Ep. 32: Tokenization of IP Rights and NFTs in Commercial Finance

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In our increasingly digital economy, cryptocurrencies and NFTs have gained popularity for everything from consumer transactions to securities. How are digital assets being used and regulated in the commercial setting, especially in the context of collateral and intellectual property?

Marshall Grodner: My name is **Marshall Grodner**. I'm a Partner in the Baton Rouge office of McGlinchey Stafford. I am in the Business and Finance section of the firm. And with me today is **Drew Patty**, the managing partner of our Intellectual Property section as well as the Managing Partner of the Baton Rouge office. And Drew, I'm going to ask you a few questions. First, why do NFTs exist? And what problems did they seek to solve?

Drew Patty: Marshall, thank you. NFTs exist because there was a need for an ability to offer rights or value in a way that was secure and validatable, and might be more efficient by disintermediating, or avoiding the transactional costs of traditional ways of transferring and exchanging rights or value. There are different kinds of tokens. NFTs are "non-fungible tokens," meaning they're unique. Rather than fungible tokens like cryptocurrencies, the individual NFTs exist as a unique asset and therefore are not exchangeable one for another, necessarily. The problem they seek to solve really is the problem of barriers to trade: transactional costs, and inefficiencies in traditional markets for these kinds of assets. Trying to make a transfer of these kinds of assets more efficient, more democratized, and yet still secure and valid.

Marshall Grodner: Well, that's interesting Drew. How are IP rights, since you're our intellectual property guru, being monetized to NFTs currently, and where do you see the future trends going in these NFTs?

Drew Patty: To take a step back: historically, IP rights, if they were to be transferred, licensed, or monetized, you would normally do it through the traditional method of a written contract. Parties would have to undergo due diligence to make sure that the assets were owned by who they thought they were owned by, and that they were being sold or licensed appropriately with no intervening third-party rights. There was a fair amount of transactional cost in doing that kind of due diligence and making sure that the parties executed the documents correctly, recorded them where necessary, and so forth. Well NFTs, the intention here in the use of NFTs, is to make that process more streamlined, digitized, and simplified for the purchaser, as well as the issuer of rights in intellectual property that the issuer owns or controls. So currently intellectual property rights can be monetized by a party who owns or controls IP rights and who decides to transfer some or all of those rights through a smart contract, digital contract, that's securely arranged on an internet website, for example, or portal. And those rights are then uniquely tokenized through that same sort of website that converts the smart contract into unique tokenized rights that are then offered to the public or to potential buyers.

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As far as where I see the future trends in this area going, many different kinds of rights, including, but not limited to intellectual property rights will become the potential subject of NFTs, whether they be licenses or ownership rights and intellectual property, because of the efficiencies that can be brought to bear with an NFT and smart contracts. It will undoubtedly be heavily regulated when the regulations catch up to the technology. But it seems like the efficiencies and also the economies of the ability to monetize for those who own the intellectual property rights is going to be too enticing for this to be a flash in the pan kind of trend. It's going to become more prevalent unless there becomes some drastic technological hack or obvious way to disrupt the validity and security of NFT offerings, such that there's a loss in trust, because once you lose the trust in the NFT process, it could be undermined. But unless something like that comes along, I see the NFTs becoming very prevalent.

Marshall Grodner: Well, you mentioned one risk associated within NFTs. What are some of the other risks associated with NFTs, particularly those based on IP, for parties buying or offering NFTs, and what steps can be taken to mitigate those risks?

Drew Patty: Many of the same risks that exist when you're doing a traditional IP transaction will exist in these transactions and will still require some due diligence on who's the issuer of the NFT. How do they validate their ownership interest or control interest in the IP that undergirds the NFT offering? What happens if some sort of intervening third-party rights come about during the existence of the NFTs? So it will be incumbent on anybody that's going to buy an interest in an NFT, or buy a token, to do their due diligence on the terms and conditions under which the NFT is offered, the party who's offering the NFT, and the assets that are supporting that NFT's value. And so it will behoove them to do their own disclosure analysis. What are the disclosures being made at the time the NFT is being offered? And what are the questions that need to be asked and answered about the IP and its ownership, to make sure that the offeror really has the rights that they purport to have in the IP and in the token that's being offered. The process may be more efficient and maybe more secure with the advent of blockchain technology. That doesn't necessarily eliminate any of the due diligence questions that still need to be asked and answered.

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On the additional mechanisms of monetization, of course, when you own an NFT, a token of this sort, you might want to use it as an asset for a loan, for example, or to secure a loan. And that's important because it gives liquidity value to the NFT. But Marshall, as a person who's skilled in all things commercial finance and UCC law, I'll ask you a question, which is, how can NFTs be used as collateral for financing purposes?

Marshall Grodner: Well, thanks Drew, and as you mentioned, there is a growing market in NFTs, as well as a maturing market in cryptocurrencies. And for any market to mature, advance, become a well-developed market, you have to be able to finance transactions in the market, just like in real estate, buying a home. Very few people buy a home with cash nowadays, they're usually financing it. And the same is happening in the cryptocurrency world and will have to happen and is developing and the NFT world. So generally an NFT seems to be a type of personal property in which you can get a security interest under Article Nine of the Uniform Commercial Code. Now, there's various permutations about how you can do it, and what you can do [with] it, but it looks like NFTs are and will be financable. Generally, they will probably be, in the most part, classified as a general intangible, and you can perfect a security interest – a lender can perfect a security interest like filing a mortgage on your property, by filing a financing statement in the appropriate jurisdiction.

There are several other ways that give better protections for the lender where, for example, with cryptocurrency and some NFTs are held by a third-party, usually called a "wallet." And when it's held by a custodian for the benefit of the actual owner of the rights, then there are some other methods to perfect. It's similar to getting a broker account – a security interest in a broker's account where you have a three-party agreement between the wallet holder, the lender, and the owner, the customer of the wallet. You get an agreement that says that the wallet will listen to the instructions of the lender without the further consent of the customer/owner of the NFTs. That's been actually well-recognized in the cryptocurrency world and it's starting to be recognized and used in the NFT world. So as the NFT market matures, more and more lenders will probably get into the NFT market as they are getting into the cryptocurrency market. So it becomes important for the markets themselves to develop, to make sure that lenders are comfortable with NFTs as collateral.

Drew Patty: Do you think that they will end up having to develop sort of smart contract systems as well for those third-party intermediary agreements?

Marshall Grodner: Yes. And in other areas of the law, including cryptocurrencies, there are, the Uniform Commercial Code is medium-neutral in this aspect. You can have not only writings and wet signatures, but you can also have electronic contracts that grant the security interest. That third-party agreement is called a control agreement. They can all be in electronic form and you can assent to it – it's called "authenticate" by the debtor or the party to whom, that wants to be bound by it. And there is no reason at all that those "electronic records" (as they're called) cannot be a smart contract, or otherwise an NFT in and of themselves.

Drew Patty: So the whole process could be digital and be a series of smart contracts: one series that grants the NFT, or issues the NFT, and then the other that receives it as an asset to be held in custody during the loan process or during the life of the loan.

Marshall Grodner: Exactly. That's sort of well documented in the cryptocurrency level and other types of electronic records, such as chattel paper, electronic "promissory notes," etc. So that's a well-developed area of the law that can be applied to sort of the new-found NFTs.

Drew Patty: Right. If IP is the asset backing the NFT, are there other issues involved or that could come up when it comes to securing or perfecting?

In addition to taking the steps that the UCC would allow, taking a security interest in a general intangible, and filing a financing statement, you would also, to the extent the underlying property interest in the NFT is a copyright, a patent, or a trademark, you would need to also file with the appropriate federal office.

Marshall Grodner: As, Drew, you're well aware, ownership or rights in many types of intellectual property, including patents, trademarks, and copyrights, are governed by federal law. And federal law provides that, generally, the assignment of such intellectual property rights needs to be recorded in the appropriate federal office: the Patent and Trademark Office for patents and trademarks, and the Copyright Office for registered copyrights. So in addition to taking the steps that the UCC would allow, taking a security interest in a general intangible, and filing a financing statement, you would also, to the extent the underlying property interest in the NFT is a copyright, a patent, or a trademark, you would need to also file with the appropriate federal office. It's just like, you could have an electronic deed to a piece of real property for whatever reason, but to put third parties on notice of the assignment or the mortgage of that real property, you will still need to file the deed with the register of deeds, or the mortgage with the register of deeds, and the appropriate real property filing office in the appropriate parish or county.

Drew Patty: So you really need to understand what it is you're acquiring when you take a security interest in the NFT, what that NFT represents – that is, what's the form of property that it can be classified as.

Marshall Grodner: Exactly. Exactly. And that's why we have our intellectual property lawyers working with us finance guys to make sure that these sorts of transactions are properly documented, and it could be electronically documented.

Drew Patty: On a go-forward basis, do you see or foresee any changes on the horizon regarding NFTs and how they're used as collateral interests are perfected?

Marshall Grodner: Yes, as of right now, the American Law Institute and the Uniform Law Commission are working on revisions to the Uniform Commercial Code as a whole, and they are introducing a new Article 12 of the UCC that will apply to "controllable electronic records," is the technical name. These will be ultimately called CERs. So that's something that's on the horizon and it will govern control, which includes perfecting a security interest, in CERs. Generally CERs include almost all commonly referred to as "digital assets," including cryptocurrencies and NFTs. So that's on the horizon coming down the pike. It looks like the final versions, or the uniform versions will be ready for enactment in the summer of 2022. And we expect that the states will start enacting them in the legislative sessions in the various states following the promulgation of the uniform code itself, the approved code.

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Drew Patty: Okay, so in the interim between now and then, parties just need to follow the Article Nine of the UCC in their respective state or the applicable jurisdiction for the collateral in question?

Marshall Grodner: Yes, exactly. And remember, there's always an overlay, as we discussed federal law regarding copyright, various intellectual property, including registered copyright, patents, and trademarks.

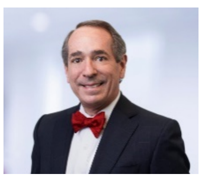
Drew Patty: Right. It also will depend on Article 12 and the new UCC being adopted in the various states, which is also could take time.

Marshall Grodner: Yes. And we're hoping that, as in the past, that although the timing may be a little different, depending on when various legislatures are in session, that we would hope that most, if not all the states and other jurisdictions in the U.S. will have adopted Article 12 and some other revisions by 2023, or sometime during 2023.

Well, thanks Drew, this has been a great discussion. I'm sure as you can see from our last little tete-a-tete, that there are some new stuff coming down the line. We hope to inform you of these in the future, as well as other development in this emerging area of the law. So we look forward to continuing this conversation in the future as these sorts of things progress, and thank y'all for listening.

Drew Patty: Take care.

Thanks for tuning into this episode of "More with McGlinchey." If you have a question or would like to propose a topic, we'd love to hear from you at podcast@mcglinchey.com. For additional resources on this topic, please visit mcglinchey.com. On behalf of the law firm that brings you more, we hope you'll join us next time.



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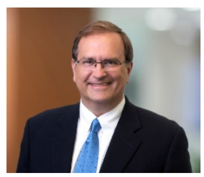

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