



Are You Ready for Web3.0 and the Legal Issues it Will Bring?

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February 2022

Blockchain is one of the most significant new technologies since the internet. It has ushered in what has been referred to as Web3.0. Some of the most popular applications of this technology include NFTs and metaverses.

At its core, a blockchain is a distributed ledger for recording transaction data. Transactions get verified by a consensus mechanism specified by the blockchain protocol. Validated transaction data is written to a “block” and time-stamped. When the block is filled, a new block is created and the system creates a cryptographic hash value of the block. This hash value is written as an entry in the new block, thereby “chaining” the blocks, hence the term “blockchain.” If someone ever attempts to change an entry in a prior block, the hash value would no longer match what was written into the subsequent block and that attempt would be deemed invalid. In part, this is how blockchain creates immutable records. Only validated transaction data is recorded and time-stamped, and this data cannot be altered. Many companies as well as the federal government are engaged in projects utilizing blockchain and continue to seek ways in which blockchain technology can be used to make transactions easier and more secure.

NFTs, or non-fungible tokens, provide a convenient way to track ownership and process transactions for digital assets and other entitlements (tickets, exclusive access, and much more). The NFT market ballooned in 2021 to \$24.9 billion up from \$94.9 million in 2020. And it is continuing to grow at a rapid pace in 2022. While many of the use cases for NFTs may not yet appeal to everyone, the technology can and will be used to record the ownership of all types of physical and digital assets and entitlements. Many brands and other companies are leveraging NFTs to offer a digital representation of ownership of a real-world item and for other entitlements. For example, see [here](#). Other examples of creative use of NFT technology are [here](#).

Metaverses have also been very popular. Many multi-billion dollar companies have made big announcements as part of their metaverse strategies. For example, Microsoft made acquisitions that “will provide building blocks for the metaverse.” Major clothing brands launched NFTs as part of their digital wearables play in the metaverse. YouTube is hiring its first-ever Web3.0 director. Large multinational companies are actively hiring metaverse engineers. McDonald’s, Epic Games, and many others have all made significant strides towards metaverse integration or development.

There are and will be many uses for the metaverse including for business, governments, social interaction, and entertainment. For example, the metaverse may change the way we work. Video calls will become obsolete while virtual interaction with coworkers will become the norm.

So what is a metaverse? At its core, metaverses are a confluence of technologies and business models. There will be many metaverses. Some of the technologies and business models will include:

- **Virtual worlds** - Shared, immersive social spaces where users, represented by an avatar, interact with the world and other users, where often land is sold to users for users to build spaces and experiences, often involving an in-world economy.
- **AR/VR/XR** - Many metaverses will include enhanced reality technologies including 3D and virtual reality.
- **Blockchain and NFTs** - At least some metaverses will be decentralized and/or rely on blockchain technology, NFTs, and Decentralized Autonomous Organizations for governance, management of communities, ownership of virtual items, and/or entitlements.
- **Social Media and Communications** - Metaverses will include in-world communications tools and often will integrate IRL communications and management of communities.
- **User-Generated Content (UGC)** - Many metaverses provide building blocks for users to build out spaces, experiences, and digital objects and transact via in-world commerce.
- **Games** - Many metaverses will include games and apps.
- **Digital Currency and Cryptocurrencies** - Many metaverses will have a native digital currency (e.g., Linden Dollars, Mana, or Sand) or will facilitate the use of cryptocurrency (e.g., ETH).
- **Advertising** - Many spaces include virtual advertising and brands will own or lease virtual land, use NFTs, and branded virtual items to promote their products and services, employ avatar-based influencers, participate in sponsored events and engage in other metaverse activities.
- **Music and Movies** - Some metaverses will enable users to create music and use existing music. Some will enable users to create movies or machinima.

Along with the many advantages of Web3.0 technology come many legal issues. The following are some of the key issues to consider.

NFT Legal Issues

NFT Licenses - Typically, NFT users own the token but only have a license to the digital asset associated with the token (e.g., digital art, video game asset, etc.). The copyright owner retains copyright in the digital asset. When licensing IP rights for use in digital assets, it is important to be clear about what is and what is not being licensed. The scope of the license should be limited to particular purposes. It is also important to ensure there is valid acceptance of the license by the NFT owner. Additional information on NFT license issues can be found [here](#).

IP Issues - Various IP issues arise with NFTs. The creator must ensure that they possess the necessary rights to distribute an NFT. Where the NFT includes any third-party IP and the NFT creator does not possess the necessary rights to that IP, lawsuits are being filed. There are a growing number of NFT lawsuits based on IP infringement and ownership issues. Companies and Brands that sell physical products should rethink their [IP protection strategy](#) to ensure that they consider protection for digital objects.

NFT Marketplaces - NFT marketplaces require customized terms of service depending on the type of marketplace and consideration of and compliance with regulatory issues. See [here](#) for more details.

Securities Laws - In some situations, NFTs and cryptocurrencies can be subject to securities law. The key test employed is the *Howey* test. In short, whether there is an investment of money in a common enterprise with profits to come solely from the efforts of others. Most NFTs that are associated with a single work and individually sold are not likely to be deemed a security under U.S. securities laws. However, various sales techniques are being used that may implicate securities laws. One technique is fractional ownership. In this scenario, ownership of a single work (or group of works) is represented by multiple tokens with different owners. This enables many people to share ownership of a single work. Depending on how this fractional ownership is structured this could constitute a pooled interest. Other scenarios that may be deemed a security include presale of NFTs (e.g., that represent game assets), where the game does not yet exist and the proceeds of the sale are used to build the game. Another is where the NFT is associated with a song or other media and represents a right to share of the revenue from the song.

Money Laundering - FinCEN, which was the first U.S. government agency to issue guidance on cryptocurrency and other convertible virtual currency in 2013 and [updated guidance](#) in 2019, has been more strictly enforcing anti-money laundering (AML) rules. A number of people have tried to launder money through NFTs. NFT marketplaces must also consider their AML compliance obligations.

Sanctions Avoidance - Recently the U.S. Treasury Department warned that NFTs may become a tool for money laundering in the high-value art world. The Treasury Department's [report](#) found there is some evidence to suggest high-value art is involved in money laundering, but likely not in any terrorist financing. OFAC has placed greater scrutiny on digital art and NFTs due to the use of art in money laundering and sanctions avoidance. OFAC published targeted [guidance](#) for digital asset companies related to compliance with sanctions and best practices for mitigating risks.

Gambling - Many game companies have been sued for allegedly engaging in gambling due to virtual goods that can be won (with some element of chance) and traded on unauthorized secondary markets. Most have failed because winning items that can only be used in-game (and not convertible to money or other value) typically are not deemed a prize of value. Many of these cases were dismissed, in large part, because the game companies' terms of services prohibited the sale, transfer, or exchange of the virtual goods (including via secondary markets) and the game companies did not partake in or facilitate secondary markets. When NFTs are won, the result may be different since they can be sold on exchanges for value.

Metaverse Legal Issues

Metaverses raise a host of legal issues in addition to those that arise from using NFTs as mentioned above. A summary of the issues is set forth below.

Governance, TOS and EULAs – Metaverse and virtual world governance is complex. Often there are platform TOS, but separate rules may apply to different virtual worlds, lands, spaces, or separate marketplaces therein. *IP protection and infringement* – With most of the content in metaverses being user-generated (UGC), IP issues abound including IP infringement, including DMCA takedowns; ownership and licensing of UGC; virtual marketplace terms and legal issues; consumer protection and legal issues with the use of virtual currencies and virtual property. This also raises significant content moderation issues.

Avatar issues – Avatar-related legal issues include right of publicity (e.g. when using another’s name, image or likeness), IP issues with brand and third party rights used in avatars and trademark protection for avatars through which services are performed in a metaverse.

Virtual advertising – Many spaces include virtual advertising and brands will own or lease virtual land, use NFTs, and branded virtual items to promote their products and services, employ avatar-based influencers, participate in sponsored events and engage in other metaverse activities. All of these can create unique issues that must be carefully considered.

Privacy – In the metaverse, there will be a desire for stricter and more transparent privacy standards. It will be crucial for companies to understand which laws will apply to what parties. Identity verification and identity theft will become the primary focal point of many entities engaging in business with the government. Blockchain technology and the metaverse offer many anonymity and security features. However, cybercriminals have and will continue to exploit any vulnerability found in these technologies. Privacy issues should also be carefully considered in the metaverse.

Conclusion

Web3.0 technologies, including NFTs and metaverses, will see increasing adoption by businesses, governments, and all types of users. For companies or other entities becoming involved in the space, it is important to understand the many legal issues that can arise. It is critical to seek legal counsel who is familiar with these issues. Our attorneys have been assisting companies with issues relating to blockchain technologies and virtual worlds for over 10 years.

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