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NFT Due Diligence Lessons From Recent Cases

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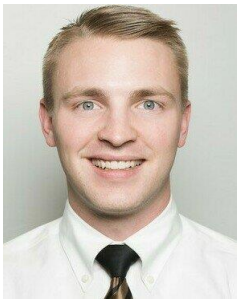

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Nonfungible tokens, or NFTs, have been a booming business since the launch in 2017 of digital collectibles like CryptoKitties and CryptoPunks. Beyond the current fascination with Bored Ape Yacht Club NFTs and modern manifestations of tulip mania, NFTs are a new and valuable technology, with increasingly innovative and sustainable commercial implementations.

This article explores four pending cases involving disputes over NFTs. While none have reached a merits decision, both sides have now set forth their positions and there are clear themes and implications. We provide an actionable NFT primer, key takeaways, and questions to help evaluate future NFT offerings.

NFTs for Beginners

Knowing the makeup of an NFT is crucial to understanding its value. The discourse is mired in technical jargon, but, for the purposes of understanding the current cases, we can think of an NFT as two associated elements: an asset and a digital token.

The asset can be just about anything, including: artwork, concert tickets, video clips, contract rights or physical goods.

Minting an NFT creates a digital token — i.e., code. The digital token is recorded and hosted on a blockchain — i.e., a ledger that tracks tokens and transactions.

The digital token and associated metadata include a unique identifier, method of specifying or retrieving the asset, ownership information, and transaction histories.

The method of specifying or retrieving the asset can have important ramifications, including how easily the asset can be located on, or scrubbed from, the internet.

One method is on-chain hosting, where a digital asset is encoded directly into the digital token itself and can be retrieved directly from the NFT. Another method, which is more common, is off-chain hosting, where the digital token or metadata provide a way to find or reference the asset. Examples of off-chain hosting include pointing to a website or URL that hosts a digital asset, providing the physical location of a safety deposit box that holds a physical asset, or including a content-based

hash that can be used to search for copies of a digital asset online.

Like transactions over property rights with ink-and-paper instruments, important considerations in NFT transactions include whether the asset is actually what it purports to be, if buying or selling the NFT is an effective means of transfer, and the terms, conditions, and limitations applicable to the underlying asset, if any. These and other issues are explored below.

Understand the Asset

Confusion and disagreement about the exact nature of the underlying asset can drive NFT disputes. While there may be obstacles, achieving clarity can be determinative.

One illustration of fundamental confusion over the nature of the underlying asset is the Roc-A-Fella Records Inc. v. Dash case in the U.S. District Court for the Southern District of New York, brought in June 2021. Dash, a former associate of Jay-Z, announced an NFT "auction of [his] ownership of the copyright to Jay-Z's first album Reasonable Doubt."[1] According to Dash's announcement, the "NFT will prove ownership of the album's copyright, transferring the rights to all future revenue generated by the album from [Dash] to the auction winner."

According to Roc-A-Fella Records, however, it owns the album copyright and Dash merely owns a one-third equity interest in Roc-A-Fella Records. Thus, the asset underlying the NFT may have been Dash's rights in the shares of Roc-A-Fella Records, rather than an interest in the copyright to the album itself.

Roc-A-Fella Records sued Dash seeking, inter alia, a declaration that it is the copyright owner, not Dash, and Dash is not permitted to sell any interest in the album. Roc-A-Fella Records won a temporary restraining order to preserve the status quo.

The parties recently filed a joint letter describing a potential settlement, citing Dash's admissions that he does not own the album's copyright.[2] The bottom line in this case is that while Dash has an asset of value that could, at least theoretically, be part of an NFT — shares of Roc-A-Fella Records — the NFT marketing materials described the asset incorrectly as an interest in the copyright to Reasonable Doubt, which Dash now admits that he does not own.

Understand Background Entitlements

NFT disputes may arise from different interpretations of basic contracts or corporate documents. For example, in Miramax LLC v. Tarantino, a case filed in the U.S. District Court for the Central District of California in November 2021, the dispute will likely turn on a contract that was written 30 years before the invention of NFTs.

Miramax sued the writer and director Quentin Tarantino for his NFT series where the assets underlying the NFTs were a digital scan of scenes from his handwritten screenplay for the film "Pulp Fiction," and audio commentary accessible only to the NFT purchaser.[3] According to Miramax, the parties disagree about whether these NFTs are permitted under the 1993 assignment of rights in "Pulp Fiction" from Tarantino to Miramax, where Tarantino's reserved rights include print and screenplay publication.[4]

So, while the NFT offering at issue in this case is new, the asset that gives the NFT its value is not. This dispute will largely come down to contract interpretation, and if it were decided against Tarantino, his

ability to sell NFTs associated with "Pulp Fiction" will be severely, or entirely, limited. The case is now in discovery.

Consider the Commercial Context

The way an NFT is marketed and promoted, its related products, trade channels, and commercial perceptions, have become increasingly important in understanding the risks associated with buying or selling an NFT and the potential for a loss of value in the NFT due to claims from third-party IP owners. The two most recent cases focus on trademark-related claims and defenses regarding the use of third-party marks, both as part of an individual NFT asset itself, as well as the related commercial context.

In Hermès International v. Rothschild, a case filed in the Southern District of New York in January, the artist Mason Rothschild created a series of digital images he called MetaBirkins that were described as "unique Birkin NFTs" that "are a tribute to Hermes' [sic] most famous handbag, the Birkin, one of the most exclusive, well-made luxury accessories," which is a "highly covetable 'holy grail' handbag that doubles as an investment or store of value."[5]

Rothschild claimed to be "inspired by the acceleration of fashion's 'fur free' initiatives and embrace of alternative textiles." He also used MetaBirkin domain names and slogans, and planned to launch a MetaBirkin marketplace.[6]

Rothschild moved to dismiss Hermès's trademark and related claims, largely based on the privilege to make artistic use of third-party trademarks under the Rogers test.[7]

Hermès opposed, arguing that the MetaBirkin NFTs are not an "art project," but rather, in Rothschild's words, are a "digital commodity" and Rothschild's use is "explicitly misleading ... as the unadorned centerpiece of the 'commodity'."[8] The case is still pending.

In Nike Inc. v. StockX LLC, a case filed in the Southern District of New York in February, the complaint describes StockX as an online third-party reseller of authenticated physical apparel, including Nike shoes, like eBay.[9]

But StockX recently expanded into selling so-called Vault NFTs that purportedly represent a physical pair of Nike shoes in StockX's vault, and can be redeemed for the physical shoes like a digital receipt, or traded as NFTs.[10] Nike alleged that StockX uses Nike's marks and imagery prominently and trades on Nike's goodwill in connection with Vault NFTs, which has caused confusion and injured its reputation.[11]

If the Vault NFTs were merely a digital receipt, then Nike argues "there would be no need to make such extensive and prominent use of Nike's trademarks."[12] Further, Nike alleged that the Vault NFTs could not be redeemed for the shoes, and StockX's terms give it the ability to "completely depriv[e] the Vault NFT owner of possession of the shoes that are supposedly connected to the NFT."[13]

Nike views the Vault NFTs not as a digital receipt, but rather "new virtual products" that leverage Nike's marks and goodwill, and also sell for "many multiples" of the physical shoe price.[14]

In its recently filed answer, StockX claims that its Vault NFTs are not virtual products or digital sneakers; rather, they are "tied to a specific physical good" and are effectively a claim ticket to access the good stored in a "climate-controlled, high-security vault."[15] StockX claims protections under first sale and

nominative fair use, and also claims to have fulfilled redemptions and updated its terms.[16]

These cases suggest that even assuming the seller of the NFT owns the underlying asset or otherwise has the legal right to sell it, use of the asset in the manner contemplated by the seller could give rise to infringement, misappropriation, or other IP claims.

Metaverse Applications

The cases described above have implications that could extend beyond the emerging field of blockchain law and into metaverse environments — a technology that has the potential to create even more value and legal controversy. NFTs are a foundational technology for many new metaverse platforms, like The Sandbox or Decentraland.

Where cryptocurrencies, like Bitcoin and Ether, can be used as a form of payment on metaverse platforms, the real killer app for NFTs is recording of digital ownership. NFTs provide a highly secure way to enable the authentication of:

- Possessions — like a digital Ferrari used on a metaverse platform;
- Real property — like an apartment on Park Avenue in a digital twin of New York City; and
- Unique forms of an avatar's identity — like facial features or body type.

As such, NFTs could become the cornerstone of all future metaverse economies.

If the buyer of an NFT expects to realize value from use of that NFT on a metaverse platform, then it is important to understand if and how the NFT can be used on the platform. For example, if the buyer of an artwork by Beeple expects to display that artwork in a digital seaside home with breathtaking views of virtual Maui, then the buyer needs to understand the technical limits on content portability on metaverse platforms and legal terms of use that may exclude metaverse applications entirely.

In other words, you could spend $69 million on a Beeple NFT at an auction at Christie's and have nowhere to put it.

Key Questions for Future NFT Diligence

The cases described above highlight some important issues to consider when conducting a due diligence on the purchase and sale of an NFT, including the following:

- What is the asset underlying the NFT? Does the seller own the artwork, video clip, shares, copyright, contract rights, or physical goods that underlie the NFT and give it value?
- Is there a terms of use, contract, or other document that conveys the underlying asset or grants licenses or other legal rights in the NFT?
- Do the marketing materials for the NFT correctly describe the asset? Do the terms of use for the NFT match the marketing materials?
- What does the seller claim the buyer of the NFT will be able to do with the asset that underlies the NFT? Will the NFT transaction transfer ownership of the asset, grant the buyer exclusive or

non-exclusive license rights to the asset, or grant the buyer the right to collect rents or royalties from third parties who use the asset?

- Does use of the asset in the manner contemplated by the seller infringe or misappropriate any third-party intellectual property rights? In other words, can the buyer of the NFT make use of the NFT without infringing on a third party's IP rights?

- Will the buyer of the NFT have the rights to police use of the underlying asset? Can the buyer pursue claims for infringement against third parties who may be viewing or copying the asset without the buyer's consent?

- Does the NFT have a metaverse use case? If so, is use in the metaverse included or excluded from the rights granted by the seller?

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[1] No. 1:21-cv-5411 (S.D.N.Y.), Dkt. 1 (Compl.) ¶¶24–26 & Ex. B.

[2] Id. at Dkt. 67 (Endorsed Joint Letter); see also id. & 68 (Joint Letter Request for Extension).

[3] See No. 2:21-cv-08979 (C.D. Cal.), Dkt. 1 (Compl.) ¶¶1, 5, 38.

[4] Id. ¶46.

[5] See No. 1:22-cv-00384 (S.D.N.Y.), Dkt. 24 (Am. Compl.) ¶94.

[6] See id. ¶6.

[7] See id. at Dkt. 27 (Mem. ISO Def.'s Mot. to Dismiss) at 9–10.

[8] Id. at Dkt. 31 (Mem. ISO Opp'n to Mot. to Dismiss) at 4, 24.

[9] See No. 1:22-cv-983 (S.D.N.Y.), Dkt. 1 (Compl.) ¶¶41–42.

[10] Id. ¶¶ 5–8, 61.

[11] See, e.g., id. ¶¶4–8, 56, 58, 61, 64–71, 78–80.

[12] Id. ¶79.

[13] Id. ¶6.

[14] Id. ¶¶5–6, 46.

[15] See id. at Dkt. 21 (Ans.) at 3.

[16] See id. at 7–8, 15–17, 27, 49.