

The metaverse, NFTs and M&A transactions

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While some critics question the value of the metaverse and digital assets, including non-fungible tokens, or NFTs, the recent rise of consumer and market interest in these asset classes has resulted in growing interest from strategic acquirers and private equity investors. This article provides a brief introduction to the metaverse and NFTs and an overview of practical considerations for deal teams and counsel engaging with the metaverse and NFTs in the context of M&A transactions.

Despite some skepticism about the value and staying power of the metaverse and digital assets, including non-fungible tokens, or NFTs, there has been a surge of interest in these asset classes and sectors as companies and consumers search for unique ways to provide access to, derive value from and maintain connectivity with one another. As more companies are entering the space—the global metaverse market size was estimated to be \$39 billion in 2021 and projected to increase to \$48 billion this year—the legal implications of these new products and business lines are becoming increasingly relevant, even outside their direct function areas.

The rise of consumer and market interest in these asset classes has in turn resulted in growing interest from strategic acquirers and private equity investors in businesses operating in these sectors. As M&A activity involving targets in the digital asset and metaverse sectors has increased, acquirers are facing novel transactional issues as well as more traditional transactional considerations applied in a new context. Recent M&A trends have made considerations specific to these sectors increasingly relevant to deal teams. More than 20 M&A transactions involving targets in the NFT space occurred in the first half of 2022 alone, a record for M&A transactions in this sector, and metaverse-related M&A activity totaled \$77 billion in the 18 months ending June 2022. These transactions have involved targets representing a broad array of sector participants, ranging from NFT creators to virtual reality (VR) and augmented reality (AR) software developers to digital marketplaces, with each presenting novel considerations.

What is the metaverse?

The metaverse, though loosely defined and constantly evolving, is generally understood to refer to an immersive digital environment involving aspects of social media, AR and VR. Users can interact in the metaverse, which can be viewed as a macro-environment, in a variety of different ways, including through the minting, trading and selling of NFTs. Current examples of businesses engaging with the metaverse include:

- Spotify's Spotify Island on the Roblox platform, a digital space where users collaborate to create and share music;
- iHeartMedia's iHeartLand, a digital space inside the Fortnite platform that functions as an always-on entertainment space, and includes State Farm Park, an "outdoor" metaverse venue; and
- Concerts hosted exclusively for VR environments (for example, AmazeVR hosted a performance by Megan Thee Stallion, iHeartLand hosted a performance by Charlie Puth, and Roblox hosted a performance by Lizzo).

At this phase in the evolution of the metaverse, interoperability is largely an aspirational feature, with participants in the metaverse space, such as Horizon Worlds, Decentraland, and Roblox, developing their own, free-standing environments. Proponents of a unified metaverse envision elements of any one metaverse environment, such as user

avatars, digital assets or user account information, flowing freely from one metaverse environment to another, but the reality of that vision seems a few years away and will likely require significant coordination among the key players in the space.

What are NFTs?

An NFT is a digital asset on a blockchain that is unique—NFTs are not fungible with each other the way bitcoin, ethereum or other digital assets are. NFTs are often used as collectibles and some NFTs can also be used to interact in the metaverse. NFTs are considered “non-fungible” because any specific NFT is not interchangeable with any other digital asset. An NFT may convey a right to an asset in the “real world,” such as ownership rights or the right to use or distribute artwork, collectibles, or other assets. Ownership of an NFT, however, does not necessarily equate to ownership of the associated asset or underlying intellectual property (IP) rights with respect to the asset. The rights granted to a holder of any NFT depend on the governing license for that specific NFT and whether the minter of the NFT actually possesses the rights it purports to grant to the NFT holder. NFT terms and conditions may be accessed via a link in the metadata of the NFT or may be available on the platform where the NFT is sold.

In most cases involving NFTs linked to artwork or collectibles, the holder of the NFT has a nonexclusive license to use and display the artwork or collectible and the real-world owner, who typically issues the NFT, retains ownership rights. For example, the artist Mike Winkelmann, known as “Beeple,” garnered significant attention in 2021 when his digital piece “The First 5000 Days” sold for over \$69 million at Christie’s. Beeple retained the copyright in the digital piece and the NFT purchaser received an NFT linked to a jpeg of the piece and a nonexclusive license.

Increasing awareness of the limited nature of rights associated with most NFTs, along with the volatility and decline of digital asset prices generally, appears to have dented the NFT market in recent months. NFT markets and M&A activity in the sector have nevertheless remained active since NFTs first entered the public mind in 2017.

Diligence considerations

Intellectual property. As with more traditional companies in the technology sector, IP rights typically represent key value for targets in metaverse and NFT markets. Many of the IP diligence considerations are similar to the diligence considerations for more traditional technology companies but require application to novel contexts.

- **IP agreements.** A prospective acquirer of a target that operates within a metaverse, or that holds assets that the prospective acquirer is interested in uploading to a metaverse, should evaluate the existing IP licenses and agreements of the target to determine the extent to which such agreements permit or restrict the use of any relevant IP rights in the metaverse. Often licenses entered into before the rise in popularity of the metaverse and NFTs may fail to include rights to digital distribution or reproduction, which would be necessary for any application of such IP in the metaverse or as an NFT. Prospective acquirers of targets that hold or that have minted NFTs should also review the agreements under which the target has acquired rights to the assets underlying the NFTs, including, in the case of NFTs linked to artwork, the original agreement with the artist and any intermediate agreements or governing terms and conditions. Such an analysis is necessary to ensure that the target holds sufficient rights in the assets underlying the relevant NFTs and to avoid liability for IP infringement.
- **Terms and conditions.** Prospective acquirers of targets that hold NFTs or that have minted NFTs or that operate in or maintain a metaverse should review the rights granted and retained under the terms and conditions that govern the applicable NFTs or metaverse. Important rights and provisions to consider when reviewing NFT terms and conditions include:
 - the scope of rights granted with respect to the asset underlying the NFT,

- any use restrictions or obligations with respect to the asset underlying the NFT (e.g., limitations on commercial use),
- royalties or other fees that may be owed in the event of any secondary sale of the NFT (though prospective acquirers should be aware of the inconsistent recourse for enforcing such royalty obligations) and
- obligations to store the asset underlying the NFT off the applicable blockchain.

Important rights and provisions to consider when reviewing metaverse terms and conditions include:

- what rights the target has to content and intellectual property rights generated in the metaverse,
- what rights the target has to operate in the metaverse or to control others operating in its metaverse and
- how disputes arising from interactions in the metaverse are governed.

— ***User-generated content.*** Prospective acquirers of targets in the metaverse and NFT sectors should pay particular attention to any user-generated content (UGC). While not unique to the metaverse and NFT sectors, UGC is particularly common in these spaces and practitioners should consider how terms of service or other platform agreements, IP laws, and applicable license agreements interact to determine the ownership of any such UGC, and any further improvements or derivative works of such UGC.

Regulatory. How NFTs are regulated is a factually intensive inquiry and depends on the individual characteristics of each NFT. An NFT could be subject to multiple U.S. and international regulatory regimes, including in the United States those administered by the Securities and Exchange Commission, the Commodity Futures Trading Commission, the U.S. Treasury Department (both its Financial Crimes Enforcement Network, or FinCEN, and Office of Foreign Assets Control, or OFAC), U.S. federal banking regulators, the Internal Revenue Service, the Federal Trade Commission and a host of state attorneys general and financial regulators. Similarly, targets operating in or providing metaverse environments may be subject to a broad array of U.S. and international regulations applicable to online platforms and service providers, including, for example, the European Union’s Digital Services Act and Digital Markets Act.

Exactly how these regulatory regimes apply to NFTs and metaverse activities is often in flux, and depending on the target’s business model an acquirer may face significant and in some cases unresolvable regulatory uncertainty. As a result, a potential acquirer of a target in the NFT or metaverse business should engage regulatory specialists early on to assess the target’s compliance with applicable law, as well as the degree to which acquisition of the target would subject the acquirer to burdensome or costly regulatory compliance obligations or liabilities.

IT and cybersecurity. As with traditional companies in the technology sector, prospective purchasers of targets in the NFT and metaverse sectors should review the target’s information technology assets and practices to ensure they are sufficient for the operation of the business and do not create unnecessary exposure to cybersecurity threats. Because blockchain technology and the metaverse are new to many consumers, they present a heightened risk for cyberattacks, including unauthorized access to user wallets, avatar identity theft and on-platform fraud.

Tax. Tax law principles can be complicated to adapt (and to adapt quickly) to a fast-changing digital world. Prospective purchasers of targets operating in the metaverse and NFT sectors should conduct diligence on the target’s tax practice to ensure there are no unexpected liabilities, but certain risks and exposures may inevitably arise given the legal landscape. For example, when and where the ownership of digital assets gives rise to tax raises complicated tax questions. Additionally, when digital assets are purchased and sold, they may be subject to various taxes, including income and sales taxes. The treatment of cryptocurrencies provides some analogous authority. For example, the Internal Revenue Service (IRS) has issued guidance clarifying that cryptocurrencies constitute property, the profit from which is taxable. The IRS has already issued subpoenas to cryptocurrency exchanges seeking information that could lead to the identification and collection of income taxes, and it would not be surprising to see taxing authorities targeting metaverse projects in similar fashion.

NFT and other metaverse asset sales could also be subject to state sales and other transfer taxes. While many states have guidance on sales tax as applied to digital assets, the area is still generally unclear as it relates to NFTs. Additionally, economic ownership and transfers of IP, and improvements to IP, created in the metaverse may raise novel issues on the taxation of related profits, including who is subject to tax, where they are subject to tax, and the amount of that tax that prospective purchasers should consider before proceeding with a transaction.

Antitrust. Antitrust law recognizes that early investors and the companies supported by them have a legitimate interest in monetizing the technology they create, and markets with digital multi-sided platforms, on which network effects are particularly strong, are more likely to “tip” in the sense that a single offer becomes dominant. If a target is found to enjoy unchallenged market power over a significant period of time, it would be subject to the same catalogue of antitrust rules that apply to any other industry.

Employment law. Prospective purchasers of targets operating in the metaverse should conduct diligence with respect to a variety of novel employment-related considerations, including:

- compliance with state and federal securities and tax laws, as well as labor laws (e.g., for purposes of calculating overtime under the U.S. Fair Labor Standards Act and similar state wage and hour laws) for targets that compensate employees with tokens or other cryptocurrencies,
- how a target’s employee handbooks, confidentiality and restrictive covenant arrangements and individual employment arrangements apply to services in the metaverse,
- any incentive compensation metrics relating to performance in the metaverse and
- whether a target has proper policies and procedures in place to monitor employee harassment and discrimination and other misconduct by employee avatars in the metaverse.

Transaction agreement considerations

In addition to the considerations present in more traditional technology-intensive transactions, deal teams will need to evaluate and address various considerations unique to the metaverse and NFT sectors when structuring a transaction agreement.

Asset transactions. With asset sales (as opposed to stock or equity transactions), purchasers must ensure that the digital assets of the target are fully captured by the terms of the asset purchase agreement. The agreement should be drafted so that purchased assets capture the specific digital assets, all underlying IP and all rights to commercialize those assets, along with any commercially significant derivative works or UGC, as applicable. For example, in the case of an acquisition of a target that has created a valuable NFT collection, the buyer should ensure that any unsold NFTs in the collection, the terms of use associated with purchasers of already-sold NFTs, the associated linked assets, and any IP rights in such assets, including any derivative works, are included in the purchased assets.

Representations and warranties. Given the complexity of the IP ownership and use considerations outlined above, practitioners should ensure that, beyond the typical IP representations and warranties such as noninfringement of IP, sufficiency of IP, IP ownership and the absence of material IP litigation and disputes, the applicable transaction agreement includes a representation that the target’s use of any IP in all relevant metaverse environments and NFT marketplaces and collections is permitted under applicable license agreements and terms of service.

Interim operating covenants. In addition to traditional covenants to maintain IP assets and not to amend or terminate material agreements, practitioners should consider whether to include covenants restricting the target’s ability to change the terms of use or other agreements governing the target’s metaverse or NFT assets without the consent of the

acquirer prior to closing.

Given the rapidly evolving regulatory environment, acquirers may also want to pay particular attention to the target's obligations to provide notice of investigations and regulatory inquiries, and perhaps bargain for rights to participate in regulatory discussions.

Exclusivity. Depending on the role that a target company plays in the metaverse and NFT sector, the barriers to entry can be very low. The success of NFT marketplaces and collections and metaverse environments relies in large part on network effects, and the success of content is closely tied to the source's popularity. In light of the low barriers to entry, it is particularly important for purchasers in the metaverse and NFT sectors to consider whether adequate exclusivity and noncompete provisions are included to preserve the value of the transaction.

Post-transaction considerations

Integration and operational. For strategic acquirers, part of the value proposition of a transaction may be tied to integration with the acquirer's existing operations. While implementing any integration plan, an acquirer should pay careful attention to a target's scope of ownership rights and licensed rights, including under any applicable terms of service. Terms of service are often central to determining the IP rights held by companies in the metaverse and NFT sectors as well as the flexibility such companies have to modify their operations.

While considering the legal latitude available for integrating and extracting value from a target, acquirers should also pay particular attention to reputational considerations, given how central consumer perception is to the sector. For example, in March 2022, Yuga Labs purchased Meebits from Larva Labs and, following the acquisition, implemented a royalty fee on secondary sales of Meebits of 5% to support a dedicated Meebits development team, taking advantage of Yuga Lab's right to modify the terms of use for existing Meebits NFTs. This unilateral change resulted in backlash from the Meebits community. The impact of this change, however, is more complex as despite the backlash, the entry price for NFTs in the Meebits collection increased following the announcement.

Trademark and copyright monitoring. Acquirers should evaluate their strategy for ongoing trademark and copyright monitoring in both conventional and digital environments to ensure that third parties are not infringing on any of the target's or acquirer's trademark or copyright rights. Creators of digital assets are not bound by traditional manufacturing and supply chain barriers, which allows digital assets to be minted and distributed very quickly. Trademark and copyright owners therefore need to be especially vigilant monitoring for infringement in digital environments so that proper action can be taken before instances of infringement escalate.

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