By email: digitalassets@lawcommission.gov.uk

3rd November 2022

The City of London Law Society Insolvency Law Committee: Response to The Law Commission's consultation on "Digital Assets"

1. Introduction

1.1 On 28th July 2022, The Law Commission published a wide ranging consultation on "Digital Assets" (the "**Consultation**"). We are aware that other specialist committees of the CLLS are responding in detail to this Consultation. We have therefore limited our response to a small number of specific, insolvency related, points raised by the Consultation. We have also taken this opportunity to highlight a number of insolvency related issues relating to digital assets that may merit further consideration.

1.2 The City of London Law Society (the **CLLS**) represents approximately 17,000 City lawyers, through individual and corporate membership, including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees. The CLLS Insolvency Law Committee, made up of solicitors who are expert in the field, has prepared the comments below in response to the Consultation. A link to a list of the individuals and firms represented on this Committee is set out at the end of this response.

1.3 We have set out at the end of this response the members of the working group who were involved in drafting this response. Any member of the working group would be happy to discuss or expand on any of the comments made in this response. Alternatively please feel free to contact our chairperson, Jennifer Marshall (Allen & Overy LLP) whose details are set out below.

2 General observations on the Consultation

The Consultation highlights the importance of minimising any uncertainty surrounding the ownership of property rights in digital assets. We are, from a pure insolvency perspective, largely neutral in relation to the question of how ownership of digital assets is determined, but we would welcome proposals that provided greater clarity in relation to the ownership of such assets. Experience has clearly demonstrated that any lack of legal clarity, particularly in a novel or developing area, is likely to result in insolvency officeholders, creditors and other interested parties becoming involved in

lengthy and costly litigation that will almost inevitably reduce the amount otherwise available for the repayment of creditor claims.

3 Custodian Arrangements

Section 17.78 of the Consultation provisionally concludes that it would be useful, when making future legislative changes, to implement a general requirement for pro rata apportionment of shortfall losses that cannot be remedied following a custodian insolvency, as such a provision would facilitate and speed up the return of user assets in a custodian insolvency.

We agree that (i) it would be helpful for insolvency officeholders dealing with an insolvent custodian to have clear statutory rules confirming what should be done, should a shortfall arise, and (ii) it would be sensible to start with the proposition that any such rules should be modelled on the relevant parts of the Investment Bank Special Administration Regulations 2011 applicable to omnibus accounts. We would, however, make the following points:-

(a) Any such rule should not apply to just one class of assets, such as crypto-tokens. If the beneficial interests in commingled holdings in a custodian account are treated as co-ownership rights under an equitable tenancy in common, there is no reason to distinguish between crypto-tokens and other commingled securities or assets held on behalf of customers by that custodian.

(b) It follows that we would prefer not to see a new Special Administration Regime which was limited to crypto-token custody arrangements,[1] particularly as its existence would create unnecessary uncertainty as to which regime would apply if, for example, an investment bank held crypto-tokens as part of its custodian services.

(c) The exact mechanics of any pro rata shortfall allocation rule (for example the question of how to address the relationship between commingled unallocated holdings and “house” assets that the custodian was beneficially entitled to) will clearly require further detailed consideration, in order to ensure that the proposed rule did not have unintended commercial consequences;

(d) As noted in the Consultation, it will be necessary to ensure that any new rule is consistent with existing or proposed special administration regimes, such as the Financial Markets Infrastructure Special Administration Regime; and

(e) Consideration would also need to be given to the question of how to implement the new rule. The most attractive, and easiest, option, might be to include the rule in special administration regimes available to companies which provide custodian services. This could, however, create a legislative gap in the (presumably limited) number of cases where the custodian was not potentially subject to a special administration regime (for example, where the relevant services were not provided by an investment bank or other entity which routinely provided custodian services in the ordinary course of its business).

4 Specific insolvency related issues which may merit further consideration

The Consultation, having addressed ownership issues, goes on to consider areas in which further legal certainty might be achieved through law reform. While not specifically addressed in the Consultation, the following insolvency related areas may merit further consideration:-

[1] See Paragraph 17.78 of the Consultation

4.1 **Is there a risk of any digital assets falling outside the insolvency estate?** As noted in the Consultation, the unique qualities of digital assets mean that many such assets do not fit easily into traditionally recognised private property law categories or definitions. This is an important point from an insolvency perspective, as it is essential that if a bankrupt individual or insolvent company owns digital assets, they should constitute "*property*" within the meaning of Section 436(1) of the Insolvency Act 1986, as otherwise such assets would fall outside the insolvency estate and could therefore not be used to meet creditor claims.

In practice, there is currently very little doubt, given both (i) the very wide definition of "property" contained in Section 436 [2] and (ii) the fact that judges and insolvency officeholders would want to conclude that digital assets did fall into the insolvent estate, that "data objects" would be treated as "property". The proposed categorisation of data objects as a new category of personal property would, however, remove any residual doubt on this point, and is therefore to be welcomed

4.2 **Quantum of claim**: As noted in the Consultation, owners of crypto-tokens routinely place crypto-tokens with a custodian or enter into arrangements in which they relinquish a direct control over their crypto-tokens. In such circumstances, the question of whether the owner had the right, in any subsequent insolvency proceedings, to recover their crypto-tokens or whether they just had a personal claim against the custodian company would be fact specific, depending on (for example) whether the crypto-tokens were held on a fiduciary basis.

If, on analysis, the owner simply had a personal claim, an insolvency officeholder would need to consider, when valuing that owner's claim, whether:-

(i) it should be characterised as a claim to recover the amount owed at the commencement of the insolvency procedure (this being the valuation date for other claims); or

(ii) it should instead be characterised as a claim for loss arising from the failure to deliver an asset, in which case the size of the owner's claim is likely to vary as the insolvency procedure progresses, with a final determination of the amount of the claim only being possible when the insolvency officeholder disposes of that asset as part of the realisation of the insolvent estate.

Further guidance in relation to the approach to valuation, in insolvency proceedings, of claims relating to crypto-assets would be helpful.

4.3 **Applicability of currency conversion rules**: Insolvency Rule 14.21, the predecessor to which is referred to in Section 10.76 of the Consultation, requires an insolvency officeholder to convert any debt owed in a foreign currency into sterling at a specified exchange rate. It is, however, unclear whether this Rule would require the conversion of a claim owed in (for example) Bitcoin.

If the claim owed in Bitcoin is treated as a personal claim to recover the amount owed at the commencement of the insolvency procedure, it would seem logical to treat that Bitcoin claim in the same way as a claim owed in US$, as there is no obvious reason why a creditor owed US$ should be locked into a set exchange rate while a creditor owed Bitcoin would be in a position to benefit from subsequent increases in the value of Bitcoin. The adoption of this approach would also avoid a situation where an insolvency officeholder was forced to

[2] Section 436 states that *""property" includes money, goods, things in action, land and every description of property wherever situated and also obligations and every description of interest, whether present or future or vested or contingent, arising out of, or incidental to, property".*

acquire Bitcoin in order to make a distribution to that creditor. There are, however, counter-arguments to the adoption of this approach, including the following:-

(i) Most cryptocurrencies cannot be categorised as a "foreign currency", if the latter is defined as the currency used by a foreign country as its recognised form of monetary exchange;[3]

(ii) The comparatively thin trading in some, less popular, cryptocurrencies, and the absence of an official exchange rate, could lead to unpredictable results when converting any liability owed in a cryptocurrency into Sterling; and

(iii) The comparative volatility of cryptocurrencies could make it particularly unfair to lock-in an exchange rate at the beginning of a liquidation or distributing administration.

Given the potential uncertainty in this area, further guidance in relation to the scope of Rule 14.21 would be helpful.

5 Point of Contact

5.1 Should you have any queries or require any clarification in respect of our response, please feel free to contact our chairperson or any of the members of the working group set out below:

Jennifer Marshall (Allen & Overy LLP),
Jennifer.marshall@allenovery.com
Chair, City of London Law Society Insolvency Law Committee

Other working group members:

Simon Thomas (Goodwin), SThomas@goodwinlaw.com
Jo Windsor (Linklaters), jo.windsor@linklaters.com

5.2 Other members of the Insolvency Law Committee are listed here:

https://www.citysolicitors.org.uk/clls/committees/insolvency-law/insolvency-law-committee-members/

[3] Although this argument might not apply to Bitcoin, given its status as a recognised currency in El Salvador