CLIENT ALERT FEBRUARY 22, 2023

NFT 101: BLOCKCHAIN, TOKENS AND SMART CONTRACTS

NFTs, and the technology underlying them, still appears to be current and relevant to many industries, yet projects using them are often incapable of expressing clear storytelling or express actual usefulness. Let us therefore start with the basics.

An NFT (*i.e.* "*Non-Fungible Token*") is a set of data stored on a blockchain representing an element of the physical world or a digital asset, with very few restrictions on the type of content that can be, in industry jargon, "*tokenized*" (*i.e.* represented by the token) and therefore "*minted*" (*i.e.*, generated on a blockchain).

Unlike cryptocurrencies, it is not fungible, meaning that is not indifferently interchangeable with other tokens of the same kind and species; in fact, each NFT is unique, singularly identified by a string of code that represents a specific element, a "*digital DNA*", which, thanks to the blockchain, is particularly suited to certify the ownership of the elements it identifies.

To better understand what makes an NFT "unique", it may be useful to list the elements that make up one that incorporates, for example, a digital image in .jpg format of a famous painting, namely:

1) name of the author of the token; 2) title of the artistic work; 3) identification code of the token; 4) address (an alphanumeric code) of the wallet under which the token is registered; 5) miscellaneous information about the image; 6) wording of the file contained in the NFT (*e.g.*, .jpg extension); and 7) address (an alphanumeric code) of the smart contract that governs the NFT.

It should therefore always be kept in mind that the NFT is distinct from the underlying asset, even when the latter is a natively digital item.

Indeed, it is possible to create more than one NFT representing the same asset, yet each copy will have a unique identifier. This feature can, for example, be useful for representing ownership of assets that by their nature would be indivisible, such as, absurdly, a set of 1,000 tokens, "authenticated" by the Louvre, each representing 1/1000th of the ownership of the Mona Lisa.

Other benefits of this technology are generally acknowledged to include the immediate representation of ownership; the ability to provide transparent and public proof of ownership via blockchain; immodifiability and durability of the token.

In addition to certification of ownership, it is possible to add additional functionalities that are useful to, and tailored for, the individual project, and may be, for example, patrimonial (such as royalty payments following a purchase or sale), as it is sometimes seen in the recording industry, or functional (such as access to events or customizable elements of a digital game), as is often the case in gaming.

These additional functionalities are made possible by the so-called "smart contracts," which are a set of data and computer protocols that facilitate, verify, and enforce the negotiation or execution of a contract.

NFT USE CASES: FROM TIGER WOODS TO RIHANNA, FROM DOLCE & GABBANA TO BOTTICELLI

The last two years of market activity has shown many use cases in very different industries.

In the **sports** world, many organizations have found in NFTs an alternative funding route to sponsorship and donations. With the NBA's Top Shots program, Dapper Labs and the NBA sold to collectors and fans NFT of the so-called "*Moments*", highlights of the league's top plays, surpassing $500 million in transactions in the first three months of 2021. Tiger Woods and Tony Hawk have sold similar NFT, as well as, in Italy, AS Roma, creating, in addition to moments of their football history, memorabilia of various kinds tokenized, as jerseys of important players.

In the **gaming** world, some games have tied ownership of the NFT to access to certain in-game features, such as the use of certain characters or skins (*e.g.*, Axie Infinity), others to the purchase of in-game items, and others (along with utility tokens) are used as transactional currency in in-game economies; in the Decentraland metaverse, NFTs representing ownership of pieces of digital land have been sold in large numbers, each granting the right to decide what can be done with and on the relevant digital land. A key feature is that when players are no longer interested, they can resell the NFT, which, in some cases, may enjoy a sale price higher than the purchase price, while the developers of the game and the NFT may receive a royalty on each resale of the NFT, leveraging on the growth of the secondary market.

In the (traditional, non-digital) **art** world, some museums and collectors have created a numbered series of authenticated NFTs of works of art of undisputed value, with the intent, *e.g.*, to finance their preservation or restoration, partly to combat the phenomenon of "*de-accessioning*", *i.e.* the selling of museum collections to obtain immediate liquidity. For example, in Italy, the Uffizi in Florence has created, in partnership with a specialized company (Cinello, DAW technology) a series of unique digital silkscreens, completely identical to the original, certified by museum and company and tokenized, of the Tondo Doni (Michelangelo); and others are planned, such as the Madonna of the Goldfinch ("*Madonna del Cardellino*", Raphael) and The Birth of Venus ("*La nascita di Venere*", Botticelli).

In the **music and recording industry**, there have mainly been attempts to change the revenue model in favor of artists and industry players, by involving fans; Rihanna sold 300 NFTs that grant the owner a royalty each equal to 0.0033% of the revenue linked to the song "*Bitch better have my money*"; the Chainsmokers, the year before, carried out the same commercial initiative, but on an entire album, "*So Far So Good*", adding several features for the development of the fan community (such as exclusive access to the artists' Discord channel or events, *etc.*).

In **fashion**, many initiatives have sought to tie elements of the digital to elements of the real, leveraging on the strength of the brand; D&G in 2021 launched a 9-piece NFT collection, each tied to a unique fashion item (sold jointly), and giving access to a range of experiences pertaining to the item, such as original sketches, fashion shows, and *ad-hoc* installations; Paco Rabanne has sold 56 NFTs of some of the most abstract pieces from its past collections, using the profits to bolster its physical historical archive; others, have used the technology for support functions, for example, during the Paris Fashion Week, all press accreditation passes were issued directly in the form of NFTs. In this industry, however, even more than in others, there have arisen in parallel numerous initiatives operating in gray areas of legality, as in the case of the "*MetaBirkin*" NFTs, minted by a private artist according to an artistic interpretation of the famous Hermès bags, recently declared by a New York court ruling to be an infringement of the French house's intellectual property. And on this decision, and the limited award of damages, it will be important to monitor the reaction of the NFT market that sometimes exploits well-known brands.

WEB3 AND CRYPTO-ASSETS LEGAL CHALLENGES

The entry of NFTs into the marketplace has placed companies, professional creators, and players in every industry before new and complex legal challenges, often requiring the engagement of consultants with specific knowledge of the field.

One problem is related to managing the contractual arrangements, the TOS, of each platform that manages or sells NFTs, which can often vary significantly, and contain onerous clauses or very broad, and sometimes void, disclaimers. The result is that two platforms selling or managing the same NFT (*i.e.*, the same set of NFTs) may apply very different terms, and this is a particularly delicate issue in relation to consumers.

For example, there has been the question of the discipline of withdrawal under the Consumer Code when this is not explicitly excluded by the platform's TOS; considering that the value of an NFT is very volatile, a withdrawal exercised by the consumer "strategically" would allow the consumer a risk-free gain to the detriment of the platform, a case that actually occurred to Yuga Labs, the operators of the commercialization of the Bored Ape Yacht Club (which at peak reached a total estimated value of $1.67 billion).

Another macro-theme is related to the intellectual property of the element digitally embedded in the NFT, as there is often still a lack of concrete cases from which to extrapolate applications of general principles to the Web3 world. For example, NFTs representing the NIKE brand (on StockX) and other immediately recognizable brands have been sold, illegally, *i.e.*, without the brand owner's authorization, demonstrating however the existence of a, still untapped, market development potential; again, many hired artists of the DC Comics publishing house have sold for millions the works they had created on the commissions for DC, which, however, remains the owner of the economic exploitation rights of the characters embedded in the tokens, and which had not given consent to their issuance.

There is also a non-minor issue related to AML compliance and anonymity, which is often intrinsic to the crypto world; for example, NFTs are often bought and sold via cryptocurrency.

Portability is another issue, involving a number of legal complications, and it arises as a result of the absence of standards for NFTs (such as UNI or ISO or EN), and even the most widely used protocol (the ERC-721 standard) applies only on the Ethereum blockchain, but for smart contracts on QTUM or NEO or Cardano, the standards change.

The problems mentioned above are located within a nascent regulatory framework that is developing at different times and in different ways around the world; in Europe, in particular, the sector will be primarily governed by the Market in Crypto Assets (MiCA) Regulation, however, the latest approved drafts contain an exemption (Art. 4) that would exclude NFTs from the scope of the Regulation, while not excluding indirect application of some obligations, and forcing market participants to reconstruct a fragmented discipline from time to time.

NFT: POTENTIAL TO BE SEIZED OR PITFALL TO BE AVOIDED?

The NFT market, among the Web3 expressions with the greatest potential, remains an attractive world yet to be explored; at the same time, many projects are showing poor upstream planning and a lack of preparation in the face of the new problems, legal and technical, arising from the new technology.

This is why *ex ante* planning of projects and obtaining, including through consultants, specific technical and legal know-how is important, enabling an assessment of the project's purpose within a jagged, complex, and, often, multi-jurisdictional regulatory framework.

About Curtis

Curtis, Mallet-Prevost, Colt & Mosle LLP is a leading international law firm. Headquartered in New York, Curtis has 19 offices in the United States, Latin America, Europe, the Middle East and Asia. Curtis represents a wide range of clients, including multinational corporations and financial institutions, governments and state-owned companies, money managers, sovereign wealth funds, family-owned businesses, individuals and entrepreneurs. The firm is particularly active on behalf of clients operating in the energy and renewable energy, commodities, telecommunications, manufacturing, transportation and technology industries.

For more information about Curtis, please visit www.curtis.com.

Attorney advertising. The material contained in this Client Alert is only a general review of the subjects covered and does not constitute legal advice. No legal or business decision should be based on its contents.

Please feel free to contact any of the persons listed below if you have any questions on this important development:

Daniela Della Rosa
Partner
Cryptocurrency, Digital Assets and Blockchain
ddellarosa@curtis.com
Milan: +39 02 7623 2057

Federico Criscuoli
Associate
Cryptocurrency, Digital Assets and Blockchain
fcriscuoli@curtis.com
Milan: +39 02 7623 2032