Do Your Due Diligence Before Participating in an NFT Transaction

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Nonfungible tokens, or "NFTs," are dominating the news cycle lately. From the $69.3 million sale of digital artist Beeple's "Everydays — The First 5000 Days," at Christie's Auction House, to a $9.00 three-pack of NBA digital trading cards, NFTs with varying price tags are everywhere. Whether this new craze is a bubble waiting to be burst or whether it is here to stay, those wishing to take part in an NFT transaction need to be aware of everyone's roles. Here's what buyers and sellers should know.

What is an NFT?

An NFT is a cryptographic token representing a unique unit of data stored on a digital ledger called a blockchain. When one participates in an NFT transaction, the NFT is not the underlying item purchased itself, but it is the digital receipt of such a transaction that is always attached to the underlying item. Thus, NFTs should be thought of as certificates of ownership for virtual assets. NFTs can contain "smart contracts" (software code) that dictate the terms of sale between the original purchaser and seller, and any potential future sales. The distinction between an NFT and the digital asset it certifies is an important one. While the receipt of the NFT transaction is reflected on the blockchain, and the purchaser can always access their NFT, the virtual asset itself usually exists elsewhere. So, although a purchaser may own their NFT forever, the underlying virtual asset may not always be within their reach.

Ensure the Virtual Asset You're Purchasing Remains Accessible

In most cases, the virtual asset—whether it be an image, video, mp3 file, etc.—is hosted on a website that is part of the current centralized system that we know today as the Internet. The NFT, on the other hand, is stored on the blockchain, a decentralized version of the peer-to-peer network that is maintained by thousands of computers around the world. Thus, if the website from where the virtual asset exists is corrupted or removed, the purchaser would be left with an NFT certifying an asset that is no longer accessible. To avoid this circumstance, buyers should ensure through the smart contract with the seller that their virtual NFT asset will be legally and continuously hosted in an accessible format. Without such language in the smart contract, there is no contractual obligation to ensure that the virtual asset will remain accessible. Such contractual language could require the seller of the NFT to host the virtual asset on a maintained website so that it will remain unaffected and accessible to the purchaser. Or, the purchaser could require that the seller transfer ownership of the domain name registration for the website hosting the virtual asset. If, however, the seller retains the obligation to maintain the website hosting the virtual asset, such obligation should be in writing so subsequent purchasers have the same guarantees from the original seller (and that term should be transferable).

Know What You Are Buying—Copyrights Are Usually Not Part of the Sale

A copyright owner has the right to, inter alia, use, display, distribute, and create derivatives of its work (17 U.S.C.A. § 106(1)-(6)). Normally, when a person acquires an NFT, the underlying copy of the virtual asset is owned, but not the copyright itself. If the purchaser desires all rights to the virtual asset, the copyright holder would need to separately assign the copyright by contract (and the copyright owner may be a different entity from the NFT rights owner). In order to obtain the rights to take pictures or make copies of the underlying virtual asset, or to make derivative works from it, the NFT purchaser must be given permission from the copyright owner. Without such written permission, the purchaser acquires only a non-exclusive license to display the underlying virtual asset. In order to create precise terms for both parties to the transaction, the purchaser and seller should detail exactly what the copyright owner has retained and what rights have been transferred in accordance with the virtual asset.

Sellers Should Be Clear About What Is Being Transferred

Sellers should too draft certain conditions of sale into the smart contract embedded in their NFT. Presuming the seller is the creator (and thus the copyright owner) of the virtual asset, the seller should not only think about the transaction at hand, but any resale of the virtual asset as well. The smart contract should include the size of a commission the seller will receive should there be a resale of the virtual asset, if there will be royalties associated with licensing the asset, whether there can be multiple owners, and any other additional details pertaining to the future sale of the NFT and/or use of the virtual asset.

Buyers and Copyright-Owning Sellers Should Be Wary of Fraud

Many purchasers and sellers have been the victims of fraud in the NFT space. In fact, an artist that appears to be impersonating Banksy has obtained over $1 million Ether in NFT sales (Ether is the cryptocurrency provided for by the network "Ethereum" where a large portion of NFT trading sales occur). Under US law, artists have traditional takedown mechanisms, such as rights under the Digital Millennium Copyright Act (DMCA), to regulate the unauthorized display and sale of their work (17 U.S.C. § 512). However, it is unclear to what extent takedown mechanisms, like the DMCA, apply to NFT platforms and how these platforms will respond to such notices. For those artists successful in removing an infringing work using traditional takedown mechanisms, the original purchaser is then left with a digital token representing a work that is no longer hosted on the website that gives the purchaser the only access to its virtual asset. Buyers and sellers should both do their due diligence to ensure that the person at the other end of their transaction is reputable. Much like the purchaser of Beeple's "Everydays — The First 5000 Days" limited the risk of buying a fake version of the artwork by undertaking the transaction through a trustworthy dealer like Christie's Auction House, both purchasers and sellers can limit their risk of fraud by doing their due diligence before participating in an NFT transaction.

Avoid a Mishap

While the world of NFTs is still emerging, and new issues and complications are regularly arising, purchasers and sellers can take some steps to memorialize their respective rights and obligations to avoid a mishap. Like any other corporate transaction, a purchaser should take the time to conduct the proper due diligence to ensure that they are contracting with a reputable seller and they are purchasing an actual virtual asset, and a seller should include language in the smart contract detailing specific terms not only for the current sale, but also any future sales of the virtual asset.

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