

NFTs and Various Copyright Issues

Young-Han LEE, Myung-Jin JIN

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A. Introduction

NFT means Non-Fungible Token. NFT is based on blockchain technology which enables digital assets, such as pictures, videos, and music, to have their own separate and unique identification codes. Such identification codes will be placed on the block permanently in a decentralized network, then they cannot be changed or manipulated. The NFT's non-fungible and irreplaceable characteristics enables people to prove its originality, authenticity, and uniqueness of the NFT. Also, it provides information about the identification of the owner and purchase history of the NFT. For above reasons, the NFTs should be protected as an ownership right.

Recently, public interest in NFT and the market size have been rapidly increasing. For instance, digital artist Beeple's NFT "The First 5000 Days" was sold for \$69.3 million at Christie's in 2021. Moreover, according to the decentralized app market data analysis platform Dapp Rader and Mirae Asset Securities Research Center in Korea, the size of the NFT market in 2021 was \$1.23 billion in the first quarter, \$1.24 billion in the second quarter, and reached \$10.7 billion in the third quarter, an increase of about eight times from the previous quarter.

The NFT utilizes ERC-721, a standard interface that is issued and traded on the Ethereum blockchain. There are various ways to create an NFT, but it is

usually issued through the Marketplace where it is purchased and sold. To create an NFT, there should be a digital file, coin, and coin wallet. The process of making a certain digital file into NFT is called Minting, and it consumes Gas which is paid in coins. In this process, you can make a detailed setup on the NFT, including the name of the NFT, description, image link (link to the digital file to be sold), resale royalty rate (e.g., 10% of the resale amount), number of copies (how many NFTs will be issued), etc. Such process may vary from each Marketplace. Some Marketplace may require indicating the name of the author and the issuance date or choose whether to transfer the copyright of the NFT.

B. Is NFT classified as Virtual Asset?

The NFTs are not classified as Virtual Assets (“VAs”) under the current law in Korea. The latest research report of the National Assembly Research Service (NARS) stated that NFTs are not VAs under the Act on Reporting and Using Specified Financial Transaction Information (“**Korean Act**”). According to the Article 3 Section 2 of the Korean Act, the virtual assets mean electronic certificates that have economic value and that can be traded or transferred electronically: Provided that (a) Electronic certificates or information about such certificates that cannot be exchanged for money, goods, or services, etc., and the place and purpose of use of which is restricted by the issuer or (b) Tangible and intangible products obtained through the use of game products under the Game Industry Promotion Act, shall be excluded.

The Financial Action Task Force (“**FATF**”), the global anti-money laundering watchdog, released updated guidelines in October 2021 stating that NFTs are used as collectibles which generally do not fall under the FATF definition of VAs. Moreover, according to the Financial News Korea on November 7, 2021, the Financial Services Commission (“**FSC**”) following the recent guidelines of the FATF stated that NFTs, unlike cryptocurrencies, are not VAs because they are neither used for investment nor as payment. However, both FATF and FSC viewed that NFTs could be considered VAs if NFTs are used as a cryptocurrency or investment vehicles, or when NFT platforms like the marketplace, metaverse, etc., incur profits by using NFTs as investment or commodity trading. Although not all NFTs will be classified as VAs, many NFTs depending on their types shall be considered VAs. Therefore, we cannot exclude the possibility of NFTs being treated as VAs in a near future.

In addition, the purpose of FATF’s updated guidelines is to prevent international money laundering and terrorist financing. Since the Korean legislature adopted these guidelines preparing the Korean Act, if NFTs are used for money laundering and terrorist financing, NFTs will likely be classified as VAs in Korea.

Whether to classify NFTs as VAs is an important issue. If NFTs are classified as VAs, any income accrued from the transfer and loan is subject to taxation as “other income subject to separate taxation” under Article 64(3)(2) of the Income Tax Act. Moreover, the NFT platforms, such as OpenSea and SuperRare, will bear various obligations, including filing obligations, securing a real-name financial system, etc.

C. NFT and Right of Exhaustion

The right of exhaustion, also known as the first sale doctrine, provides that an individual who knowingly purchases a copy of a copyrighted work from the copyright holder receives the right to sell, display or otherwise dispose of that particular copy, notwithstanding the interests of the copyright owner. In other words, the distribution rights of a copyright holder are exhausted upon the sale of the copyrighted work. After the sale, the buyer can freely distribute such copyrighted work to third persons. However, the distribution rights only exhaust the sales of tangible assets but do not apply to the sales of digital assets. Since NFTs exist in digital form, the right of exhaustion does not apply. Thus, the buyers of NFTs can no longer be able to display or sell copies of NFTs without the consent of the copyright holder.

The Supreme Court of Korea, in the *Soribada* case, held that the copyright holder’s distribution rights are not exhausted in the sales of digital assets unless they are sold in a tangible form such as CDs or USBs that contain the digital copy. However, we should treat NFTs differently from any other digital files because of their distinctive characteristics. Although NFTs are not sold through CDs or USBs which can authenticate ownership, the sales of NFTs have very similar characteristics to the sales of tangible properties. The NFTs are capable of verifying the originality and ownership through their separate and unique identification codes placed on the blockchain. Even though most NFT platforms grant distribution rights to the NFT buyers through their terms and conditions, it may not be enough because the size of the NFT market is rapidly increasing. There are remaining concerns about whether to extend the scope of the right of exhaustion to be applied in the sales of NFTs. At some point, it will be necessary to allow the right of exhaustion in the sales of NFTs.

D. What do you actually own when you buy an NFT?

The buying and selling of the NFTs appear to be that there is a transfer of ownership. However, under the current law, the sales of NFTs, which still exist in digital form, are deemed that the parties are entering into a licensing agreement. Unlike ordinary digital assets, the NFTs limit infinite duplication of the files and provide uniqueness to the digital asset. It suggests that we should recognize NFTs as our private property that ownership should transfer rather than merely granting a license. As a result, it is necessary to consider NFTs as private property especially when they were used and sold to make a profit.

In general, when a digital file is distributed, there is no complete transfer of ownership because the former owner, a seller, still has access to or uses the digital file without obtaining approval from the buyer. For example, if the buyer is capable of having complete dominion of the NFT and can prove its ownership right, there may be a transfer of ownership. In contrast, if the seller still has access or can make use of the digital file even after the sale, there is no transfer of ownership, but rather granting a license to the buyer.

The NFTs can be treated exclusively. For instance, NFT codes are immutable, and there is no centralized custodian (administrator) who controls or manages the blockchain after the smart contract is activated. Moreover, the buyers can use the NFT independently from the seller, exclude the use of others, and inherit, or destroy the NFT after the purchase. These aspects indicate that, unlike any other ordinary digital files, the NFTs can be owned and controlled by a specific person. Therefore, the sales of NFTs should be regarded as a transfer of ownership.

Furthermore, if the transfer of ownership is not permitted, it may lead to inconsistencies in the actual intentions of transacting parties. First, the buyers and sellers of the NFT usually intend to transfer ownership of the NFT through sale rather than granting a license. Second, the NFT buyers are likely to pay a higher price than equals an amount to the ownership of the NFT without realizing that the actual effect of the transaction is a licensing agreement. Considering the transacting parties' actual intention of buying and selling the NFTs, we should treat such a sale to effectuate a transfer of ownership rather than granting a license to the buyer.

The problem is that most NFT platforms advertise as if they are selling ownership of NFTs. The buyers of NFTs will likely be involved in a legal dispute claiming their ownership rights in the future. To match the actual intention of the parties, and to protect the interest of the buyers, we should presume that the sale of NFTs is meant to transfer ownership unless there is a separate agreement with respect to the ownership and license of NFTs. Therefore, the NFT platforms should provide clear guidelines to the buyers and notify them about their rights to prevent potential controversies in the future.

E. NFT and the Resale Royalty Right

The resale royalty right provides artists with an opportunity to benefit from the increased value of their works overtime by granting them a percentage of the proceeds from the resale of their original works of art. If the right of exhaustion is to protect the interests of the buyer by exhausting the distribution rights of the copyright holder, the resale royalty right is to protect the interests of the copyright holder whose distribution rights exhaust upon sale.

Under the current Korean law, the resale royalty right has not been introduced. In the cases of NFT, the seller can set up a royalty rate, and as soon as the pre-entered conditions are met, the smart contract will execute the contract automatically without the need for legal enforcement. Again, the resale royalty right has not been introduced in Korea in which it is still unclear to whether what kind of legal protection is available to the copyright holder or seller.

For example, the seller can set a 10% resale royalty rate on the NFT through a function provided in the NFT platforms. If the buyer wants to resell the NFT in the same platform, the agreed 10% royalty will be automatically paid to the seller upon sale. However, the problem is that if the buyer chooses to resell the NFT on a different NFT platform, a 10% resale royalty will not be paid automatically to the seller. When the seller's royalties are not paid properly in subsequent transactions, the seller might have to claim his royalties every time his NFT is sold. Since the resale royalty right has not been recognized in Korea, the seller will not have a legal ground to claim his royalties. Moreover, there may be a potential dispute under the privity of contract doctrine because the seller is not a contracting party that directly enters into a contract with a number of consecutive buyers. As result, there are many difficulties in asserting the seller's right to payment.

To protect seller's right to payment under the copyright law, we should recognize the resale royalty right reciprocally among countries when the NFT was sold to the countries recognizing the resale royalty right.

In respect to the contractual protection, it is necessary to extend the scope of the privity of the contract. Even if the seller is not a direct party to the continuing sales of NFT, if the seller or its agent was able to prove that he is entitled to the royalties, it should be presumed that the seller and the subsequent buyers are deemed to have a horizontal contractual relationship.

F. Smart Contract and Right Protection of the NFT buyers

A smart contract is a self-executing contract with the terms of the agreement between buyer and seller being directly written into lines of code. Although it is disputable whether smart contracts should be treated as traditional contracts, smart contracts are less likely to be treated as traditional contract. It is more appropriate to treat smart contracts as computer programs or codes that are guaranteed to perform automatically the pre-entered codes on the block.

Since the smart contracts are composed of plain and inflexible codes, their performance is very limited compared to traditional contracts that are written in natural language. The smart contract can execute objective and predictable contractual obligations through pre-entered codes, but it is almost impossible to codify all the arising circumstances that will occur after the creation of the smart contracts. Additionally, the smart contract cannot manifest subjective standards of the contracts such as good faith, equity, or best effort. Thus, the use of smart contract is bound to have certain limitations.

Furthermore, the contract interpretation may be necessary to solve contractual disputes between the parties. For example, it is important to determine whether there was an agreement, whether statements clearly reflect the intention of the parties, whether a party has a binding obligation, etc. Even though the smart contracts are created fully in codes or a mixture of the codes and natural language, the contract interpretation may be required. In that case, considering that the seller is the one who creates the smart contract including the configuration of the codes, the interpretation of the smart contract should be in favor of the buyer.

Moreover, even when the contract becomes invalid between the original contract parties for any reason, the bona fide third-party buyers should be protected as well. For instance, the contract terms agreed by a bona fide buyer should be presumed to be valid so long as they do not exceed the rights of the original right holder.

G. Conclusion

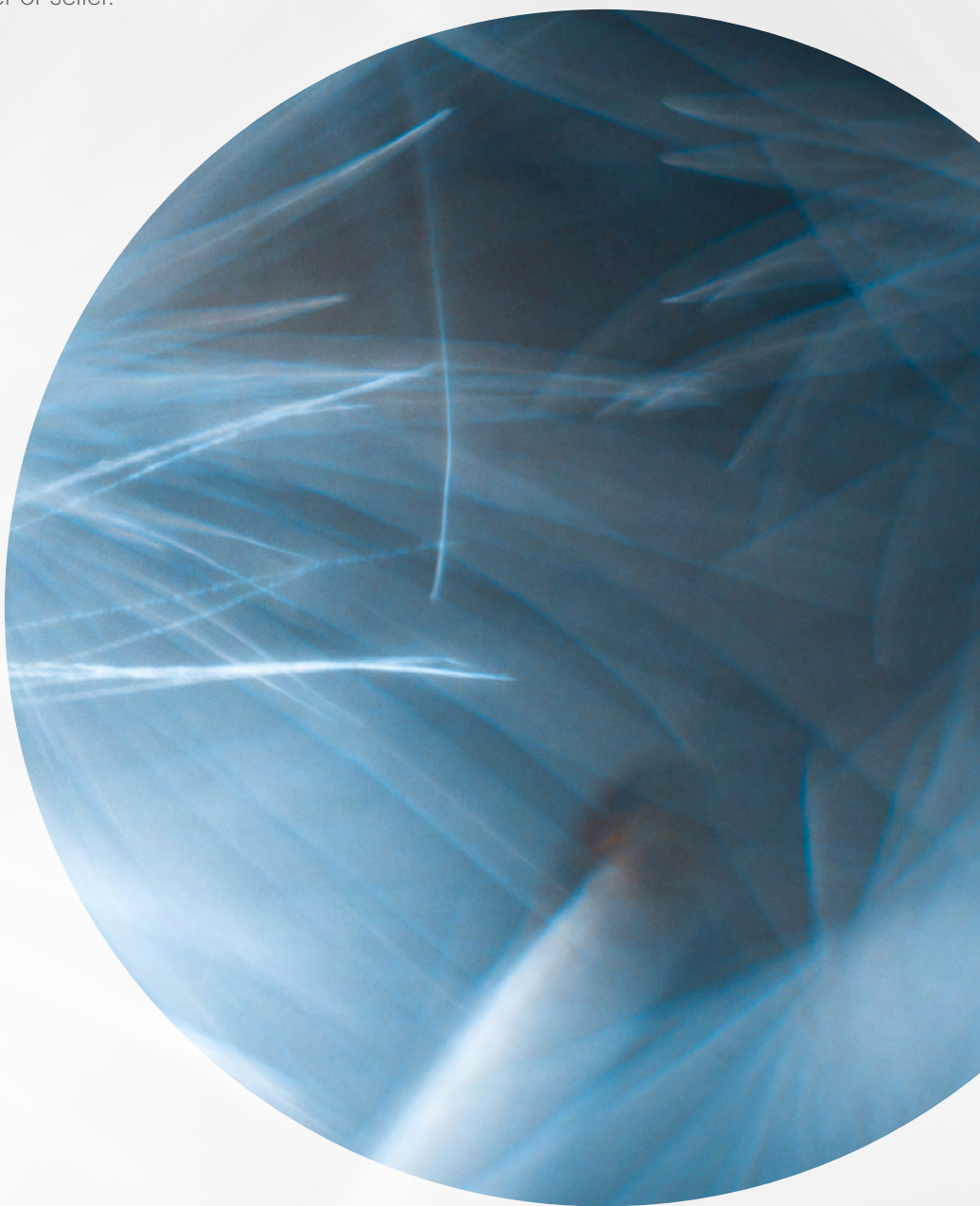
The NFTs are based on blockchain technology which indicates various information including the owner's identification information and purchases history of the digital assets by providing separate and unique identification codes. Unlike any other digital assets which can be duplicated and distributed indiscriminately, the NFTs are a kind of digital assets that can prove ownership. Because of the NFTs' non-fungible characteristics, they can be viewed from various legal perspectives.

First, any transactions of the NFTs are considered as licensing agreements under the current law, but not as a transfer of ownership. However, considering the non-fungible nature of the NFTs, and to achieve the actual intentions of the parties of the transaction, the NFTs should be treated as private property



that ownership can transfer. Second, the right of exhaustion is to exhaust the distribution rights of the copyright holder for the legitimate sales of physical copies. The NFTs should be treated similar to the transfer of physical copies, and therefore apply the right of exhaustion in the sales of NFTs. Third, although the resale royalty right has not been introduced in Korea, the NFT platform provides an option to set a resale royalty rate for automatic payment of the royalties. However, this can lead to a legal dispute when royalties are not properly paid automatically to the copyright holder or seller. Unfortunately, there is no legal basis to protect the royalty right of the copyright holder or seller.

Lastly, smart contracts consist of codes or a mixture of codes and natural language. However, they are not treated as same as traditional contracts. The performance of the smart contracts is very limited to the pre-entered codes of the NFT. Therefore, it may lead to potential legal disputes due to changing contractual obligations of the parties in the changing circumstances after creating a smart contract. Therefore, there are various legal measures to be taken into place to address these issues or the limitation of the current law and protect NFT consumers in a rapidly growing NFT market.



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