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Navigating NFTs: Considering Best Practices and Avoiding Pitfalls

All of a sudden, no one can talk about anything but NFTs! For those people who have used up all of their tech tolerance on Zoom meetings this year, understanding this latest frenzy can seem like an insurmountable task. But FOMO tends to be very motivational! Given that the value of the crypto art market has now reportedly surpassed \$200 million, the fear of missing out may very well be warranted. And actually, as it turns out, NFTs really aren't that difficult to understand. If you can shop online, then you can understand NFTs.

Let's start with the 30,000-foot-view of what exactly is going on: NFTs—or non-fungible tokens—are a mechanism to make digital files into a unique asset, created and sold on the blockchain using cryptocurrency. If you only understood one or two words in the previous sentence, everything will be explained shortly. In the meantime, as you may be aware, an important event happened few weeks ago when Christie's auction house sold an NFT for \$69 Million and everyone went crazy. Now that it looks like there is a market with real money for digital assets, people are creating NFTs by the thousands in an effort to participate in the gold rush. While this frenzy will likely settle down sooner than later (predictions of a bursting bubble are already circulating), there is technology here that is evolving, and almost certainly some version of what is happening now will endure into the future. So, it is definitely worthwhile to become at least somewhat familiar with what this is all about.

There is a large quantity of incredibly complex information, and those with advanced crypto-savvy will want to interject all of the various nuances and details into the somewhat simplified explanations here, but this is crypto-triage. If at the end of reading this article, your interest is piqued and you're hungry for more, there is an entire (ever-expanding) universe of information online just waiting for you to dive in. Hopefully, with the information here, you can at least doggie paddle your way through some of the more sophisticated information waiting for you in the digital ocean.

Part of the challenge for those trying to catch up is that the acronym “NFT” has been layered on top of “blockchain” and “cryptocurrency” and since many people are still struggling with those concepts, one more new tech term can easily lead to panic and surrender. So let’s start at the beginning and break it down a piece at a time with some extremely simplified explanations in plain(ish) English. Along the way, questions and considerations are highlighted so that you can start thinking about how to position yourself and hopefully avoid any big blunders.

Blockchain. (If this is the 600,000th time you’ve heard this foundational element described, skip down to Cryptocurrency). The blockchain is an immutable ledger that stores information on a network of computers (each is called a “node”). It is considered to be a secure system because once the information is entered into the blockchain, it cannot be changed. One of the biggest pitfalls of the blockchain is a “garbage in, garbage out” problem. In other words, if incorrect information is entered into a blockchain—intentionally or not—it cannot be edited or corrected.

Best Practice: Look before you leap! Make sure that your information is correct and that, if applicable, you have all underlying rights, titles, permissions, and licenses before entering anything onto the blockchain.

Cryptocurrency. (If you have cryptocurrency all figured out, skip down to NFTs). Cryptocurrency is digital currency, or tokens, for which transactions are verified and maintained on the blockchain. Cryptocurrency may be acquired three basic ways: Mining, baking, or purchasing.

The most well-known and widely-used currency is Ethereum, which is based on a Proof of Work (POW) system. Mining is required for POW currencies. Mining means having computers (often enormous groups of computers) solve complex algorithms to add blocks to the chain and in the process earn currency. Whoever solves the algorithm first, wins the tokens as a reward. The big criticism of this process is that it uses an enormous amount of carbon-based resources in powering the computers which are all competing to solve the algorithms first, making the whole process ridiculously harmful to the environment.

Additionally, the transaction validation process of POW systems involves all nodes on the blockchain. This creates a structure that is not easily scalable. As it grows (ie. more blocks on the chain are added), more computational power is required, and thus more resources are used. As a result, payments (called “gas”) are charged to users to compensate for the energy required to process and validate transactions on the blockchain. These fees may change depending on the congestion on the blockchain at the moment that the user wishes to enter information onto the chain.

The alternative cryptocurrency system is called Proof of Stake (POS). With POS, tokens are earned by depositing an amount of that currency in an account where it is essentially an investment in the system. Based on the value of the stake (and sometimes other factors as well), the owner staking the currency will be assigned blocks to solve and receive new tokens without competing. This process is called “baking”, requires far less computing power, and is therefore a much more environmentally sound system. Since transactions do not rely on computational power, gas is not an issue and transactions are extremely inexpensive.

While POS currencies are lagging behind their POW siblings, in the last few weeks, the chorus of environmentally-conscious cryptoverse voices has grown louder and is putting pressure on the entire ecosystem to embrace more earth-friendly solutions. There is no question that as the NFT market evolves, the POS systems will gain traction and stability. Certainly if this new frontier is to continue to develop in a sustainable manner, POS will have to lead the way.

Finally, you can, of course, simply purchase crypto with your debit or credit card online. There are over 1500 currencies to choose from, and many fluctuate in value tremendously. While you can always exchange currencies on exchange platforms, be aware of the fees and costs of buying with fiat and making exchanges.

Best Practice: Understand the environment consequences of your choices in cryptocurrencies, and of course, never invest more than you can afford to lose! Also, important to note that there are potential tax consequences relating to exchanging crypto into fiat, so proceed with caution when pulling value out of cryptocurrencies to make use of it in dollars.

Wallets. Cryptocurrency and the digital assets you purchase with it are stored in a “wallet”. This might be called a cryptocurrency wallet, or a blockchain wallet. The password for a wallet is incredibly important to keep someplace safe as there is no way to retrieve a password (or in some cases a “seed phrase” consisting of a string of random words) if it is lost or forgotten. If you lose the password, you lose your wallet. As you can imagine, there have been some incredible, if not heartbreaking, stories of enormous amounts of cryptocurrency and digital assets lost when the holder of the password loses it or dies without storing the information someplace discoverable.

Best Practice: Hope for the best, but plan for the worst. It is always good to keep your password someplace secure, but make sure that it is safely accessible in the event you forget it, or meet an untimely demise.

NFTs. (If you’ve already spent your mad money collecting the latest that Nifty Gateway has to offer, you can either skip to the last few paragraphs of this article, or go finish binging Cobra Kai, which I predict will be selling its own NFTs shortly). So finally, we get to the heart of the matter: NFTs. Non-fungible token is just a fancy term for a unique item—in this case a unique digital asset. This is in contrast to a fungible item such as currency where one item is interchangeable for another . . . like a dollar bill or Ethereum.

NFTs are “minted” by using an online platform that creates the NFT by customizing a “smart contract” to include specific information pertaining to a particular asset. In the case of artwork, music, or other creative endeavors contained in a digital file, the NFT includes metadata that points to the file containing the artwork. The file might be “baked into” the NFT, but given the limited storage on the blockchain, the actual artwork most likely “lives” on an Interplanetary File Server (IPFS) off of the blockchain on which the NFT exists.

“Smart contract” is actually a somewhat inaccurate term to describe the coding that underpins NFTs. Anyone who was first introduced to computer coding in the after-school classes at Radio

Shack in the early 1980s, knows that the simplest form of coding relies on “if-then” propositions. This is all that an NFT is—a series of “if-thens” that determine what happens when an NFT is bought or sold.

NFTs can nevertheless be quite powerful in creating new standards for art world transactions. Currently, one feature that often is included is a built-in resale royalties term. This is one way that NFTs could potentially create real long term disruption in art market transactions—at least those happening online (we’ll have to see how well these new practices translate to non-digital transactions). Some people minting NFTs are adding other terms as well, such as dedicating a portion of the sales to carbon offsets—presumably to make up for the horrendous toll all of this digital transacting is doing to our planet.

With the potential to be creative in customizing some of the transaction terms, NFTs could provide an interesting testing ground for new business models. It is important to understand however, that the terms embedded in the NFT are fairly limited currently due to the cost involved with creating elaborate and new structures. The more elaborate, the more likely there will be problems in the ability of the NFT to interact in the digital ecosystem. Until this environment has evolved quite a bit further, off-chain contracts—meaning agreements that are not embedded in the NFT itself—will still need to be integrated into the promotion and sale of NFTs. These off-chain contracts can be pointed to in the metadata in the same way the NFT links to the artistic asset. Thus, making sure that an NFT asset is protected over the long term will require a balancing of embedded language and referenced documents.

Best Practice: Understand the limits of NFT embedded terms and make sure to consider the entire scope of protection needed to ensure the sustainability of an NFT asset. Figuring out how to dovetail “smart contracts” with off-chain contracts currently remains crucial.

If the NFT market can legitimately and sustainably grow beyond the group of crypto-bros who have made millions in the crypto market and need to circulate their inflated fortunes, NFTs could be the new gateway drug to developing new collectors of both digital and object-based art in the fine art marketplace. Or NFTs might just evolve to be another world parallel to and only loosely affiliated with the fine art market. Given the flexibility of NFTs, it will likely be a little of everything, and without a doubt, the possibilities are endless. For now, it is an exciting new frontier that offers a complex online laboratory for testing new business models in a wide range of creative practices. While this digital frenzy sorts itself out, remembering to rely on common sense, well-drafted agreements, and traditional rights protection tools will be key in tempering the potential risks posed by this lightning-fast technological marketplace transformation. Bottom line: keep your crypto wallet close, and your legal counsel closer.

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