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Insights

UNPACKING THE LAW COMMISSION'S DIGITAL ASSETS CONSULTATION

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On Feb. 22, the U.K. Law Commission launched a consultation on the Property (Digital Assets etc) Act 2024, a draft legislation that confirms the existence of a third category of personal property.

Given the current model of property rights, the intention of the draft legislation is to better recognize, accommodate and facilitate the development of digital assets, including cryptocurrencies.

Common law has already confirmed that digital assets can be treated as personal property. Nevertheless, there is a desire to codify this, and to set clearer legal foundations through law reform.

Accordingly, in this article, we consider the difficulty of applying current models of property rights to digital assets, the legal consequences of digital assets being considered a third category of personal property, as well as other potential impacts.

NEED FOR LEGAL REFORM

OUTDATED MODEL OF PROPERTY RIGHTS

Historically, English law classified property as either real property, i.e., interests in land, or personal property, i.e., interests in other things. Personal property rights are then recognized as two distinct categories, namely a thing in possession — a tangible item — or a thing in action — a bundle of legal rights that can be enforced.

- **Things in possession**: Things in possession refer to any object that is capable of possession, including assets that are tangible, moveable and visible, such as a bag of gold. Things in possession can be used, enjoyed and exploited irrespective of whether a legal system is available to recognize the object in question.
- **Things in action**: Things in action refer to property that can only be claimed or enforced through legal action or proceedings. This includes rights to sue under a contract, debts or shares in a company. Unlike things in possession, things in action exist to the extent that there is a party against whom that thing in action can be enforced.

Colonial Bank v. Whinney, a Court of Appeal of England and Wales case from the 19th Century,[1] is often used as authority for the proposition that these two categories of personal property are exhaustive such that any object of personal property rights must fall within one of those two.

However, to restrict personal property rights to a two-category model is to limit the law's ability to provide nuanced legal treatment to emergent objects, including digital assets — hence the need for legal reform.

DIFFICULTY IN APPLYING CURRENT MODELS TO DIGITAL ASSETS

Digital assets do not sit easily in either of these traditionally recognized categories of things in possession or things in action.

In the 2019 High Court of Justice of England and Wales' decision in AA v. Persons Unknown,[2] the court stated, "Prima facie there is a difficulty in treating Bitcoins and other crypto currencies as a form of property."

The difficulty arises because of the unique nature of digital assets, which do not fit traditional concepts of possession, control or ownership.

From a legal perspective, digital assets are not tangible, and, so, in a conventional sense, they are not things in possession. However, unlike things in action, digital assets can be used, enjoyed and exploited independently of whether any rights or claims exist in relation to them.

Digital assets would continue to exist even if the law failed to recognize them as objects of property or outlawed their existence altogether. Users can exclude others from a digital asset and in turn be excluded from it. This also means that digital assets, similar to things in possession, can be alienated from a person without their consent or a legal process.

Nevertheless, in AA v. Persons Unknown, the court acknowledged the narrowness of the current model of property rights, and found that the fact that digital assets might not be easily classified within the current model does not in itself mean that they cannot be treated as property.

The Court of Appeal of England and Wales, in the subsequent February 2023 decision in Tulip Trading Ltd. v. Wladimir Jasper van der Laan,[3] also recognized that "a cryptoasset such as bitcoin is property."

In short, English case law now recognizes that digital assets, such as crypto tokens, can be objects of personal property rights, even if they do not fit squarely within the existing concepts.

CREATING A THIRD CATEGORY THROUGH LEGAL REFORM

Given these developments, the Law Commission has recommended new legislation to explicitly recognize a third category of personal property rights.

OVERVIEW OF PROPERTY (DIGITAL ASSETS ETC) ACT 2024

The draft legislation is short, and simply provides that "a thing (including a thing that is digital in nature) is capable of being an object of personal property rights even though it is neither (a) a thing in possession, nor (b) a thing in action."

The obvious effect of this is to remove any lingering judicial authority from Colonial Bank v. Whinney that property rights only exist within the two-category model. There is also a clear reference that things that are "digital in nature" can be subject to property rights.

Though not crucial to the draft legislation, since nondigital objects can also fall into the third category, clearly this reference provides clarity on the legal status of digital assets.

The language of the draft legislation is technology-neutral in that it does not focus on any single or class of digital asset, or any protocol, system, network or technological feature.

The Law Commission makes it clear that the purpose of explicit recognition, in statute, of a third category of personal property is to encourage a more nuanced consideration of new, emerging things.

It is the commission's view that the creation of a distinct third category will better allow the law to focus on attributes or characteristics of the things in question without being fettered by previous traditional principles.

WHAT CONSTITUTES A THIRD CATEGORY THING

Despite being clear that it does not want to draw arbitrary boundaries or create rigid definitional issues, the Law Commission has provided broad examples of items that do not fall into the third category.

These include pure information, which is separate from the means or medium on which the information is recorded, and certain digital things such as — though not in all cases — digital files and records, email accounts, in-game assets and domain names.

This is largely because these items are not rivalrous — their use by one person does not necessarily prejudice the ability of others to make equivalent use of that item at the same time.

The commission argues that rivalry, as endorsed by the Court of Appeal in Tulip Trading, usefully distinguishes this type of digital asset from other digital things, such as normal digital files that are not capable of attracting personal property rights as a matter of law.

LEGAL DEVELOPMENT OF THIRD-CATEGORY THINGS

The commission intends for common law to develop specific legal principles for third-category things, as it already has for things in action and things in possession. This is important, as the technology behind digital assets remain nascent, and therefore the law requires flexibility to adapt as the technology develops.

However, where legal principles for things in action and things in possession are consistent, the commission suggests that the same treatment be applied to third-category things, which includes, for example, causes of action and remedies.

Interestingly, the commission suggests that a good approach is for the common law to develop through analogy, even if those analogies are imperfect. As an illustration, the commission mentions the following examples:

- Pledge: An equivalent control-based proprietary interest could be developed to facilitate security arrangements over digital assets like cryptocurrencies. However, such a principle would need to be adapted to third-category things where different concepts of control may apply.
- Conversion: A corresponding principle to the tort of conversion would need to be created for wrongful interferences with digital assets, such as "burning" crypto-tokens, since conversion is not available for intangible objects.
- Good faith purchaser defense: The existing defenses, which are contained in statute and common law, only cover goods, money and negotiable instruments. The common law should recognize a special defense where cryptocurrencies, and other third-category things, are purchased for value without notice.

FURTHER POTENTIAL IMPACT

The draft legislation would remove any lingering authority or concern regarding a third category. In addition to building out new forms of personal property rights, we think this development:

- Streamlines legal disputes and reduces associated litigation costs, given that courts have a clearer basis on which to operate;
- Rides on the U.K.'s recent moves to boost its attractiveness for fintech, which includes initiatives in share dematerialization[4]and the creation of a digital securities sandbox;[5]and
- Provides the legal flexibility for common law to create analogous concepts for digital assets and nascent and developing technologies.

Ultimately, the legislation allows parties to focus on the substantive aspects of objects, and their legal treatment, without being tied to outdated models of property.

The commission asked for responses to their consultation paper by March 22.

This article was originally authored by Tom Bacon and Andrew Tsang and published on Law360

FOOTNOTES

[1] Colonial Bank v. Whinney
(1885) 30 Ch. D. 261.

[2] AA v. Persons Unknown
[2019] EWHC 3556 (Comm).

[3] Tulip Trading v. Van Der Laan
[2023] EWCA Civ 83.

[4] The UK's initiative to dematerialise the current shareholding structure and the potential role of distributed ledger technology is discussed in our previous Law360 article .

[5] The UK's Digital Securities Sandbox, which was designed with digital asset technology in mind, is discussed in our previous Law360 article.

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