

# What Are the Legal Risks of Purchasing NFTs?

The arrival of non-fungible tokens (NFTs) as a proposed avenue for the sale of art and collectibles has earned a divisive reaction in the art space. A year on from NFTs' first explosion of popularity, many investors are still unsure of the rights and risks associated with purchasing them. Below, Mazzola Lindstrom associate Kevin Kelly answers some commonly asked questions on the subject of NFTs.



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## What issues are traditional art buyers and collectors facing with their first forays into the NFT space?

First and foremost, it is important to note the scale in which NFT sales are disrupting the art sales market. Last year, the volume of NFT sales totaled \$24.9 billion, Reuters reported, up from \$94.9 million in 2020. In 2020, the traditional art and antiquities market was estimated at \$50 billion.

As traditional collectors try to understand NFTs (non-fungible tokens), it is best to define it as an irreplaceable piece of data that is verified on the blockchain. As such, many of their questions I have received have focused on the exclusivity of rights of artworks minted as NFTs. Recently, I was asked if it would be possible to mint a copy of a Picasso that an art collector owned. Technically, the answer is no, as the act would be an infringement on the copyright of the Picasso work. The collector does not own the copyright – the Picasso Estate

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does. Mere ownership of an original painting does not mean that a collector owns the copyright of the piece.

Another common question that I receive about NFTs concerns their virtual, digital nature. Traditional collectors seem to question why an NFT is valuable when it is solely virtual; whereas traditional art includes a physical piece of art. NFTs and traditional art are valuable for similar

reasons. Before NFTs, critics lamented that they did not utilize techniques like Jackson Pollock's drip painting technique since, according to them, it "took no skill" and are now somehow worth millions of dollars; however, these critics fail to understand the true value of a Pollock drip painting. While the technique may appear "easy", these critics fail to realize that the price does not come solely from the physical paint on the canvas, but what the work represents. If the price comes from what the work represents, then what difference does it make to own a physical canvas or an NFT?

As NFTs and the traditional art world become more interconnected, artists and galleries are beginning to offer NFT and physical art pairings. For example, artist Arina BB's ManManLaiZzz collection pairs NFTs with physical paintings. Additionally, artists can receive royalty payments automatically to their crypto wallet as their works are sold on the secondary market. The royalties gives artists a chance to share in their future success too because, unlike the traditional art world, NFT artists will receive a portion of future sales. These

royalties are a completely new avenue for artists to generate passive income. These royalties further provide some additional financial security to artists so they can focus on what they do best: creating art.

## Do NFTs give rise to unique cybersecurity concerns?

NFTs give rise to unique cybersecurity concerns for individuals, but your exposure is limited. There are two main types of NFT wallets. A "hot" wallet is an electronic wallet that exists on your browser or phone and is connected to the internet. A "cold" wallet is a physical wallet that you can purchase that is only connected to the internet when you are performing a transaction. The significance of this is that cyber criminals can easily target hot wallets and transfer the NFTs and cryptocurrency that you have stored there. Generally, these hackers use typical techniques like phishing links or emails to gain access to your hot wallet and transfer its contents to themselves.

With a cold wallet, since you need to approve the transaction on the physical device, a cybercriminal cannot steal your NFTs as easily compared to if you were using a hot wallet; however, hackers are using other techniques to convince individuals to willingly transfer their NFTs from their cold wallet. It is important to clarify that although your NFT is stored on the blockchain, what is stored within the wallets is akin to a key to unlock, transfer, and own the NFT.

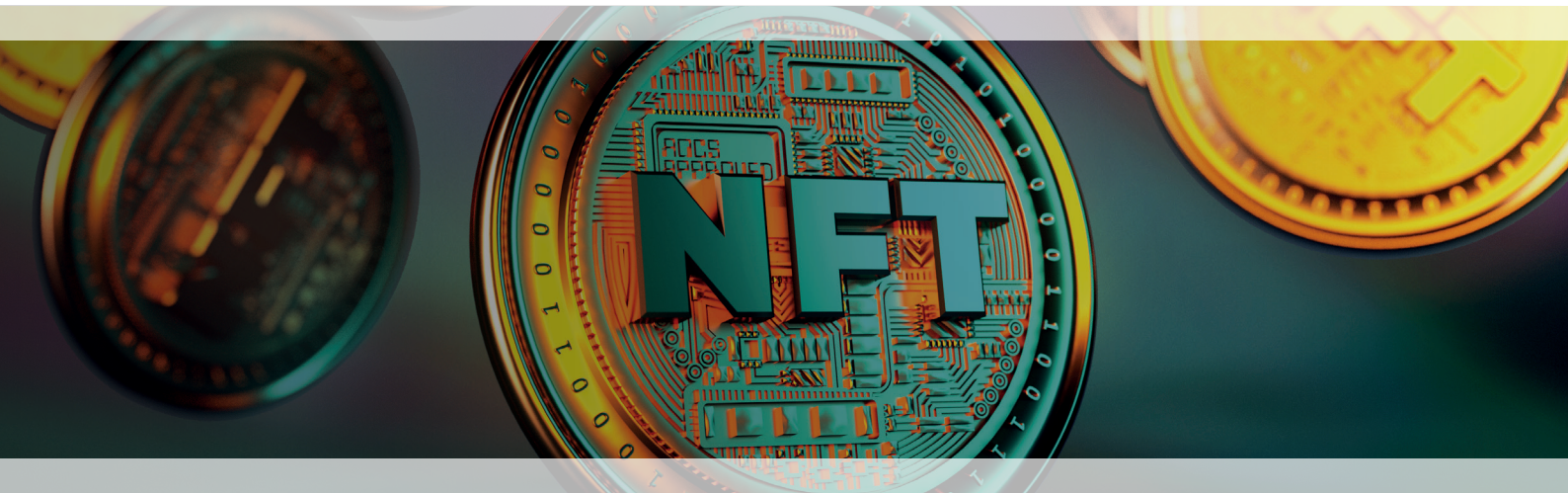
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There are also options for recourse in the event that your NFTs are "stolen" or unknowingly transferred to a hacker's cryptowallet. Since all transactions on the blockchain are public, it is possible to track down stolen NFTs; however, recovering them is a different story. Some individuals have gotten lucky and were able to track down, reach out to the owner of the wallet where their NFT is now located, and then repurchase their stolen NFT from the innocent third party purchaser.

## Given the lack of regulation, how can individuals in the NFT space protect themselves from threats and limit their exposure?

For artists, traditional art laws still apply so contracts and intellectual property rights. There are a few legal questions that remain unanswered in the NFT space, but the best way to protect your exposure as an artist is to make sure that you speak with legal counsel who





understands NFTs and Web3 prior to making a purchase. It also helps if your legal counsel has an art law practice and understands the fine art marketplace equally, such as Mazzola Lindstrom LLP.

As a consumer, the best way to protect yourself is to do your own research. The best way to do this is through learning about the NFT space and interacting with the NFT community through in-person events and specifically on Twitter and Instagram. Do not be afraid to ask questions. Very few people have been involved with NFTs for more than a year at this point and even the true “veterans” have only been in the NFT space since 2017 at the earliest. While there are risks out there, the NFT community is very helpful, welcoming and quick to identify unscrupulous behaviour.

Regarding NFT projects themselves, you need to pick a certain risk tolerance and adhere to it. You may see people buying an NFT for 2 ETH (about \$6,000) and selling for 30 ETH (about \$180,000). That is not typical. The key is to become educated and mitigate your risk tolerance by being consistent and not getting too caught up in the hype. As an attorney I lean towards being risk-averse, but I have personally begun to collect NFTs for their artistic value and to support my favorite artists and projects. My suggestion is to make sure that you

know the artists and leaders behind a project before investing in it.

### **What additional security measures should one consider to ensure their digital wallet is safe and their NFT portfolio is protected?**

If you are lucky enough to own NFTs that are hundreds of thousands or even millions of dollars, my best piece of advice is to contact Appraisal Bureau and have your NFTs appraised, insured by Lloyds of London, and stored on a Ballet wallet in a secure vault with Malca-Amit. Caroline Taylor of Appraisal Bureau is currently the only fine art appraiser who has developed a proprietary method to appraise NFTs and Lloyds of London requires that all NFTs use her method for appraisal before they will insure the NFTs. Once insured by Lloyds of London, your NFT is then stored on a Ballet Card, which is a form of a cold wallet and physically stored in a vault by Malca-Amit. Currently, this is the only way to receive full liability insurance for your NFTs and, in my opinion, this is the best way to fully protect your NFTs.

#### **Kevin Kelly**

Kevin Kelly is an associate at Mazzola Lindstrom whose practice focuses on commercial litigation. Kevin represents domestic and international commercial businesses in arbitration or litigation on transactional matters, and has also worked on a variety of insurance matters including subrogation, coverage determinations, broker liability and handling bad faith claims. His practice also includes work on art law relating to NFTs, and he has experience advising on intellectual property rights and jurisdictional issues in this area.

#### **Mazzola Lindstrom LLP**

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