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PERSPECTIVE

Legal issues to watch in navigating the secondary market for NFTs

By Michael Dore

For many in the art world, “flipping” is something of a dirty word. Buying a piece, only to turn around and sell it in the secondary market for a quick profit, risks creating a speculative bubble for that artist’s work. The price shoots higher and higher, even before a young artist has had their own solo gallery show, let alone an exhibition in a museum. For most artists the price soon falls precipitously, the artist’s market is burned, and it is a struggle for them to build a long-term financially successful career. As this all plays out in the secondary market, the artist has no control over the piece once it is sold to the first buyer and, under U.S. law at least, the artist does not make a dime from its subsequent sales.

One of the great appeals of non-fungible tokens — or “NFTs” — is that in theory they can be designed to provide some protection for the artist after the work is first sold. Unlike the brick-and-mortar art world, flipping in the NFT space is generally expected. The blockchain technology provides a transparent history of transactions and prices paid, with pieces sometimes sold within minutes of their prior sale. But unlike a work on canvas or other tangible media, an NFT can have a resale royalty right for the creator embedded in its code. As the piece moves from new owner to new owner, the creator may receive a percentage cut of each transaction, benefitting from a run-up

in price even if a decline may eventually follow.

At least that is what NFT artists might expect after reading most reporting surrounding the digital tokens. Separating the technology’s reality from its promise is more complicated. NFTs provide their creators with unique and seemingly unprecedented control over the artwork in the secondary market. That power creates significant new opportunities for copyright owners to monetize and control their intellectual property. It also has less-discussed limitations and potential vulnerabilities. Many of these nuances are reflected in computer source code that an average purchaser may not readily understand. This makes it all the more important that an NFT platform plainly and transparently explain how NFTs work in order to limit potential claims under false advertising and unfair competition statutes, for example.

Limitations on Royalties

An NFT is a unique unit of data stored on a public ledger of transactions called a blockchain. Most NFTs are part of the Ethereum blockchain, though there are others, including the Wax blockchain and the Flow blockchain. NFTs are stored on the blockchain through what is called a “smart contract,” which essentially is a computer program that is capable of running automatically according to pre-set functions.

The most common standard used to create NFT smart contracts is known as ERC-721, with “ERC” standing for Ethe-

reum Request for Comment. It provides basic functionality to track and transfer NFTs. ERC 721 uses a computer programming language known as Solidity to implement the smart contract on the Ethereum blockchain platform.

A creator has a great deal of freedom in configuring the smart contract that manages the NFT, but the existing ERC-721 standard has some limitations. Of particular significance here, the standard does not include uniform code for programming a royalty. As a result, an NFT created based on that standard may be limited in what royalty it can provide the creator.

When creating an NFT on a particular platform, the creator generally can decide the amount of a royalty they should receive with each secondary sale. But that royalty typically only is paid when the work is sold on that same platform. The platform royalty payment implementations are not easily compatible with the other platforms and they do not carry over across the entire NFT platform ecosystem. So if someone creates (or “mints”) an ERC-721 NFT using Platform A, they can program the NFT’s smart contract to pay the creator a percentage royalty every time the NFT is subsequently sold on Platform A. If a buyer moves the NFT to Platform B and sells it there, the creator does not get a royalty.

Programmers are working to address this incompatibility across platforms. For example, some have proposed EIP-2981, with “EIP” standing for Ethe-

reum Improvement Protocol. That new standard would extend ERC-721 to enable setting a royalty amount to be paid to the NFT creator or rights holder with each sale. Its proponents argue that it would allow for standardized royalties to be accepted on all marketplaces. But even this single royalty payment standard would be voluntary.

Various companies separately are seeking to implement an ecosystem-wide solution for resale royalties. Given its importance to creators and the platforms that cater to them, a widely adopted solution could arrive soon. In the meantime, however, NFT platforms should be clear to artists and other users about when an NFT creator will be paid a royalty and when they may not be in order to avoid accusations that the platform misled its users.

The Power to Control the Fate of the Work

The computer programming underlying NFTs gives their creators unprecedented power to control the disposition, and even continued existence, of their work.

To start with, it is important to note that an NFT typically is the unique digital identifier and smart contract corresponding to an image, but not the image itself. It is technologically possible to include the image in the blockchain, but very expensive and rarely done. Thus, in certain cases the artwork corresponding to the NFT can be changed.

For example, the digital art-

ist known as “Neitherconfirm” documented how he minted NFTs that originally showed computer-generated portraits before he then swapped in photos of ordinary floor rugs. The “immutable” NFT — that is, the token identifier and smart contract — remained the same. The linked image was now very different. Neitherconfirm later tweeted, “I am the artist, my decision, right?”

His image-switch showed how a token can be distinct from the artwork that someone may think they are buying. It is an important point for NFT platforms to convey and buyers to understand. Someone could tokenize a tweet, sell it as an NFT, and then delete the tweet, leaving the buyer with a set of numbers reflecting a unique token ID (similar to a receipt) but potentially no actual image to show for it. Perhaps more understandably, a platform could delete an image associated with an NFT that a purchaser is using in violation of terms of service — for example, using the image associated with the NFT to engage in hate speech. But that retained power held by the NFT creator raises thorny questions about ownership and what the NFT purchaser is actually “buying.”

Responding to NFT Theft

Like most things, an NFT can be stolen. For example, one could steal a password to a digital asset wallet, offer that person’s NFT for sale, and pocket the money. The NFT then might continue to be sold to innocent buyers downstream. An interesting question is how a platform should respond when that happens.

Discussions of NFTs often cite the “immutability” of the blockchain. But smart contracts are extremely versatile, and while one cannot modify an NFT on the blockchain it is possible to effectively make it disappear. The Solidity programming language for ERC-721 tokens can include a “selfdestruct” command that renders the smart contract inoperable. Some artists already have experimented with “burning” tokens to increase the scarcity (and price) of the remaining pieces.

The Cadence programming language used on the Flow blockchain seems to have the same capability. The Central Smart Contract for NBA TopShot available on Github.com states, for example, that “NFT’s can be destroyed.” As noted above, a platform that controls the image associated with the NFT also could change it — say, to a photo of

a rug — thereby devaluing the NFT.

At least in some circumstances, then, the platform that helped create an NFT could respond to an NFT theft by destroying it. But should it? If caught quickly enough, doing so could prevent the thief from profiting from their misbehavior. At the same time, the creator (and any platform that takes its own cut of sales in the secondary market) would lose out on royalties from future sales because the NFT would be taken out of the market. It is a fraught choice that artists and art dealers have never had to consider before.

Conclusion

In many ways, the plane is being built in mid-air. Concrete statements about what an NFT can or cannot do, and even what it is, have the potential to mislead. The technology is evolving, and NFTs present opportunities and risks with which the art world and others have never grappled before. Just this month, a new attack called “sleepminting” gained attention when an artist named Monsieur Personne configured a smart contract to falsely make it appear that the digital artist Beeple had created a second edition of an NFT that recently sold for almost

\$70 million at auction; with its false provenance, Monsieur Personne could then try to sell the NFT for the millions of dollars that Beeple’s work now commands.

Of course, the issues described here are not comprehensive. They are not necessarily permanent either, as the technology surrounding NFTs continues to evolve. Even if terms of service must be revised, however, NFT platforms should continually strive to be current and transparent about the variability of NFT technology. This will help minimize the risk of lawsuits by artists and other users who could end up with frustrated expectations and empty wallets both real and virtual.

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