

UNIDROIT Principles on the Private Law of Digital Assets

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Principles

- Focus of areas of law which relate specifically to digital assets
- Private law and not regulation
- Largely property law and not contract law
- ‘Checklist’ for states
- Many issues will be dealt with by the applicable domestic law: the Principles make it clear where this is the case.
- Principles: lay out certain substantive rules and supporting analysis.
- Also commentary explaining, where relevant, the impact of variations in domestic law eg in relation to ‘linked’ assets

UNIDROIT Principles: substantive 'rules'

Proposition of substantive law	Supporting analysis
<ul style="list-style-type: none">• Digital assets can be the subject of proprietary and security rights	<ul style="list-style-type: none">• Definition of digital asset• Definition of 'control' as ingredient of definition of digital asset
<ul style="list-style-type: none">• Conflict of laws rule	<ul style="list-style-type: none">•
<ul style="list-style-type: none">• Innocent acquisition rule and shelter principle	<ul style="list-style-type: none">• Definition of control and person in control• Definition of transfer and of IA• Application of IA rule to assets held with a custodian
<ul style="list-style-type: none">• A security right in a digital asset can be made effective against third parties by control	<ul style="list-style-type: none">• Definition of control• Definition of custodian
<ul style="list-style-type: none">• Priority rules where security right in a digital asset is made effective against third parties by control	<ul style="list-style-type: none">• Definition of control• A security right in a digital asset can be made effective against third parties by control
<ul style="list-style-type: none">• Rights and interests of an innocent acquirer and a secured creditor who has made its security right in a digital asset effective against third parties by control are effective on insolvency	<ul style="list-style-type: none">• Innocent acquirer rule• A security right in a digital asset can be made effective against third parties by control

Proposition of substantive law	Supporting analysis
<p>A digital asset held with a custodian for a client is not part of the assets made available to the custodian's creditors on the insolvency of the custodian.</p>	<ul style="list-style-type: none"> ● Definition of custodian ● Definition of control ● Definition of 'holds' ● Digital assets can be the subject of proprietary rights
<p>Custodians of digital assets owe certain duties to their clients (and may, according to the applicable law, owe others)</p>	<ul style="list-style-type: none"> ● Definition of custodian
<p>Rules to protect the interests of others (including custodians, grantors and other secured creditors) on enforcement of a security interest, particularly automatic enforcement</p>	

Digital assets can be the subject of proprietary rights: underlying analysis

- Definition of digital asset
- ‘Electronic record’ means information which is (i) stored in an electronic or other intangible medium and (ii) capable of being retrieved. Netherlands comment 33: avoid ‘other intangible medium’
- ‘Digital asset’ means an electronic record which is capable of being subject to control.

Digital assets can be the subject of proprietary rights: underlying analysis

- Definition of 'control' as ingredient of definition of digital asset
- Factual control (factual situation: may have legal consequences but does not depend on a rule of law for its existence)

A person has 'control' of a digital asset if:

- (a) subject to paragraphs (2) and (3), the digital asset or the relevant protocol or system confers on that person:**
 - (i) the exclusive ability to change the control of the digital asset to another person (a "change of control");**
 - (ii) the exclusive ability to prevent others from obtaining substantially all of the benefit from the digital asset; and**
 - (iii) the ability to obtain substantially all the benefit from the digital asset; and**
- (b) the digital asset or its associated records allows that person to identify itself as having the abilities set out in paragraph (1)(a).**

- Control can be shared
 - With a 'smart contract'
 - By agreement

Digital Assets can be the subject of proprietary rights: consequences

A digital asset can be owned

A digital asset can be the subject of a security right

A client of a custodian can have a proprietary right in a digital asset and so is protected on the insolvency of the custodian

Proprietary tracing and freezing remedies can apply

A digital asset can be held on trust (in common law countries)

General property law applies (except where inconsistent with the Principles)

Where general property law applies

- **whether a person has a proprietary right in a digital asset;**
- **whether a proprietary right in a digital asset has been validly transferred to another person;**
- **whether a security right in a digital asset has been validly created;**
- **the rights as between a transferor and transferee of a digital asset;**
- **the rights as between a grantor of a security right in a digital asset and the relevant secured creditor**
- **the legal consequences of third party effectiveness of a transfer of digital assets;**
- **the requirements for, and legal consequences of, third party effectiveness of a security right in a digital asset; and**
- **the existence of, requirements for, and legal consequences of any link between a digital asset and another asset, whether the other asset is tangible or intangible.**

Linked assets

Digital
asset



Other
asset

A

A

Possible 'other' assets

Intangibles

- Shares
- Debt securities
- (Contractual) rights eg to money, goods or services
- Money ie a right against a bank or central bank currency
- Another digital asset
- Intellectual property

Tangibles

- Land
- Goods eg gold
- (documentary intangibles)

Nothing

- NFTs

How to achieve a link?

- Statute provides for the link
 - “Register” established by statute
 - Specific legislation (‘container’ in Lichtenstein)
- The digital asset is treated as a documentary intangible
- A ‘real world’ obligation is expressly owed only to the person who controls the digital asset
- Control of the digital asset is evidence of who owns the real world asset
 - Strength of evidence will depend on how the link is structured.
 - Danger of desynchronisation.
- No link: transfer of real world asset requires a step other than transfer of the digital asset
- No link because no asset: NFTs

Conflict of laws

- Only covers proprietary questions, and maybe not all of those (eg location of grantor will govern any requirement of registration of security right)
- Waterfall of possibilities
- (1) Law specified in the asset itself (eg metadata)
- (2) Law specified in the system or platform
- (3) The Principles and, to the extent that they don't address the specific issue in hand, the law applicable under the conflict of law rules of the forum.

Innocent acquisition rule and shelter principle: supporting analysis

- Definition of control and person in control
- Definition of transfer and of IA
- Application of IA rule to assets held with a custodian

- Definition of person in control:
 - some presumptions to assist with proving who is the person in control
 - Eg presumption that if a person has the abilities making up control those abilities they are exclusive.

- The transfer of a digital asset is the change of a proprietary right from one person to another person.

Innocent acquisition rule and shelter principle

Examples:

- A (B's employee) transfers a digital asset owned by B to C without B's authority.
- A hacks into B's computer and transfers a digital asset owned by B to C without B's consent.
- Under many laws (nemo dat principle) C would not get good title.
- IF C is an innocent acquirer the IA rule applies.

Innocent acquirer rule:

- An innocent acquirer takes a digital asset free of conflicting proprietary rights ('proprietary claims'). **C TAKES FREE OF B'S CLAIM**
- No rights based on a proprietary claim relating to a digital asset can be successfully asserted against an innocent acquirer of that digital asset. **B CAN'T ASSERT RIGHTS AGAINST C**

Innocent acquisition rule and shelter principle

- In order to qualify as an innocent acquirer, a transferee must **obtain control** of a digital asset. **C MUST OBTAIN CONTROL (UNLESS C HOLDS THROUGH A CUSTODIAN IN WHICH CASE IT IS ENOUGH IF THE CUSTODIAN HAS CONTROL)**
- An innocent acquirer can acquire a proprietary right in a digital asset even if control of that digital asset is changed by a person who is acting wrongfully and has no proprietary right in the digital asset . **IT DOESN'T MATTER IF A IS ACTING WRONGFULLY**

What is an innocent acquirer?

- The requirements in a State for a transferee to be an innocent acquirer should be equivalent to those found in relevant good faith purchase and take-free rules of that State.
- If the Principles apply by virtue of the choice of law rules the IA definition is more hard edged and taken from the Geneva Securities Convention:
 - A transferee of a digital asset is an innocent acquirer of a digital asset unless, at the time the transferee takes control of the digital asset, the transferee actually knows or ought to know that another person has an interest in the digital asset and that the acquisition violates the rights of that other person in relation to its interest.
 - Gratuitous transfers not included.

Shelter Principle

Example:

C in the previous examples then transfers the digital asset to D, who knew that A was unauthorised, or that A hacked into B's computer.

Shelter principle

- An initial transferee from an innocent acquirer and any subsequent transferee has the same protection as the innocent acquirer from conflicting proprietary rights and the successful assertion of proprietary claims.

IF C TAKES FREE, D TAKES FREE REGARDLESS OF KNOWLEDGE.

Custody

- **Custody** of a digital asset (in accordance with the principles) is where **A controls a digital asset on behalf of B in the course of a business pursuant to a custody agreement.**
- To be distinguished from agency (eg where A is an employee of B plc and A controls the DA in the course of his employment: there A's control is treated as B's control for the purposes of the Principles)
- An agreement for services is a custody agreement where:
 - **the service is provided in the course of the service provider's business;**
 - **the service provider is obliged to obtain (if this is not yet the case) and to hold the digital asset on behalf of the client; and**
 - **the client does not have the exclusive ability to change the control of the digital asset;**
- **unless it is clear from the wording of the agreement that if the service provider enters into any insolvency proceeding, a digital asset that it holds for the account of a client forms part of that service provider's assets for distribution to its creditors.**

Consequences of custody

- Protection for client on the insolvency of the custodian
- Custodians of digital assets owe certain duties to their clients (and may, according to the applicable law, owe others)
- Private law duties and not regulatory
- Examples:
 - the custodian is not authorised to transfer the digital asset, or use it for its own benefit, except to the extent permitted by the client and the law (mandatory according to the principles)
 - the duty to maintain a record of the digital assets it holds for each client;
 - the duty at all times to securely and effectively hold digital assets in accordance with the records it maintains for its clients;
 - the duty to acquire digital assets promptly if this is necessary to satisfy the duty under sub-paragraph (b); (according to applicable law: suggested duties)

Making a security right effective against TPs

- **A security right in a digital asset can be made effective against third parties by control**
- In addition to any other means of making a security right effective against TPs under applicable law
- ‘Control’ means
 - the secured creditor controls the digital asset; or
 - a custodian controls the digital asset on behalf of the secured creditor,

Priority rules where security right in a digital asset is made effective against third parties by control

- **Where a security right in a digital asset has been made effective against third parties by control the security right has priority over a security right, in the digital asset, of a secured creditor that does not have control.**
- **EXAMPLE:**
 - A grants a security right over her digital asset to B, who registers it in the appropriate secured transactions register
 - A then grants a security right over the same digital asset to C who take control of the digital asset.
 - C has priority over B

Enforcement of security interests

- Judicial enforcement not covered in the Principles at all (other UNIDROIT project on enforcement)
- Practically, enforcement much easier where the secured creditor has control
- Principles make 3 specific points.
 1. Enforcement should be as simple and quick as possible
 2. Third parties such as custodians should be protected

EXAMPLE:

A has digital assets which B (a custodian) controls on A's behalf. A grants a security right to C. If C registers the security right and does not take control, on enforcement C could try to instruct B to transfer the digital asset to C. B (who has never heard of C) should not be required to comply with this instruction without (a) prior agreement or (b) a court order).

3. Automatic enforcement should be facilitated except to the extent that it is necessary to ensure that the enforcement is carried out in a commercially reasonable fashion and that the secured creditor is obliged to distribute any surplus value to the grantor or any other secured creditor entitled to it.