmental effects, mining sites may increasingly rely on renewable energy and "stranded" energy, which is surplus energy created, for example, by excess power that some hyrdroelectric dams around the world generate during rainy seasons.

Another option, at least for the Ethereum blockchain, is moving to a "Proof of Stake" model. Rather than relying on miners using significant amounts of electricity in a race to solve an equation the fastest, the Proof of Stake model involves validators of transactions who are assigned randomly via an algorithm. These validators also have to commit some of their own cryptocurrency, giving them a "stake" in keeping the blockchain accurate.

Reports indicate that Ethereum may move to the Proof of Stake model as soon as this year.[8] Doing so would decrease energy consumption associated with NFTs, allow more transactions per second than in the Proof of Work model, and seemingly remove (or at least mitigate) an apparent drag on the willingness of some to embrace NFTs.

At the same time, one recent article noted what a crypto-mining finance company executive called the "'inherent security issue of using the native tokens of a blockchain to decide the future of those tokens or the blockchain.'"[9] If the value of the tokens fall, the value of a validator's stake falls along with it. The validator then has less to lose if they decide to propose an incorrect transaction or otherwise misbehave.

VI. Conclusion

NFTs present significant opportunities for content creators and owners, but they also present novel legal and policy issues across a wide range of areas as the technology continues to evolve. Beyond those listed here, areas of potential concern include Commodities/Derivatives, Tax, Data Privacy, and Cross-Border Transactions. Understanding the potential complications of moving into the NFT space is a necessity in anticipation of the regulatory scrutiny and litigation that often follow similar explosions of interest and investment.

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[1] https://www.sec.gov/news/public-statement/statement-potentially-unlawful-promotion-icos (Nov. 1, 2017).

[2] *Id.*

[3] https://cointelegraph.com/news/sec-s-crypto-mom-warns-selling-fractionalized-nfts-could-break-the-law (Mar. 26, 2021).

[4] https://www.bbc.com/news/technology-56012952 (Feb. 10, 2021).

[5] https://www.theverge.com/2021/3/15/22328203/nft-cryptoart-ethereum-blockchain-climate-change (Mar. 15, 2021).

[6] https://medium.com/superrare/no-cryptoartists-arent-harming-the-planet-43182f72fc61 (Mar. 2, 2021).

[7] *Id.*

[8] https://www.coindesk.com/ethereum-proof-of-stake-sooner-than-you-think (Mar. 17, 2021).

[9] https://cryptonews.com/exclusives/proof-of-disagreement-bitcoin-s-work-vs-ethereum-s-planned-s-9788.htm (Apr. 3, 2021).

The following Gibson Dunn lawyers assisted in the preparation of this client update: Michael Dore and Jeffrey Steiner.

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