WORKING GROUP ON THE LAW
APPLICABLE TO DIGITAL ASSETS

matthias.lehmann@univie.ac.at
gilles.cuniberti@uni.lu
antonio.leandro@uniba.it

EAPIL
The European Association
of Private International Law

POSITION PAPER

In response to the public consultation on

THE UNIDROIT DRAFT PRINCIPLES AND COMMENTARY ON DIGITAL ASSETS AND PRIVATE LAW

March 16th, 2023

The European Association of Private International Law (EAPIL) is an independent and non-partisan organisation established in 2019 as a non-profit association under the law of Luxembourg with the aim of promoting the study and development of private international law. It does so by fostering the cooperation of academics and practitioners in European countries and the exchange of information on the sources of the discipline, its scholarship and practice. EAPIL has currently more than 400 members, mostly academics and practitioners, based in more than 60 countries.

For the purpose of taking part in the discussion launched by the UNIDROIT's public consultation on its draft principles on digital assets and private law, EAPIL has established a Working Group to issue this position paper, which focuses on the private international law aspects of the draft principles.

The paper was primarily drafted by Matthias Lehmann, Gilles Cuniberti and Antonio Leandro, with the contribution of Francesca Villata, Pedro de Miguel Asensio, Teemu Juutilainen, Poomintr Sooksripaisarnkit, Kirsten Henckel, Burcu Yüksel Ripley, Johannes Ungerer, Vassiliki Marazopoulou, Konstantinos Rokas, Ioannis Revolidis, Gustavo Moser, Jorge Erazo and Frederick Rielaender. The Law Commission of England and Wales participated as an observer.

.

Contents

A. Introduction

1. The purpose of this Position Paper is to comment on the private international law aspects of the UNIDROIT Draft Principles on Digital Assets and Private Law published in January 2023 (hereafter 'the Draft Principles' or 'the Principles').

B. Nature of Instrument

2. The Draft Principles do not contain any provision and comment clarifying their nature. This is remarkable, as many similar instruments such as the UNIDROIT Principles of International Commercial Contracts ('UPICC') and the Hague Principles on Choice of Law in International Contracts ('Hague Principles') include each a preamble and comments addressing the nature of the instrument.

3. The Commentary of the Draft Principles does include certain statements which indirectly address the issue, but they are not fully consistent. The Introduction to the Commentary recommends "*to States to adopt legislation consistent with these Principles*" (para. 4) and explains that the Principles should be "*included*" and "*implemented*" in the laws of States (para. 8). Principle 5(2)(a) provides that "proprietary issues in respect of digital assets, and in particular their acquisition and disposition, are always a matter of law". This suggests that the nature of the Principles is that of a Model for legislators, which

will be applied as national law once implemented in domestic legislation. This is one of the functions identified by both the UPICC and the Hague Principles.

4. However, Principle 5(1)(c) provides that, in both Option A5(ii) and Option B(i), in the absence of any specification of the applicable law in either the digital asset or the system/platform on which the digital asset is recorded, the Principles apply, in whole or in part. The Commentary clarifies that the goal of these provisions is not to provide for the application of a national law implementing the Principles, but the Principles themselves, i.e. as 'rules of law' or non state law (Commentary to Principle 5, para. 5). This is "*[b]ecause these Principles are generally accepted on an international level as a neutral and balanced set of rules*" (idem).

5. The proposition that the Draft Principles could be applied autonomously and directly, as non state law, raises three major issues. The first is that, at the present time, there is no general acceptance of the power of *courts* to apply non state law as the rules governing a given legal issue. In the European Union, introducing such power was proposed, but ultimately rejected, in the legislative process leading to the adoption of the Rome I Regulation. [1] While the Hague Principles propose to innovate in this respect, the innovation was only endorsed, to the knowledge of the authors, by one State at the present time, Paraguay, and is in any event limited to *parties* choosing a non-state law, as discussed below.[2] In contrast, such power has long been recognised in the context of international *arbitration*.[3]

6. The second issue is that even in the context of arbitration, the power of arbitrators to apply non state law is only widely recognised where the parties have actually chosen 'rules of law'. In contrast, the power of arbitrators to apply non state law *in the absence of choice by the parties* is not as widely recognised.[4] The Hague Principles themselves only contemplate the possibility of 'rules of law' applying where this has been chosen by the parties (and provided the rules of law satisfy certain requirements), for the simple reason that their scope does not extend to the determination of the applicable law in the absence of choice by the parties. Furthermore, the choice of non-state law in the Hague Principles is only permissible "unless the law of the forum provides otherwise" (art 3).

7. Yet, the current proposal of the Draft Principles is to resort to the Principles as non state law precisely in the absence of any choice to that effect by the parties, and regardless of whether the forum provides otherwise. It is submitted that this would be a far reaching innovation (without precedent), and that it would be unwise to use this

[1] The Proposal of the European Commission expressly allowed for the choice of non state law (with certain qualifications). This provision was ultimately rejected, and Recital 13 of the Preamble to the Rome I Regulation only recognizes that non state law can be incorporated by reference in contracts, but not govern them.
[2] Paraguay Law on the Applicable Law to International Contracts (2015), art. 5.
[3] See, in particular, Article 28 of the Model Law on International Commercial Arbitration, which provides that the applicable rules on substance can be 'rules of law', as opposed to (national) 'law'.
[4] Article 28(2) of the UNCITRAL Model Law on International Commercial Arbitration only recognizes the power of arbitrators to apply a law designated by a choice of law rule.

instrument to promote it. In contrast, it would be less controversial to allow the direct application of the Principles where an applicable law is specified in the asset or the system/platform (Principle 5(1)(a) and (b)), with the caveat that the competent adjudicator should have the power to decide disputes on the basis of 'rules of law' (non state law), which in practice would point to arbitral tribunals.

8. A third issue is that the subject matter of the Draft Principles concerns *proprietary issues*. Unlike contractual issues, the power of the parties to provide for the applicable law is not widely accepted in the field of property law (see below, Section D). The power of the parties to provide for the application of non state rules would be even more controversial. Whilst the Commentary on Principles 5(1)(a) and (b) mention that the "reliance on party autonomy is consistent with Article 3 of the Hague Conference Principles on Choice of Law in International Commercial Contracts" (para 4), it is important to note that Article 1(3) of the Hague Principles provides that "*These Principles do not address the law governing (...)* e) *the proprietary effects of contracts*". The Hague Principles are thus not suitable examples supporting subjective connecting factors (i.e. freedom of choice) for proprietary issues. This being said, arbitration laws recognise the power of arbitrators to apply rules of law chosen by the parties without distinguishing between property and contractual issues.

9. The members of the Working Group debated and were ultimately divided as regards appropriateness of the Draft Principles setting out whether and, if so, (i) the basis, and (ii) the extent to which, the Draft Principles could apply as non State law. Some members are of the view that the Draft Principles should not address the issue. Others consider that the Draft Principles should clarify that the Draft Principles may apply in the form of either by Parties' direct choice or, failing such prior choice or subsequent agreement, by the arbitral tribunal subject to the provisions of the applicable arbitration rules and the mandatory provisions of any applicable law.

10. If the goal of the drafters was not to allow the application of non state rules (including code), as Principle 5(2)(a) and the associated commentary strongly suggest, then the reference to 'these Principles ... or the relevant Principles or aspects of these Principles' in Principle 5(1)(c) should be deleted.

11. In contrast, if the goal of the drafters is to allow the application of non state rules (including code), then the reference in the various options of Principle 5(1)(c) to 'these Principles (…)' should instead appear in Principle 5(1)(a) and (b), which could be amended along the following lines:

    (1) Subject to paragraph (2), proprietary issues in respect of a digital asset are governed by:

        (a) the domestic law of the State (excluding that State's conflict of laws rules) expressly specified in the digital asset as the law applicable to such issues or, where the law of the competent adjudicator

allows the rules applicable to the merits of a dispute to be rules of law emanating from non-state sources or non-state law, these Principles, or the relevant Principles or aspect of these Principles, expressly specified in the digital asset as the rules of law applicable to such issues;

(b) if sub-paragraph (a) does not apply, the domestic law of the State (excluding that State's conflict of laws rules) expressly specified in the system or platform on which the digital asset is recorded as the law applicable to such issues or, where the law of the competent adjudicator allows the rules applicable to the merits of a dispute to be rules of law emanating from non-state sources or non-state law, these Principles, or the relevant Principles or aspect of these Principles, expressly specified in the system or platform on which the digital asset is recorded as the rules of law applicable to such issues;

12. A preamble clarifying the functions or nature of the instrument could also be added for the sake of clarity, along the lines of the preamble to the UPICC and to the Hague Principles.

13. The applicable law in the absence of choice should be determined by uniform choice of law rules relying on predictable connecting factors.

C. Scope of Principle 5

14. Principle 5 is concerned with "proprietary issues in respect of a digital asset". Its scope is thus broader than the scope of the substantive rules laid down by the Draft Principles which exclude a number of issues listed in Principle 3(3). It is submitted that this difference of scope should be mentioned expressly in the text of Principle 5, for instance by adding a caveat in Principle 5(1), first paragraph: "Subject to paragraph 2 *and notwithstanding Principle 3(3)*, …"

15. Principle 5 is silent on whether it applies only in international situations. The issue is of particular significance for choice of law rules granting power to choose the applicable law, as parties to domestic transactions are typically not recognised any power to provide for the application of a foreign law, except for the limited purpose of incorporating by reference foreign law into the contract of the parties.[5] It is submitted that it would be hard to justify allowing an unlimited choice of law for domestic transactions, but the Draft Principles could address the issue by establishing a presumption of internationality for transactions in digital assets, which could be rebutted in exceptional cases, e.g. a permissioned network limited to participants established in the same country.

[5] See, e.g., Article 3(3) of the Rome I Regulation.

D. Freedom of Choice of the Applicable Law

16. Principle 5(1)(a) and (b) provides for the applicable law governing proprietary issues relating to digital assets to be specified in either the digital asset itself, or the system or platform on which the asset is recorded. As already underscored, while the power of the parties to choose the applicable law is widely recognised in contractual matters, it is not in proprietary matters. The fundamental reason is that proprietary matters affect third parties. Third parties should thus be able to ascertain the law governing the proprietary aspects of assets. The protection of third parties forms part of the rationale for the application of the *lex situs* in the field of property law.

17. It is difficult, however, to locate geographically digital assets. Resorting to the *lex situs* does not seem, therefore, to serve any meaningful function. It thus seems appropriate to grant freedom of choice to the issuers of digital assets or to the participants in a platform or a system to increase legal certainty.

18. The issue of the protection of third parties nevertheless remains. It is therefore submitted that the choice of the applicable law should only be effective with respect to third parties if the latter are able to clearly determine or ascertain that such a choice was made. The choice of the law governing a particular digital asset or a system should be visible. It should thus be attached to the relevant asset in a format accessible to any third party willing to investigate the status of the asset, or for choices made in systems or platforms, be accessible to all participants to the system or the platform.

19. Principle 5(2)(b) already provides that "*in determining whether the applicable law is specified*" in a digital asset or in a platform, "*consideration should be given to records attached to or associated with*" the digital asset, the platform or the system "*if* such records are readily available for review by persons dealing with the relevant digital asset". However, this provision has the potential to cause confusion because it does not *require* such records to be readily available, but rather says that such records *should* be taken into account if they are readily available for review. If no records are available for review, no consideration can be given to them. But then it is not clear how third parties are to ascertain the applicable law. It is submitted that a choice of law should only be effective towards third parties if the specified law appears in such records, and such records *must be* ascertainable.

20. The members of the Working Group debated, but were ultimately divided on whether it would be desirable to limit the freedom of choice to certain laws connected to the relevant assets, in particular if a number of objective connecting factors were identified for the purpose of determining the applicable law in the absence of choice.

21. In a number of jurisdictions, freedom of choice is only fully recognised as between professionals, but may be limited when consumers are involved. It is submitted that the Draft Principles should clarify whether they reserve the application of special choice of law rules protecting consumers, or whether the issue need not be addressed and why.

22. The issue was raised of whether problems might occur where the law chosen for the asset pursuant to Principle 5(1)(a) contradicts the law of the platform. For instance where the platform's rules specify law X to be applicable but law Y is chosen for the asset, then applying law Y might not be feasible in practice contrary to the 'framework' law X. It might therefore be recommendable to clarify that, insofar as the choice of law under Principle 5(1)(a) contradicts the law of the platform, the platform law takes priority: either on the basis of an 'issue by issue' analysis (similar to the preferential law approach under Art 6(2) 2 of the Rome I Regulation for consumer contracts) or simply by displacing the contradicting law completely for all issues. The former approach would be more gentle and considerate, respecting the choices made, but it would be very difficult in practice; the latter approach would be significantly easier to handle but very blunt.

23. The form of the choice of the applicable law should also be clarified. Principle 5(1) provides that it should be expressly specified. However, Principle 5(2)(c) seems to contemplate implicit consent to the choice of law when providing that any form of dealing with a digital asset is consent to the stated law for the purpose of Principle 5(1). It is submitted that, while it is not necessary that choice of law be express in the relations between the parties to a particular transaction on a digital asset,[6] a choice of law governing proprietary aspects should be express and publicly available to be effective towards third parties. The requirement that the choice be express should thus be addressed in the context of the rule requiring that such choice appears on the public record attached to or associated with the relevant asset, system or platform.

24. Finally, the Draft Principles or the Commentary should clarify whether the parties may change the applicable law to a digital asset or system or platform,[7] and how such change would interact with Principle 5(2)(d) and (e).

E. Applicable Law in the Absence of Choice

1) The Reference to the Private International Law Rules of the Forum

25. Both options A and B contain as a fallback-rule a reference to the "law applicable by virtue of the rules of private international law of the forum" (see Principle 5(1)(c) Option A (iii) and Option B (ii)).

26. This blanket referral has no apparent purpose: it is clear that the applicable law is identified by the law of the forum, and it is equally clear that it will use conflicts rules to this effect.

[6] In EU private international law, Art. 3 of the Rome I Regulation provides that the choice of law governing a contract can be express or result from the circumstances.
[7] As expressly allowed in certain jurisdictions: see e.g. Art. 3 of the Rome I Regulation.

27. More problematic than the emptiness of the rule is that it does not give a single recommendation how states should fashion their private international law. Quite to the contrary, it leaves to each state how to identify the applicable law. Differences between national laws are not overcome, but set in stone.

28. This runs counter the very idea of private international law, which aims at the determination of the applicable law *in the same way*. It is also incompatible with the mission of UNIDROIT as an institution charged with *legal harmonisation*. And it will disappoint states who will expect at least some guidance as to how they should determine the applicable law in the absence of a choice and a rule in the Principles.

29. Such guidance is all the more necessary as the prior levels of Principle 5(1) – which basically consist in a reference to the chosen law as well as to the Principles themselves – only seldomly provide a solution. First, the vast majority of digital assets, systems or platforms today do not contain any choice of law. Even if this would change any time soon – which is highly unlikely –, it would not solve the wave of disputes over digital assets that is already reaching the courts.

30. Second, the Principles themselves leave gaping holes. They do not provide any solution to most legal questions, from the conditions of the validity to the effects of digital asset transfers, but are limited to some high level recommendations that need to be implemented by more precise national rules. Again, choice of law rules are necessary to designate the national rules implementing the Principles that courts should apply.

31. Principle 5 as it stands does not indicate which law should be applied to the many disputes that already have arisen or are likely to arise in the coming years in the wake of bankruptcies such as those of FTX or Genesis. It would be particularly harmful if courts in various countries would submit these disputes to diverging laws even where the facts are identical or similar. This creates opportunities for forum shopping as well as the danger of differing judgments and judicial conflicts.

32. The commentary to Principle 5 justifies its silence on this issue with three arguments: 1. the “considerable degree of freedom” it would afford to states, 2. the fact that in many cases the digital asset may not have a connection with any state and 3. the impossibility of a definitive “one size fits all” approach for all digital assets.

33. None of these arguments convinces. First, states anyway have a considerable degree of freedom to fashion their private international law and do not need the UNIDROIT Principles to remind them of it. In reality, the problem is that conflicts will ensue by their use of this freedom in different ways. The purpose of legal harmonisation precisely is to avoid these conflicts, and it is somewhat ironical that UNIDROIT as an institution charged with this task underlines the advantages of states having the freedom to adopt different approaches.

34. Second, the fact that there are many cases in which digital assets have no connection with any state does not mean that one must abstain from any recommendation at all.

As will be shown below, in many cases – indeed in most –, a strong connection to a legal system can be shown. There is no reason to ignore those cases for the sole "reason" that one cannot solve some others.

35. Third, it is unnecessary to adopt a "one size fits all" approach. Modern conflict of laws has various techniques that allow for a differentiated determination of the applicable law, for instance, a waterfall of connecting factors, a principle with exceptions, or escape clauses.

2) Possible Connecting Factors

36. In the following, several connecting factors will be suggested that could be chosen, without any intention to create a hierarchy between them.

37. First, one could have referred to the custodian or the custody agreement. The vast majority of digital assets today are held with a custodian. The custodian plays a significant role in regulation because it is supervised by national authorities. Its outstanding role is also highlighted by the Principles themselves, which dedicate many provisions to it. It is all the more surprising that they abstain from providing guidance on the law applicable to this relationship. Principle 5(6) merely states that "other law" would govern the law applicable to the relationship between the custodian and the client, without giving any guidance. One could instead have clarified that digital assets held by a custodian are subject to the law chosen in the custody agreement. As a matter of fact, most custody agreements specify such a law, and the industry seems to assume their effectiveness also for proprietary issues. In the exceptional cases in which a choice of law in the custody agreement is lacking, one could refer to the law at the place of principal establishment or the place of incorporation of the custodian. This would provide a safe and uniform anchor to determine the applicable law.

38. A large number of tokens have an issuer that can be identified and whose address is specified in the white paper. This location could equally be used as a connecting factor to determine the applicable law.

39. Networks called "permissioned" or "private" have a central authority. Following a proposal by the UK Financial Markets Law Committee, one could refer to the law at the place of principal establishment or the place of incorporation of this central authority to determine the law applicable to the assets recorded on the network.

40. Some networks are supervised by a state. For example, Germany and France provide for networks that are regulated and supervised. In line with existing conflict-of-laws rules, e.g. in Germany, one could in this case have opted for the law of the state of supervision.

41. These are just some examples that illustrate that 1. it is not impossible to provide connecting factors 2. this does not result in a "one size fits all approach" and 3. even

though not all digital assets are covered, such a rule could have a significant harmonising effect.

42. Even for the remaining digital assets, which are recorded on an open, permissionless and not supervised network, not held in custody, and have no known issuer, one could find a solution, by referring e.g. to the law at the habitual residence of the person currently in control of the digital asset. We do, however, not want to enter into this debate. The connecting factors mentioned above would cover more than 90% of all current digital assets and would therefore significantly enhance the legal situation, even where the rest were not covered by them.

43. It is to be hoped that UNIDROIT will rethink its approach to conflict-of-laws issues. We believe the recently announced joint project between UNIDROIT and the Hague Conference on Private International Law (HCC) will provide an opportunity for providing more detailed rules on this crucial problem.

F. Impact on Insolvency Proceedings

1) Insolvency Proceedings in the Draft Principles

44. Principle 2 (8) defines 'Insolvency proceeding' as a 'collective judicial or administrative proceeding, including an interim proceeding, in which, for the purpose of reorganisation or liquidation, at least one of following applies to the assets and affairs of the debtor: (a) they are subject to control or supervision by a court or other competent authority;[8] (b) the debtor's ability to administer or dispose of them is limited by law; (c) the debtor's creditors' ability to enforce on them is limited by law'. This definition can include in-court, hybrid, and out-of-court proceedings.

45. Principle 5 (3) states that 'notwithstanding the opening of an insolvency proceeding and subject to paragraph (4), the law applicable in accordance with this Principle governs all proprietary issues in respect of digital assets with regard to any event that has occurred before the opening of that insolvency proceeding'.

46. Principle 5 (4) establishes that paragraph 3 'does not affect the application of any substantive or procedural rule of law applicable by virtue of an insolvency proceeding, such as any rule relating to: (a) the ranking of categories of claims; (b) the avoidance of a transaction as a preference or a transfer in fraud of creditors; (c) the enforcement of rights to an asset that is under the control or supervision of the insolvency representative.'

47. Principle 5 (3, 4) should be read in conjunction with:

[8] The word 'control' is to be understood here in its ordinary meaning rather than in the special meaning related to digital assets (Principle 2, Commentary, para 28).

i. Principle 19, according to which '(1) A proprietary right in a digital asset that has become effective against third parties under Principles law or other law is effective against the insolvency representative, creditors, and any other third party in an insolvency proceeding. (2) Paragraph (1) does not affect the application of any substantive or procedural rule of law applicable by virtue of an insolvency proceeding, such as any rule relating to: (a) the ranking of categories of claims; (b) the avoidance of a transaction as a preference or a transfer in fraud of creditors; or (c) the enforcement of rights to an asset that is under the control or supervision of the insolvency representative'.
ii. Principle 10 'Custody' and Principle 13 'Insolvency of custodian'. These Principles bear importance as they exclude from the insolvent estate those digital assets that are maintained by insolvent custodians for clients pursuant to a custody agreement.

2) General Policy: Protecting legal certainty and legitimate expectations.

48. The Draft Principles assume that digital assets trading, secured rights, avoidance transactions, and any other profiles usually fall under special private international law rules when digital assets are handled in cross-border insolvency proceedings (no matter whether the proceedings have been opened with respect to the custodian, the holder, the transferee, and so on).

49. The Draft Principles also assume that many systems provide for some exceptions to the rule whereby the insolvency proceedings and the effects thereof are governed by the *lex concursus* (i.e. the law of the State in which the proceedings are opened). See, for instance, Regulation (EU) 2015/848 and the regime established for rights *in rem* (Article 8), reservation of title (Article 10), and detrimental acts (Article 16).

50. Principle 5 (1) provides a 'waterfall' of connecting factors for the law applicable to proprietary issues on digital assets. Principle 5 (3) makes sure that this 'law' continues to apply in relation to 'any event that has occurred before the opening of the insolvency proceedings'.

51. Principle 19 somehow echoes this framework as it takes into account both the specificities of insolvency proceedings and the demand to protect rights that have been validly and previously constituted under law A from the effects of the following insolvency proceedings governed by law B.

52. In the light of the foregoing, the Draft Principles are to be welcomed in striking a balance between interests underlying the competence of *lex concursus* and interests underlying special treatment for rights and obligations validly and effectively constituted under a different law before the opening of the insolvency proceedings.

53. Needless to say, insolvency rules referred to in Principle 5 (4) may provide for a different treatment (e.g. fiscal authority privileges over secured persons) or for the avoidance of the security agreement that is perfected under law/Principles applicable according to Principle 5 (1).

3) Allocation of insolvency rules.

54. Principle 5 (4) ensures the application of substantive and procedural rules of law that should apply *by virtue of an insolvency proceeding.*

55. Convincingly, Principle 5 (4) does not specify if these rules belong to the *lex concursus*. The fact that rules apply as *lex concursus* or as insolvency rules of other laws will depend on the private international law system before which the issues listed in Principle (4) (a)-(c) arise (ranking of categories of claims; the avoidance of a transaction as a preference or a transfer in fraud of creditors; the enforcement of rights to an asset that is under the control or supervision of the insolvency representative). Notably, this list is not exhaustive.

56. The implementation of the Principle among the enacting States will differ as States are divided as to the exceptions to the application of the *lex concursus* on the mentioned issues. For instance, while avoidance transactions usually fall under the *lex concursus*, exceptions like that established in Article 16 of Regulation (EU) 2015/848 are not commonplace. The same is true for the enforcement of rights in *rem* according to Article 8.

57. The general reference to 'rules of law applicable by virtue of an insolvency proceeding' seems to encompass the case of rules governing systems or platforms in respect of which special provisions apply in the case of insolvency of one participant. Notwithstanding the differences between platforms of digital assets and financial systems or markets, it would be necessary to strongly safeguard the legal certainty of platform-exchanged digital assets when it comes to the insolvency of one participant.

58. This outcome depends on putting the avoidance of such transactions or, generally speaking, the issue of finality and stability thereof under the law governing the system/platform. [9] Accordingly, Principle 5 (4) could be amended as including the following item:

    d. the effects of the proceedings on rights and obligations resulting from systems or platforms on which digital assets are recorded or exchanged.

59. Actually, 'rules of law applicable by virtue of an insolvency proceeding' ends up including also certain Draft Principles as a sort of sub-category of Insolvency Principles.

[9] *Mutatis mutandis* see Article 12 of Regulation (EU) 2015/848.

60. The first stems from Principle 13, which keeps digital assets separate from the custodian insolvency estate. The second Insolvency Principle is embodied in Principle 19, which provides for the effectiveness of a proprietary right in a digital asset against the insolvency representative, creditors, and any other third party in an insolvency proceeding if the right has become effective against third parties under the 'Principles law' or other law.

61. Such a rule whereby 'pre-insolvency effectiveness continues in insolvency proceedings'[10] may be applicable also in cross-border cases. It would have a major impact where the *lex concursus* does not provide the same as the law governing the effectiveness of rights on digital assets.

62. Other Insolvency Principles stem from the rules governing 'situations of shortfall' in relation to fungible digital assets controlled in a pooled account (Principle 13 (4-6). Even at first glance, they set up a sort of creditors class – those having assets in the pooled account – and, consequently, impinge on the ranking of claims and the creditors' satisfaction.

G. Third-party effectiveness

1) General Policy

63. Principle 5 (5) applies to cross-border transactions in which security rights are constituted in digital assets (by means of digitalized records, platform-based trading, and alike).

64. Clarity and predictability about the law that determines priority among conflicting titles on digital assets are of the utmost importance for the sake of efficiency in trading digital assets or in trading claims that are secured by collaterals on digital assets.

65. On the other hand, Principle 5 (6) makes it clear that the relationship between the custodian and its client (i.e. the relationships derived from the custody agreement) is different and, consequently, is governed by other laws than that governing the effectiveness of rights *on* digital assets and priority issues.

2) 'Control', or 'not control', that is the question

66. The Draft Principles emphasize the role of 'control' over digital assets as a functional equivalent of 'possession' of movables.[11] The concept works as a criterion to protect an innocent acquirer, to determine third-party effectiveness (perfection), and to assess the

[10] Principle 19, Commentary, para 2.
[11] Principle 6, Commentary, para 1.

priority of security rights on digital assets.[12] The concept is different from ownership; accordingly, a change of control does not necessarily convey a transfer of the proprietary right.[13]

67. Since 'control' basically means 'exclusive ability' to benefit from the digital asset, the question arises as to which law governs this ability in an objectively ascertainable way. The question arises against a backdrop of a lack of tangible/physical location.

68. The question becomes more complicated in the case of digital assets 'linked' to another asset, as holding/transfer of digital assets is 'legally neutral in relation to the other asset'.[14] The Draft Principles do not address the contractual or proprietary effects of the link and, consequently, leave the question to national law (Principle 4), including its private international law. Actually, the national law's competence starts with the characterization of the 'link' for the purposes of private international law.

69. The fact that Principle 5 (5) deals only with issues of effectiveness and priority of 'security rights made effective against third parties by a *method other than control*' – e.g. by notification or registration – means that it is for the law governing the 'proprietary issues' under Principle 5 (1)[15] to determine the effectiveness and priority of rights perfected by *control*.[16]

70. In the absence of control, Principle 5 (5) does not suggest such connecting factors as might be consistent with the Draft Principles. It only clarifies that 'other law' applies, which means that the issue is referred to the private international law provisions other than those that States would adopt when enacting the Draft Principles. Besides, the commentary to Principle 5 (5) recognizes that a rule rooted in the concept of 'control' is not appropriate when it comes to secured rights whose ownership is recorded in a registry.[17]

71. However, the caveat that 'other law applies' conveys *per se* a 'principle' which serves to keep separate the private international law profiles of secured rights in transactions involving digital assets. Particularly, interpreters should bear in mind at least four different relationships and the related private international law treatment: i) that stemming from digital assets custody (the law governing the custody agreement applies); ii) that arising out of secured transactions by means of digital assets (the law governing the security agreement applies); iii) that arising out of rights on assets that are recorded as digital assets (the law governing such rights applies, e.g. intellectual property law); iv) that arising

[12] Principle 6, Commentary, para 3. See also Principle 15.
[13] Principle 2, Commentary, para 23.
[14] Principle 4, Commentary, para 7.
[15] Including the criteria of interpretation provided for in Principle 5 (2).
[16] See also Principle 15.
[17] Principle 5, Commentary, para 12.

out of transfer of rights on assets that are recorded as digital assets (the law governing the transfer applies). The Draft Principles do not address such issues.[18]

72. The Draft Principles are instead much concerned with the impact of insolvency proceedings. As noted above, Principle 19 establishes that proprietary rights in a digital asset that has become effective against third parties under the Principles law or other law are also effective against the insolvency representative, creditors, and any other third party in an insolvency proceeding. On the other hand, consistently with Principle 5 (4), Principle 19 (2) safeguards the application of any substantive or procedural rule of law applicable by virtue of an insolvency proceeding, such as 'any rule relating to: (a) the ranking of categories of claims; (b) the avoidance of a transaction as a preference or a transfer in fraud of creditors; or (c) the enforcement of rights to an asset that is under the control or supervision of the insolvency representative'.

73. It remains to assess which law should govern the priority and third-party effectiveness in the case of competing rights perfected *by means other than control*, or in the case of competing rights among which *not all* are perfected by control,[19] or in the case of competing rights on digital assets *controlled or maintained in a chain of sub-custodians*.[20]

74. Despite not being concerned with secured rights *perfected by means other than control*, the Principles or the Commentary thereto should at least consider that such rights might conflict with secured rights *perfected by means of 'control'*.

The WG suggests two alternative ways to address third-party effectiveness and priority in such cases.

[Option A]

It may be stated that priority is given to the right that becomes first effective against third parties according to the law that applies to its proprietary aspects.[21]

[Option B]

Principle 16 provides for the priority of security rights made effective by means of control over rights made effective by other methods. This Principle might also work as a substantive priority rule in the case of third-party effectiveness governed by different laws.

[18] Commentary, Introduction, para. 10. See also Principle 3 (3).
[19] According to commentary, para. 13, Principle 5(5) seems to also deal with this issue by referring it to 'other law'.
[20] See Principle 10, Commentary, para 4, for the difference between 'maintaining' and 'controlling' a digital asset when it comes to multi-layer custody.
[21] This priority rule somehow draws on Article 4 (4) of the Proposal for a Regulation of the European Parliament and of the Council on the law applicable to the third-party effects of assignments of claims COM(2018) 96 final, as amended by the General Approach (doc. no 9050/21, 28 May 2021).

Evidently, a temporal order would apply if more than one creditor obtained ‘control’ over the same digital assets.