



Current German legislation to protect property rights regarding crypto coins in insolvency proceedings

- Planned legislation and practical problems for recovery-

The German legislator is currently planning a law to make the regulations for the custody of crypto assets more legally secure, with the aim of enabling the holders of crypto assets (in the form of crypto tokens, NFTs etc.) to separate their assets from the insolvency estate. These new regulations were introduced into the legislative process by the German Federal Government on 11 September 2023 (Bundestag printed paper 20/8292) in the form of the "Draft of a law on the financing of future-proof investments (Future Financing Act - ZuFinG).

In this context, the Future Financing Act - via new regulations in the German Banking Act – is supposed to oblige those institutions that operate crypto custody business to ensure that the private keys of the customers are kept separately from the crypto assets and the private keys of the institutions, in order to enable a segregation of the crypto assets in favour of the customers, especially in the case of insolvency of the crypto custodians. Furthermore, the institutions may no longer dispose of the assets held in their custody without the express consent of the customer.

The new regulation is a welcome start, but will very quickly reach its limits where, for example, crypto custodians based outside Germany go bankrupt. In addition, the costs of segregation are to be borne by the customer, which will also present the customer with not inconsiderable practical problems.

According to section 47 of the German Insolvency Code, a creditor may demand the segregation of his property from the insolvency estate if he is the legal owner. This applies in particular not only to movable property but also to rights and claims. However, the prerequisite for the segregation of property and rights held in trust by the debtor for the creditor is that they are distinctively present in the insolvency

Draft "Future Financing Act" to secure property rights in crypto assets in insolvency

Obligation to segregate assets under the control of the German Federal Financial Supervisory Authority (BaFin)

Problem: No segregation without separate administration

estate, i.e. that they are administered separately from the other property to be allocated to the insolvency estate.

In principle, the same principles apply to crypto assets, i.e. the owner of crypto assets can only demand the segregation of the assets if they are managed separately for each creditor from the assets of other creditors. However, this should often not (yet) be the case with many crypto custodians. In particular, when crypto assets are held in omnibus wallets, the legal requirements for the separate custody of assets will not be met and thus segregation of the assets will not be possible. If the custodian also grants the holder of the assets the authority to dispose of the assets from the omnibus wallet, this will also mean that segregation will not be possible.

The German government has now defined requirements for the administration of crypto assets by crypto custodians with the aim of enabling the holders of such assets to segregate them in the event of the insolvency of the crypto custodian through the Future Financing Act, which is intended to implement the EU MiCA Regulation ("*Regulation (EU) 2023/1114 of the European Parliament and of the Council of 31 May 2023 on markets in crypto-assets, OJEU L 150/40*"). Under the supervision of the German Federal Financial Supervisory Authority, institutions that hold crypto assets in custody must essentially ensure the following in the event of the law coming into force:

1. Separate administration: An institution engaged in crypto custody business shall ensure that the crypto assets and private cryptographic keys of customers are kept separate from the crypto assets and private cryptographic keys of the institution.
2. If crypto assets of several customers are bundled (e.g. in omnibus wallets), the institution shall ensure that the shares of the total assets held in joint custody attributable to the individual customers can be determined at any time.
3. The institution shall ensure that the customer's crypto assets and private keys held in safe custody cannot be disposed of for the institution's own account or for the account of another person without the customer's express consent.
4. If, however, the customer has given the custodian permission to dispose of the crypto assets held in custody for the account of the institution or third parties, the customer will probably not

EU MiCA Regulation

Separate administration of crypto assets

have a right to segregate these assets in the event of insolvency.

5. The costs of the segregation must be borne by the creditor invoking segregation rights.

It remains to be hoped that the law will actually pass. Nevertheless, in view of the strong international context of crypto asset trading, the law will probably have little practical effect:

- The majority of providers of administrative services for crypto assets are located abroad, so that the question of whether holders of crypto assets have rights of segregation will not be governed by German insolvency law, but by the law of the state in which the provider has its centre of main interest.
- In addition, due to the lack of regulation in the past, already the allocation of the values to the respective owner will cause considerable delimitation difficulties.
- Finally, providers will try to protect themselves via the contractual set of rules (General Terms and Conditions), and many years will have passed by the time the highest German courts have ruled on legal disputes in the interpretation of this set of rules.
- Despite the current "crypto winter", the crypto market is developing at a rapid pace, and this pace will increase with the next Bitcoin halving in 2024 at the latest. It is already foreseeable that legislators will have great difficulties in regulating the market in a meaningful way, as shown e.g. by the Ripple vs. SEC lawsuit.

In conclusion, crypto holders should continue to closely monitor developments in the regulatory environment of crypto assets and carefully consider the advantages and disadvantages of having their crypto assets held by service providers.

Strong international context of crypto trading as a general legal problem

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