A new kind of trust asset? Welcome to the world of NFTs and digital collectables

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Those who have spent even just a short time online in recent weeks will have likely seen many references to the sale and purchase of what might seem a strange new range of virtual assets - animated cats, short videos of celebrities, and virtual furniture to name just a few. These new "digital collectables" are known as Non-Fungible Tokens or NFTs and are a form of digital asset piquing the interest of more than just a few high net worth investors across the globe.

However, for long-established professional trustees already troubled by how best to appropriately hold and manage cryptocurrencies for their clients - which themselves depart significantly from traditional trust assets such as real estate, precious metals, and securities - the concept of investing in, protecting, and managing entirely new forms of virtual assets may not only seem headache-inducing but fundamentally disruptive to a trustee's established and mandated risk profile.

What are NFTs?

NFTs have been around for a few years but it is only in recent months that their popularity has exploded, resulting in millions of dollars trading hands[1]. By way of explanation, NFTs are one-of-one digital art and media on blockchains like Ethereum. While more established forms of physical assets like dollar bills and gold bars can be exchanged like for like, and other forms of digital media can be easily copied, shared and stolen, this new form of digital collectable relies on blockchain technology (in broad terms, a distributed database or ledger) to identify and designate an original piece of digital media. In an NFT sale, all the computers linked into a cryptocurrency network record the transaction by which the NFT changes ownership, making it part of an immutable record which gives a permanent certification of authenticity that cannot be altered or erased. While others might be able to screenshot or reproduce a digital copy of the NFT, they will not be able sell it or trade the "original". The proof of originality and authenticity is therefore always in the blockchain.

NFTs appear to have found increased popularity via the well-trodden path of wealthy individuals seeking emotional connections to and valuable investments based on the beauty and singularity of certain physical goods: collectable baseball cards and fine art are other good examples of this type of investment. Purchasers of NFTs may not be looking to purchase copyrights or trademarks of the art or media comprising the NFT (in fact, the artist may still retain the copyright and reproduction rights, just like with physical artwork). NFTs are attractive because they come with the knowledge and reassurance, via the blockchain, that the NFT is the only "authentic" one of its kind.

Artists, influencers, sports stars and musicians all look set to dive into the NFT trend. According to the New York Times, NFTs recently sold include a clip of NBA superstar LeBron James blocking a shot in a Lakers basketball game that sold for $100,000, and a one-of-a-kind digital artwork of a flying cat with a Pop-Tart body leaving a rainbow trail (a meme of which has been viewed and shared across the web hundreds of millions of times) sold for US$580,000 following a bidding war[2]. Even the distinguished auction house Christie's is about to complete its first sale of an exclusively digital work, a "monumental collage" by the artist known as "Beeple"[3].

1 Just three years ago, the NFT market was worth no more than US$40 million. By the end of 2020, it had grown 705% to $338 million in value, according to the latest estimate from Nonfungible.com, which monitors the NFT marketplace (see Bambysheva, N., *"BNP Paribas Subsidiary Helps Identify $250 Million Leap In NFT Sales"*, Forbes).

2 Griffith. E., *"Why an Animated Flying Cat With a Pop-Tart Body Sold for Almost $600,000*, The New York Times

3 *"Beeple: A Visionary Digital Artist at the Forefront of NFTs"*, Christie's.

Holding digital collectables in trusts

So, why should trustees be paying attention to what might be considered by many to be yet another strange market trend? Many trustees are, pursuant to the terms of the trust deed governing the trust, tasked with diversification of trust assets and have discretion to consider early stage or alternative investments. Before making any investment decisions, it is of course vital that trustees understand both their powers and duties when managing, investing, and reviewing the trust assets they hold, and (in relation to financial and virtual assets) the growing body of statute law in the jurisdiction in which the assets are held. In investing or delegating investments, trustees must always act with care and prudence and ensure that the level of risk and diversification they approve is consistent with that mandated by the trust deed. Increasingly, trustees must also balance the interests of different categories of beneficiaries who may be spread across different generations and have wildly different risk appetites.

Many trustees used to dealing with longstanding generational wealth are also now engaged in relation to "first generation" new wealth, working alongside much younger settlors who have had impressive liquidity events, are very open to early stage investing, and have a well-developed risk appetite. Those settlors will likely also have a solid understanding of, and some experience in, alternative investments and speculative assets such as NFTs.

As noted in our briefing from late last year, the Cayman Islands offers a number of ideal vehicles for holding cryptocurrencies and this extends to digital collectables like NFTs. Careful structuring of ownership rights, considered drafting of powers and duties of those who are to hold or have custody of the "keys" to digital collectables, and frank discussions with settlors about their risk appetite and the uncertainty over the stability of values is essential. For trustees, it will be very important to build in robust limitation of liability provisions, and exoneration clauses related to the holding, delegation, or management of digital collectables. Consideration may also have to be given to any applicable virtual asset legislation (see for example our briefing note on the Cayman Islands VASP regime). In most cases, it will be invaluable for settlors, trustees and their legal advisors to work closely with specialists and custodians in the digital collectables market.

A blip...or a new way of life?

Just a few weeks ago a range of ten digital collectables labelled "Impossible Objects" – essentially virtual furniture – were offered for sale online by Argentinian designer Andrés Reisinger. All objects (five of which also came with physical counterparts) were promptly snapped up, and the sale achieved close to half a million dollars[4]. The NFT trend looks unlikely to ease off any time soon and trustees tasked with wide discretionary investment powers, and a book of clients skewed heavily towards entrepreneurs and new wealth, would be well advised to familiarise themselves with the fast-moving and ever-evolving digital collectables market.

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FIND US

Carey Olsen
PO Box 10008
Willow House
Cricket Square
Grand Cayman KY1-1001
Cayman Islands

T +1 345 749 2000
E cayman@careyolsen.com

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PLEASE NOTE

4 Cormack, R., "This designer just sold a bunch of trippy 'virtual furniture' for nearly half a million dollars", Robb Report.