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Protecting IP and Limiting Liability When Licensing IP for Digital Art and NFTs

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Many things are being tokenized, but the growth of NFTs for digital art is booming. This, in part, is due to the recent headline news that Beeple's iconic digital art work was sold at auction by Christie's for \$69 million. Other digital art is being created to leverage pre-existing IP and physical art. This boom is creating great opportunities for IP owners who want to license their IP for use in NFTs. However, for those just entering the space, there are many things to consider given some of the unique aspects of NFTs and digital art.

The IP owners that may capitalize on this NFT boom can include:

- brands that have famous trademarks, logos, and other brand identifiers;
- game companies that have unique characters or game art
- book, movie, and other publishers that have unique characters and other IP;
- artists and celebrities who have created physical or digital works;
- other IP owners

When licensing IP rights for use in digital art and other NFTs, it is important to be clear what is and what is not being licensed. The scope of the license should be limited to particular purposes. Various other limitations may also be appropriate. For example, a creator may grant rights to create a specified number of NFTs associated with a copyrighted work, in order to maintain the scarcity (and associated value) of the NFT based on such work.

Other examples to consider include imposing limitations on:

- modifications of the IP or the art in which it is included;
- what can be combined with the IP-based art; and
- where and how the NFTs are distributed.

Considerations relevant to each of these potential limitations is set forth below.

What Could Possibly Go Wrong? NFT Lawsuits and Legal Disputes

The art of drafting effective licenses requires an understanding of what can go wrong and doing what can be done to address these possibilities in the license agreement. The following are some of the NFT-related lawsuits and disputes that have arisen. These legal issues should be of interest to both NFT marketplaces, as they formulate their Terms of Service, and NFT creators as they design their licenses. For many of these issues, we have included concise guidance on how companies should consider addressing these issues.

1. **Insider trading**—an Open Sea executive resigned for trading NFTs on non-public information, leading to Open Sea developing an NFT insider trading policy.

Guidance: NFT marketplaces and NFT creators should develop and enforce written NFT insider trading policies. The Open Sea issue is just one of the many issues that companies should consider in developing an NFT insider trading policy.

2. **IP Ownership Disputes**

Copyright

- Miramax sued Quentin Tarantino over who has the right to create *Pulp Fiction* NFTs
- Roc-A-Fella sued Damon Dash to stop NFT sales relating to Jay-Z's debut album, *Reasonable Doubt*; Roc-A-Fella says Dash has 1/3 stake in the company, but it owns the album

- NFT site HitPiece was accused of selling NFTs of songs by musicians like Britney Spears and Taylor Swift without permission.
- TamarindArt sued for the right to make an NFT of a 60-foot-long physical mural it purchased from the artist in 2002 for \$400K. The artist's estate alleged that such NFTs would be copyright infringement.
- The Gathering card game, sent an email to mtg-DAO alleging that the DAO's intention to launch a series of NFTs based on Magic constitutes copyright infringement.

Trademark

- Nike Sued StockX for selling Vault NFTs (proof of ownership) of limited-edition Nikes that include an image of the sneaker in question
 - Hermès sues the creator of an NFT collection resembling Birkin bags alleging it has no right to make and sell art that depicts the bags.
 - Nintendo sued the maker of an unauthorized NFT gambling game which used Super Mario assets.
Guidance: It is imperative to conduct IP clearance to ensure that the NFT creator owns or has rights to any third-party IP used in the NFT. A Marketplace TOS should include appropriate representations and related provisions.
3. **Right of Publicity (NIL)**—Many popular gaming YouTubers have had their likenesses stolen and turned into NFTs.
- Lil Yachty sued Opolous for utilizing his name and likeness to make an NFT without his consent
 - ItsBlockchain offered an NFT package based on the likeness of 46 infocore pioneers without their permission. They were soon shut down and in defense alleged “We were not aware of the likeness laws in NFTs as the market is not regulated.”
Contrary to their belief the market is subject to applicable laws and regulations.
Guidance: As with other types of rights, it is imperative to ensure that the NFT creator owns or has rights to any third-party IP used in the NFT, including any name, image, and likeness rights.
4. **License Disputes**
- One of the most popular NFTs, Crypto Punks, has created user concerns due to the uncertainty over the terms of the applicable license.
Guidance: NFT creators can adopt a variety of licensing models, but that model needs to be clearly set forth in an NFT license and that license must form a valid contract.
5. **Title Slander**
- Free Holdings sued Artist Kevin McCoy and Sotheby's over the 2014 artwork *Quantum* (the

first-ever NFT minted in May 2014, which sold at auction for \$1.47 million during Sotheby's 'Natively Digital' auction), alleging that Free Holdings was the actual owner of the NFT.

Guidance: Conduct proper diligence to ensure actual ownership.

6. **Unjust Enrichment**

- Kim Kardashian and Floyd Mayweather, among others, were sued for allegedly promoting a Crypto “scam.”
Guidance: Anyone endorsing an NFT should ensure that they conduct proper diligence and in many cases disclosure of paid endorsements is necessary.

7. **Ill-conceived NFT Ideas Lead to Consumer Backlash**

- ArtStation, a popular website for video game artists to share their work, said it would open up a market to buy and sell NFTs until thousands of artists slammed the decision on Twitter and threatened to delete their accounts. ArtStation backtracked, apologizing and saying in a statement that it hoped “at some point in the future we'll be able to find a solution that is equitable and ecologically sound.”
- A well-known video game company decided to hold back on their plans for NFT content after fan outrage on social media criticized the move. See “Sega Rolls Back NFT Plans After Negative Fan Reaction,” Sheehan, Gavin at bleedingcool.com.
Guidance: Consider the impact that creating NFTs will have on your existing business before you decide to take the leap.

8. **Fraud**

- Blockverse was an unofficial Minecraft NFT game, which offered a play-to-earn model with access restricted to those who owned a relevant token. It offered an initial supply of 10,000 NFTs priced at 0.05 ETH each and reportedly sold out in less than eight minutes. But just a couple days later, the project's creators deleted their website, Discord server, and game server, and disappeared with the money.
- Evil Ape offered “Evolved Apes” NFTs, which were intended to be a character in an NFT fighting game where NFT owners would pit their apes against one another in battles for cryptocurrency rewards, but one week after Evolved Apes went live, the head of the project vanished, taking 798 Ether (worth roughly \$2.7 million) with them.
Guidance: The amount of NFT-related fraud is increasing. According to some reports, over 80 percent of NFTs minted for free on OpenSea are fake, plagiarized,

or spam. Many NFT Discord channels are allegedly flooded with criminals using NFTs to scam individuals. More stringent diligence is advised.

Limitations on Modifications and Combinations

In some cases, licensors may wish to limit or exercise control over modifications of the IP as used in the art and/or modification of the IP-based art itself. Also, it may be advisable to consider limitations on what can be combined with that art.

To understand the potential need for limitations on modifications and combinations, it is important to understand the range of options that exist with certain forms of NFTs (*e.g.*, digital art). Failure to consider these options may result in granting rights that are too broad and permit your IP to be modified or combined with other content in ways that you may not want associated with your IP.

Layered Art

For example, one cool feature of NFT-based digital art technology is layered art. This technology enables a single work to include multiple layers of art, each created by a different artist. Each layer may be tokenized and owned by a different entity. And the work as a whole can also be tokenized and that token can be owned by yet a different entity. Due to this feature of digital art, you should consider the scope of the license you grant to prevent art based on your IP from being associated with works that you find undesirable. For example, without appropriate limitations, your licensee may create one layer of such a work based on your IP, while other layers may include offensive materials or other content that you would not want associated with your IP.

Programmable Art

Another interesting genre of digital art is programmable art. Programmable art may be autonomous or not. In either case, the art is programmed to change based on certain triggers. In a simple case, the work may have two fixed layers and the art may change from one layer to the other based on some fixed event. In this simple example, one layer may be presented during the day and the other at night. In this scenario, there are two fixed layers that are alternately displayed. However, programmable art can be much more complex and can morph a single image in various, sometimes random ways. In some cases, programmability can modify or distort the

image. This, too, could lead to some undesired representations of your IP.

Generative Art

Yet another form of digital art is referred to as generative art. Generative art uses AI or other algorithms to create or modify art. In some cases, an artist specifies some of the inputs or starting points for the art, then the algorithm takes over. Depending on the effect of the algorithm, if generative art is based on your IP as an input, this too could lead to some undesired representations of your IP.

Collaborative Art

Another form of digital art that is becoming more popular is collaborative art. This is a form of art where many individuals contribute to a single piece of art. Layered art (discussed above) is one way that collaborative art is being created. However, in some cases the art is much more openly collaborative in a crowd-sourced manner. See for example Dada. Due to the open nature of contributions to collaborative art, this too could lead to unintended consequences for your IP if the licensee contributes to such a work with art based on your IP.

Without sufficient knowledge of the digital art landscape, and the ever-evolving tools and techniques, it is difficult to effectively draft licenses that protect your IP from undesirable modifications or combinations. When licensing your IP for digital art or other NFTs, it is important to understand the potential ramifications of these and other technologies. Simply granting a license to use your IP in one or more NFTs can be risky. While that may seem like a limited license, without other appropriate limitations, it may be a lot broader than you intend. Depending on the intended use, licensors should consider including language in their license to protect against potentially undesired outcomes.

License Revenue Models

Another unique and advantageous aspect of many NFTs is the ability for creator and/or licensor to collect a fee not just when the NFT is originally sold but each time it is resold as well. This capability can be implemented through smart contracts. Smart contracts typically comprise autonomous code that is associated with a token and manage the sale and resale of the token. They can be programmed to automatically transfer a portion of the sale and resale to a designated digital wallet. To take advantage of this capability, licensors should make sure the license is properly worded to cover a royalty or revenue share for the initial sale and each resale.

Liability Avoidance

While the upside of licensing IP for NFTs is appealing, there can be potential liabilities as well. For example, various potential legal liabilities may arise based on how and where the NFT is sold. Most of the well-known NFT platforms are mindful of and address these issues. However, without appropriate limitations, licensees may use alternative distribution methods that are not necessarily regulatorily-compliant.

Securities Laws—Fractional Ownership and Pooling

Most NFTs that are associated with a single work and individually sold are not likely to be deemed a security under U.S. securities laws. However, various sales techniques are being used that may implicate securities laws. One technique is fractional ownership. In this scenario, ownership of a single work (or group of works) is represented by multiple tokens with different owners. This enables many people to share ownership of a single work. Depending on how this fractional ownership is structured this could constitute a pooled interest.

According to another technique, multiple artists may pool together a collection of their independent works, tokenize that collection and share in the proceeds from sale and resale of the token.

In both of these scenarios, depending on how the fractionalization or pooling of interests is structured, securities law issues may arise. The seminal case on whether a token offering is subject to securities law is the *Howey* case. This case dealt with a pooling of assets (orange groves) and a sharing of the collective proceeds. Other scenarios that can raise securities include pre-sales and NFTs that include a revenue-sharing right. Whether the foregoing techniques raise securities law issues must be decided on a case-by-case basis, considering the totality of facts and circumstances of the particular offering. However, prudent licensors can include language in their licenses to NFT creators that can help prevent or mitigate any such liability.

Money Laundering and Sanctions Circumvention

It is well known that high value art has been used in money laundering schemes and to circumvent sanctions. The record sums being obtained for some NFTs has caught the attention of FinCEN and OFAC. These entities administer the anti-money laundering and sanctions circumvention laws governing these

activities. IP owners should consider provisions in their licenses to address these possibilities.

Requirements for a licensee to ensure compliance with all applicable laws and to indemnify the licensor in the event of breach are common in IP licenses. These requirements are recommended. However, in some cases, it may be prudent for licensors to understand and limit where licensed NFTs will be sold and/or to include language in their licenses to exercise a certain level of control to prevent unwanted scenarios. A certain level of diligence on the distribution methods and/or platforms through which a sale of the licensed work will be sold is advisable.

OFAC recently sanctioned a Latvia-based exchange, Chatex, its associated support network, and two ransomware operators for facilitating financial transactions for ransomware actors. In total, OFAC designated Chatex and 57 cryptocurrency addresses (associated with digital wallets) as Specially Designated Nationals (SDNs). While the designation of Chatex and the other cryptocurrency addresses are itself significant, what is interesting is that these designations appear to be the first time NFTs have been publicly impacted as “blocked property” – as one of the designated cryptocurrency addresses owns non-fungible tokens (NFTs). Because U.S. persons are essentially prohibited from transacting with the individuals and entities associated with the designated cryptocurrency addresses, dealing in those NFTs is prohibited for U.S. persons as well.

Conclusion

The digital art and NFTs markets are, fascinating, growing and will undoubtedly continue to evolve. Many fortunes already have been made. Many more likely will be made. But as with any other big opportunity there are some potential risks and liabilities. The foregoing are just some of the legal issues that should be considered when licensing IP to capitalize on these trends while avoiding or minimizing liability.

Sheppard Mullin’s Blockchain Team includes intellectual property licensing lawyers who focus on helping NFT creators and IP owners protect their intellectual property, avoid claims of infringement and enforce rights when infringement is found.

For an overview of some of other legal issues in these areas, see our articles on art, games and collectibles. Sign up here for our Law of the Ledger blog to automatically receive updates on these issues.

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