

Non-Fungible Tokens: A 2022 Retrospective and a View towards 2023

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The use of non-fungible tokens (“NFTs”) has grown dramatically in 2022 across many different industries, from sports to entertainment to consumer products. This year has also seen the rise of a number “crypto native” companies which will challenge traditional companies in the NFT as well as the metaverse market. NFTs will be a critical part of the infrastructure of the metaverse from identity to tickets; McKinsey estimates the size of the metaverse market to be \$5 trillion by 2030. Despite the dramatic downturn across the crypto sector, the trading volume of NFTs increased slightly: according to DappRadar, NFT trading volume rose from \$24.7 billion in 2021 to \$24.8 billion in 2022 (with almost half of the trading volume, \$12.4 billion in the first quarter of 2022).¹ During 2022, many traditional companies have begun using NFTs, from the NFL using NFTs as tickets for the Superbowl to Starbucks launching a blockchain-based component to its loyalty program, including coffee-themed NFTs that translate into real world experiences.

2022 also saw the dramatic rise of “crypto native” companies, of which Yuga Labs LLC (“Yuga Labs”) is the best known. Yuga Labs launched the Bored Ape Yacht Club (“BAYC”), a collection of 10,000 JPEG images of cartoon apes in 2021 with an initial focus on use as “profile pictures” for social media. Yuga Labs gave BAYC owners the right to commercialize their JPEGs and these owners have created hoodies, t-shirts and, even, wine. Yuga Labs has created a very active community with both virtual and real life events. Less than a year after the launch of BAYC NFTs (in March of 2022), Yuga Labs raised \$450 million at a post-money valuation of \$4 billion in a round led by Andreessen Horowitz. A month later, Yuga Labs launched a metaverse project, Otherside, through the sale of plots of “virtual land,” “Otherdeeds”. The sale of Otherdeeds raised over \$300 million and was so popular that the minting of the Otherdeed NFTs caused the Ethereum network to crash.

A well-known crypto-artist, Pplpleasr, announced a platform, Shibuya, to enable collaborative development and funding of films.² The economics of NFT sales puts traditional entertainment business models at risk. The Web3 technologies permit the swift organization of communities to focus on a particular project, such as a film or a collection of images and, potentially, create larger ecosystems around such projects. NFTs dramatically reduce the cost of interacting with large groups of individuals and permit continuing interactions, such as providing new NFTs and special access to real life events or virtual spaces.

Despite its youth, the NFT market has generated a number of legal disputes, frequently based on copyrights. For example, Shawn Carter (aka Jay-Z) filed a lawsuit against his initial partner, Damon Dash, over the right to make an NFT of the cover of the *Reasonable Doubt* album. In *Roc-A-Fella Records, Inc. v. Damon Dash & Godigital Records LLC*, Jay-Z claimed that the copyrights were owned by Roc-a-Fella Records, Inc., which was not controlled by Damon Dash (he owned only one third of the shares).

The lawsuit was filed in the U.S. District Court for the Southern District of New York and was settled in 2022. In *Miramax, LLC v. Quentin Tarantino*, Miramax sued Quentin Tarantino for breach of contract, copyright infringement, trademark infringement and unfair competition based on Tarantino's announcement of his intent to sell NFTs of seven "exclusive scenes" from the movie *Pulp Fiction*. Tarantino described the NFTs as follows: "The NFT collection contains scenes from the never-before-seen, handwritten screenplay of *Pulp Fiction*, one of the most influencing artworks of modern film. Each NFT consists of a single iconic scene, including personalized audio commentary from Quentin Tarantino."³ Tarantino claimed that the NFTs were based on rights that he retained in his agreement with Miramax. He sold the first NFT for \$1.1 million. The suit was filed US District Court for the Central District of California and the parties announced a settlement to the dispute in 2022, although the terms of the settlement were not disclosed.

Other disputes have been based on trademarks. For example, Hermès, which famously sells high-end Birkin bags, sued digital developer, Mason Rothschild for Rothschild's NFT collection entitled "MetaBirkens," alleging that Rothschild's success in selling the MetaBirkens NFTs arises from "his confusing and dilutive use of Hermès famous trademarks."⁴ Mason Rothschild claimed that his NFTs are protected by the First Amendment. The case, *Hermes International et al v. Rothschild*, was filed in the US District Court for the Southern District of New York, and raises the scope of First Amendment defenses to trademark infringement; ironically, the most influential case in the field, *Rogers v. Grimaldi*, also originated in the US District Court for the Southern District of New York. The case involved a claim by Ginger Rogers that a movie entitled *Ginger and Fred* violated her rights under the Lanham Act. The decision by the Second Circuit Court of Appeals has set the basic standard for the conflict between the First Amendment and trademark law⁵. The *Rogers* court sought to balance the public's interest in preventing consumer confusion with the First Amendment interest in encouraging creative expression. An expressive work does not violate the Lanham Act (1) unless the trademark use has no artistic relevance to the underlying work whatsoever, or, (2) if it has some artistic relevance, unless the trademark use explicitly misleads as to the source or the content of the work. Yuga Labs sued Ryder Ripps and Jeremy Cahen for creating a series of "RR/BAYC" NFTs which are similar to the very well-known Bored Ape NFTs⁶. The suit, *Yuga Labs. Inc. v. Ryder Ripp and Jeremy Cahen*, was filed in the District Court for the Central District of California and is notable because Yuga Labs did not bring any claims for copyright infringement and limited the claims to trademarks, unfair competition, false advertising and similar theories. In its answer and counterclaim, the defendants claims that the RR/BAYC NFTs were meant to be satire and were protected under the *Rogers* doctrine. And they asserted that Yuga Labs did not own the copyright in the Bored Ape NFTs because the NFTs were generated by a computer algorithm which lacked the necessary human authorship for copyright protection and the copyrights were assigned to the purchasers of the NFTs due to the BAYC Terms and Conditions.⁷ Many NFT projects use algorithms to generate the relevant artwork, so this litigation could have broad consequences.

Although NFTs would appear to be unlikely candidates for regulation under the securities laws, they may be offered in a way which would subject them to regulation as securities. Under US law, securities are not limited to what many consider traditional securities such as stocks and notes; the definition of securities in the Securities Act of 1933 (“1933 Act”)⁸ is very broad and includes “investment contracts” which can cover a wide variety of transactions. In the United States, the sale of securities is governed by both federal and state law. Under the 1933 Act, it is illegal to offer or sell securities, unless the offer and sale are made pursuant to an effective registration statement filed with the United States Securities and Exchange Commission (“SEC”) or are exempt from registration under the 1933 Act.

Most of the SEC enforcement actions relating to digital assets are based on the US Supreme Court case, SEC v. W.J. Howey Co. (“Howey”)⁹, which addressed the definition of “investment contracts” in the 1933 Act. In Howey, the Supreme Court defined an investment contract as a “contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party”. The Howey test is flexible and reaches “novel, uncommon, or irregular devices, whatever they appear to be.” The leading decision involving the application of the 1933 Act to digital assets is SEC v. Telegram Group & Telegram Issuer, Inc.¹⁰ and applied the Howey test to the proposed issuance of the Gram tokens. The case was filed in the US District Court for the Southern District of New York, the most respected court for securities disputes. The court decided that the “Gram Purchase Agreements” promising future delivery of the Gram tokens once the TON blockchain launched were part of a “scheme” to issue securities and that the securities law applied to both the Gram Purchase Agreement and would apply to the Gram tokens when issued. The case was settled with the Telegram entities agreeing not to issue the Gram token after they lost a preliminary injunction to the SEC, to pay \$18.5 civil penalty and return \$1.2 billion to its investors.¹¹

Commissioner Hester Pierce (nicknamed “Crypto Mom” for her support of the crypto industry) warned at the Draper Goren Holm Security Token Summit in March of 2021 that: “The definition of securities can be pretty broad” and warned that certain types of NFT sales could be considered securities¹². She reiterated this warning in December of 2021.¹³ More recently, sources have noted that the SEC is investigating certain NFT projects to determine if they should be regulated as securities.¹⁴ NFTs issuers (like other issuers of digital assets) need to consider whether the manner in which the offering is structured would create a risk that it would be considered an “investment contract”.

In addition to the SEC, each state has a securities regulator which enforces state securities laws which are generally similar to federal laws. Recently, the regulators in Texas, New Jersey, Kentucky, and Alabama have issued a cease and desist letter to Slotie, a blockchain based “casino”, for offering NFTs that promised holders shares of casino profits on the basis that they were unregistered securities.¹⁵

Private parties have also made such claims. In 2021, a customer of Dapper Labs, the well-known NFT platform, sued Dapper Labs (also claimed to represent a class of customers) claiming that NBA Top Shots are securities¹⁶. The case was initially filed in the New York Supreme Court, but was removed to the US District Court for the Southern District of New York. Dapper Labs has rejected the claim, comparing NBA Top Shots to basketball trading cards. In December, a group of plaintiffs sued Yuga Labs in a class action claiming the Yuga Labs NFTs (including BAYC) and ApeCoins were securities, and that their sale violated the federal securities law (as well as unfair competition laws). The case, *Adonis Real v. Yuga Labs*, was filed in US District Court for the Central District of California¹⁷.

Finally, the American Law Institute and Uniform Law Commission introduced amendments to the Uniform Commercial Code to provide rules for emerging technologies, such as digital ledger technology and virtual currency. The major change was the introduction of a new article, Article 12, which deals directly with the acquisition and disposition of interests (including security interests) in “controllable electronic records,” which would include NFTs as well as Bitcoin, Ether and other digital assets. Although some states have adopted a draft version of Article 12, the finalization of Article 12 in 2022 means that many states are likely to adopt Article 12 in the near term.

As NFTs are used more broadly, practitioners should follow the following issues in 2023:

1. Licenses to Artwork. NFTs consist of a token (with metadata) which is stored on the blockchain and artwork which is frequently stored off the blockchain and linked to the token (due to the cost of on-chain storage). Most artwork is protected by copyright and the NFT industry is just beginning to develop licensing models for granting “rights” to NFT purchasers. Many purchasers continue to be confused about these rights and believe that the ownership of the NFT means ownership of the copyright in the artwork. And many NFTs do not have a license and, thus, the rights of the purchaser under copyright law are very limited. Even major projects with an “agreement” such as BAYC have terms which are very confusing: the BAYC Terms and Conditions for BAYC NFTs suggests “ownership” of the NFT means ownership of the rights in the copyright of the artwork but imposes restrictions more appropriate to licenses. This ambiguity has been raised as a counterclaim in the *Ryder Ripps* litigation. Another trend is the use of CC0, the Creative Commons dedication to the public domain for artwork. However, even Creative Commons notes that CC0 may not work in some jurisdictions: “Second, the laws of some jurisdictions don’t allow authors and copyright owners to waive all of their own rights, such as moral rights. When the waiver doesn’t work for any reason, CC0 acts as a free public license replicating much of intended effect of the waiver, although sometimes even licensing those rights isn’t effective. It varies jurisdiction by jurisdiction”.¹⁸ Some projects start as CC0 and at least one prominent project, Moonbirds, adopted CC0 after it had launched with a commercial license. This year has seen increasing sophisticated licenses being used, such as the license introduced by Yuga Labs for the CryptoPunk project (Yuga Labs bought the IP for CryptoPunks earlier this year)¹⁹. And the a16z venture fund sponsored the development of six template NFT licenses, the “Can’t Be Evil” licenses, which were dedicated to the public domain so they could be used as flexibly as possible.²⁰ However, the industry is still exploring how to deal with many fundamental issues, from the effect of sale of the NFT on sublicenses to reasons for termination.

2. Royalties on Secondary Sales. Many artists have been attracted to NFTs by the prospect of a continuing revenue stream from royalties on secondary sales of their works. These royalties can be substantial: Galaxy Insights reported that secondary royalties totaled \$1.8 billion to Ethereum based NFT collections: \$147,602,791 for Yuga Labs, \$82,015,895 for Art Blocks and \$52,061,077 for Chiru Labs (Azuki). Unfortunately, most of the major Level 1 blockchains do not permit the automation of the payment of such royalties and the enforcement of such royalties depends on implementation by the NFT platform hosting the sale. The payment of such royalties has recently become a subject of controversy, with many NFT buyers trying to avoid them and NFT exchanges are accommodating such NFT buyers by not enforcing payment of royalties on NFT secondary sales. For example, SudoSwap and X2Y2 announced that they were making the payment of secondary royalties “optional” at the discretion of the buyer (although the founders of X2Y2 suggested at the time that the policy is a work in process). Creators, such as Tyler Hobbs, have reacted by implementing smart contracts for new projects that “blacklist” certain exchanges (including X2Y2) that do not pay royalties. X2Y2 recently announced that they would re-implement the payment of royalties.
3. Application of Securities Laws to NFTs. The scope of the application of securities laws to NFT projects (like its applications to other digital assets, such as Gram tokens) is uncertain. As noted above, several class actions have already been filed against major NFT projects and the SEC has been rumored to be investigating Yuga Labs and its sales. This risk will vary by the nature of the project and how it is “marketed”. The NFT projects most at risk of being considered a security are those which include an economic component, such as a share of revenues from a song.

¹ <https://dappradar.com/blog/dapp-industry-report-2022-dapp-industry-proves-resilient-in-crypto-winter/#2022-on-chain-metrics-forecast-a-bullish-future-for-NFTs>

² <https://decrypt.co/94172/pplpleasr-ethereum-shibuya-nfts-fund-shape-films>

³ <https://tarantinonfts.com/>

⁴ *Hermes International et al v. Rothschild*, SDNY 1:22cv384.

⁵ *Rogers v. Grimaldi*, 875 F.2d 994 (2d Cir. 1989).

⁶ *Yuga Labs. Inc. v. Ryder Ripps, Jeremy Cahen*, CDCA 2:22-cv-4355-JFW-JEM.

⁷ <https://boredapeyachtclub.com/#/terms>

⁸ Section 5, 15 U.S.C. § 77(a), (c); 77d.

⁹ *SEC v. Howey*, 328 U.S. 293 (1946).

¹⁰ *SEC v. Telegram Group Inc. & TON Issuer Inc.*, 19-cv-943z9 (PKC) (S.D.N.Y. Mar. 24, 2020).

¹¹ <https://www.sec.gov/news/press-release/2020-146>

¹² <https://markets.businessinsider.com/currencies/news/sec-crypto-mom-hester-peirce-selling-nft-fragments-illegal-2021-3-1030250153>

¹³ <https://www.coindesk.com/policy/2021/12/30/sec-commissioner-hester-peirce-says-washington-doesnt-need-a-new-crypto-regulator/>

¹⁴ <https://cointelegraph.com/news/sec-investigating-nft-market-over-potential-securities-violations-reports>

¹⁵ <https://decrypt.co/112624/state-regulators-nft-casino-securities-violations>;

https://www.nj.gov/oag/newsreleases22/2022-1020_Slotie-C-and-D.pdf

¹⁶ *Friel V. Dapper Labs*, SDNY 1:21-cv-5837, *Friel V. Dapper Labs*, New York Supreme Court, 653134/202

¹⁷ Adonis Real et al V. Yuga Labs, No. 2.22-cv-8909, CDCA.

¹⁸ https://wiki.creativecommons.org/wiki/CC0_FAQ

¹⁹ <https://licenseterms.cryptopunks.app/>

²⁰ <https://a16zcrypto.com/introducing-nft-licenses/>