

Kluwer Copyright Blog

NFTs: promisingly transformational, yet fraught with IP pitfalls – Part II

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Part I of this blog introduced the first of three ambiguities NFT purchasers may face. In this part II we discuss two additional aspects, with a focus on UK copyright law and the EU copyright acquis.



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The First Sale Doctrine in the Metaverse

The first sale doctrine, also referred to as the ‘[principle of exhaustion](#)’, is a longstanding tenet of copyright (and more in general intellectual property) law. This doctrine has a significant effect on the economic vitality of the NFT industry, especially when it comes to ‘online exhaustion’ and the prospect of a secondary market in digital content. The first sale doctrine restricts the rights holder’s exclusive right to distribute a copyrighted work to the public, where the distribution right to control secondary sales is ‘exhausted’ upon completion of the first lawful sale of a copy of the work by the rights holder or with their consent. In response to the challenge of defining guidelines for digital exhaustion, which calls into question the rationale of the traditional exhaustion principle, two significant yet discordant CJEU rulings can be used to decide the matter of exhaustion in the blockchain-based environment.

Firstly, in conformity with the CJEU’s 2012 *UsedSoft* case, the exhaustion doctrine applies to [first sales of computer software copies](#). However, the Court specified that this *UsedSoft* judgment exclusively protects computer programs, as the Computer Programs Directive is *lex specialis* to [Directive 2001/29/EC](#). As such, this ruling is not deemed pertinent as a precedent for the application of the first sale doctrine in relation to NFTs.

Secondly, the concept of exhaustion has been increasingly marginalised and has decreased in its legal and market impact in relation to digital assets in the EU after the CJEU’s 2019 landmark judgment in *Tom Kabinet*. Other than with regard to software, the CJEU rejected the admissibility of digital exhaustion under Article 4(2) [InfoSoc Directive](#) by ruling that immaterial copies of e-

books made obtainable via download are excluded from the exhaustion doctrine. Similarly, it could be argued that the right of distribution (Article 4 of the InfoSoc Directive) does not apply to the sale of an NFT linked to a work, hence the virtual sale does not exhaust such right. The CJEU noted that the online dissemination of intangible protected content is regarded as an act of communication to the public within the meaning of Article 3.1 of the InfoSoc Directive, which is not subject to the exhaustion exception, as opposed to distribution as per Article 4 of the InfoSoc Directive. Simply put, only physical goods are subject to the exhaustion of the distribution right, whereas digital goods are merely subject to the right of public communication.

The fundamental nature of NFTs might disrupt the arguments put forward in the *Tom Kabinet* case. Arguably, the non-fungible nature of NFTs allows them to differentiate themselves from fungible, non-exclusive digital assets in the resale market of digital copies such as e-books. As a means of cryptographically proving ownership on the blockchain, each NFT has a unique hash, distinguishing it from other copies, as opposed to the non-exclusive license to access the copyrighted material obtained when purchasing an e-book. This categorisation of NFTs suggests that a single copy might be sold repeatedly, much like a tangible work. Additionally, the economic rationale for the *Tom Kabinet* ruling stipulating that digital exhaustion would adversely affect the rights holders' capacity to obtain satisfactory recompense from their works' exploitation is here absent. Indeed, the interests of rights holders, who retain control of the work's exploitation, are unaffected by subsequent exchanges of digital commodities. Therefore, as one may consider an NFT to be merely metadata, the first sale doctrine appears untenable. For example, the Chinese Court in the *BigVerse* case confirmed there is no premise or basis for the application of the exhaustion doctrine to the transactions of NFT digital works.

Thus, in conformity with a stringent, literal interpretation of EU law which rejects exhaustion in the face of digital distribution, the first sale doctrine will likely not be applicable to the resale of NFTs. Moreover, as explained below, despite this 'doctrinal murkiness', many NFT sales seem to circumvent the first sale issue by including an automatic resale provision in the smart contract, providing NFT minter with an unprecedented continuous stream of royalties upon each resale.

Resale Rights

Another notable difficulty when it comes to tokenising artworks is brought on by the resale right regime. By virtue of the artist's inalienable and unwaivable resale right, authors of original artworks are entitled to a resale royalty upon reselling their work via qualifying intermediaries, hence participating in its further success. Whether the creators of the tokenised works can assert this continuous financial participation opportunity following the resale is a subject of considerable debate. Firstly, the applicability of the resale right would appear evident at first glance given that an NFT is designed to generate a digital original of an artwork. However, as previously stated, an NFT does not satisfy the 'originality' criterion, primarily because an NFT is merely a representation of the original work of art. Consequently, one might argue that the sale of an NFT represents the reassignment of a dataset on the blockchain rather than the sale of an original work

of art. Note that depending on the scope of the agreement, the sale of an NFT may also amount to a simultaneous sale of the original physical artwork. Such resales of works of art taking place in tandem with NFT undertakings may generate the resale right, presupposing that on-chain NFT ownership and off-chain artwork ownership are aligned. Secondly, based upon the unambiguous language of the EU Directive, on which the [UK legislation](#) is based, the artist's resale right solely applies to works that are tangible and physical in nature and thus cannot apply to NFTs.

Though the resale right regime does not apply as a matter of law, an analogous approach may be applicable as a matter of code. Authors do not necessarily need to satisfy the statutory requirements in order to assert the resale right, as NFT creators can impose an [automated contractual requirement](#) programmed through the means of an NFT smart contract on the blockchain, enforcing the payment of a resale royalty upon each subsequent sale in the secondary market in perpetuity.

While not all marketplaces are geared towards offering such passive income, some do. For example, the [OpenSea](#) Platform offers authors the opportunity to determine a commission percentage, also referred to as 'creator earnings', of up to 10% for each resale that is ascribed to the NFT creators as a service during the minting process.

However, smart contracts merely permit such coded [resale royalty](#) commands, they do not ensure their operability. Firstly, NFT owners are able to transfer their NFTs from the original minting platform to an off-platform wallet and thereafter sell them on another marketplace that does not employ the original minting platform's design and smart contract protocols. Therefore, NFT creators can subvert resale royalty protocols via technical loopholes, as marketplaces are not cross-market interoperable. Secondly, the NFT transaction can simply be taken off-chain. Thirdly, notwithstanding the technical advancement of platforms and smart contract architectures over time, an existing smart contract cannot be modified, as they are encrypted on an immutable and transparent blockchain by default. For greater legal protection across the NFT platform ecosystem, any coded resale royalty outlining the resale royalty duty should be supported by a written, natural language contractual term.

Concluding remarks

NFTs stand for a meta-ownership notion that uses code to enable ownership-like digital distribution, exhaustion, resale and enforcement inside the framework of a blockchain-based network. The preferred form of regulation in the NFT sector is code rather than copyright law. Correspondingly, copyright legislation must be modernised to include digital artworks and products in the world of Web3, as enhancing consumer and creator protections will promote market growth and preserve the characteristics of NFTs that initially piqued public and corporate interest. These adjustments need not be severe, as the majority of obstacles posed by NFTs and the ever-evolving metaverse are difficult to predict. Even so, seemingly insignificant adjustments may spell the difference between a thriving market and a collapsing one. Furthermore, analysing the legal recognition and enforceability of smart contracts in each concerned jurisdiction is crucial.

NFTs do not appear to conform neatly to copyright law axioms. However, as with any innovative application of technology that achieves a sufficient level of public acceptance, they do present a chance to retool key concepts of copyright law. Outdated paradigms must be substituted with innovative thinking in order to fully realise the potential of a blockchain-based system.

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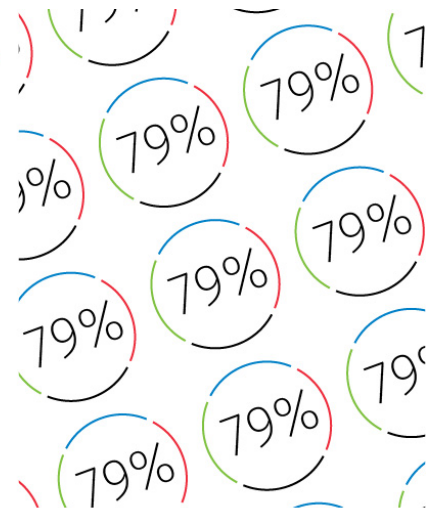
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