Questions from Attendees and Answers from the Speakers

NFTs: How Do They Work?

Intellectual Property Network Legal Update – 11 May 2022

Joshua S. Ganz, Partner, and **Anthony D. Glossun**, Associate
Kilpatrick Townsend & Stockton LLP

1. a question for the presenters, can they please discuss how smart contracts are being enforced? I heard that there was an issue with OpenSea not enforcing the smart contracts for royalties to brands upon the sale of an NFT.

Smart contracts are programs that automatically execute a transaction according to predetermined terms that are coded into the program. While there is little legal precedent in this area, smart contracts are likely not binding legal documents and a party to a smart contract would not have recourse to a court or other third party arbiter; however, smart contracts should not *need* to be enforced by any third party because the transaction occurs automatically.

It is possible that a coding error could cause a smart contract to fail to deliver the anticipated royalties. A content creator who did not receive royalties due to such a coding error may have a claim against the entity that coded the smart contract (which would likely be handed as an ordinary software dispute subject to applicable law and any agreements between the creator and the smart contract coder), but the creator would likely not be able to enforce the intended terms of the smart contract against downstream purchasers of an NFT because the smart contract is not a legally binding agreement.

The OpenSea issue is a bit different: transactions on OpenSea can generate royalties, but (controversially) those funds are held by OpenSea and then OpenSea manages royalty pay-outs via its own separate processes not based on the blockchain ("off-chain"), in an effort to reduce gas fees. There are reports that OpenSea does not always pay out royalties on time or accurately. However, any claims in connection to these reports would likely be governed by OpenSea's terms of use and ordinary legal principles, rather than by attempting to "enforce" the smart contract as if it were a binding document.

2. Could the speakers give some detail on the use of NFTs for tracking and paying royalties?

Smart contracts govern the payment of royalties in connection with an NFT transaction. The creator of the NFT can code the smart contract to collect the desired amount of royalties from each transaction. If coded correctly, the royalty will be paid automatically as part of the NFT purchase/sale transaction (though as discussed above, the smart contract may be set up to distribute the royalties to a middleman rather than directly to the creator of the NFT, which entails risk of incorrect/non-timely royalty distributions from the middleman to the creator). While each transaction involving the NFT will be recorded on the blockchain, there should be no need to track royalties owed, because the royalties are paid automatically in conjunction with each covered NFT transaction.

3. How is the smart contract perfected? Etherscan shows the status but how does the transfer work? when the owner transfer from their wallet to another, does it automatically load data into Etherscan?

   Because a smart contract is not a legally binding document, there is no need to perfect it. When the an NFT is transferred from one wallet to another, the transaction is automatically recorded on the blockchain. Etherscan is a tool used to view transactions recorded on the Ethereum blockchain.

4. For businesses that are not minting NFTs but plan to engage with owners of NFTs, are transfer of IP rights apparent in the blockchain ledger? Does the ledger include sufficient information of buyer and seller (name, location, etc.) to confirm ownership status as well as allowing a business to perform Know Your Customer (KYC) analysis? I'm only seeing Hash numbers in place of Buyer and Seller.

   The purchase of an NFT does not inherently entail the transfer of any IP rights to the underlying digital art or other digital asset. Some content creators choose to associate IP rights with an NFT such that the owner of the NFT receives certain IP rights. The manner in which IP rights (and associated contractual/license terms) are associated with an NFT remains unsettled, but a creator of an NFT can place those terms on a webpage devoted to that NFT, or can place them in the description of the NFT, or may try to publish the terms in some other way. There are challenges associated with each option, and it's unclear whether any particular option will be legally binding on the creator and/or downstream purchasers.

   Wallet accounts on most public blockchains do not contain personal details, so there are significant KYC challenges associated with participation in the NFT space. We generally recommend attempting to contract away as much KYC risk as possible when engaging a vendor to assist with an NFT offering.

5. **Not really a question:** Sharing a couple columns on NFTs that might be helpful: https://sportsradioamerica.com/2021/03/28/what-are-nfts/; https://sportsradioamerica.com/2021/08/29/nfts-the-digital-original-of-things/. Great presentation and info Josh and Tony.