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UPDATE

Fund finance x crypto - the next frontier

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With the growth of fund finance we have all observed cross-over between areas such as securitization, structured finance, and the insurance sector, blurring the lines between historically separate areas. The next frontier is rapidly coming into focus: crypto. It would be unwise to try to forecast exactly how the relationship between crypto and fund finance will evolve but in the Cayman Islands, which is somewhat of a 'sandbox' for virtual asset experimentation and innovation, we are already thinking about virtual assets in the fund finance context. While crypto presents some challenges to fund finance, it may also provide some novel solutions.

In the first part of this series, we will examine the potential for fund finance facilities backed by virtual assets held in custody accounts.

Part One - Custodied virtual assets

Lending backed by custodied virtual assets gives rise to two issues for lenders to solve: a legal challenge and a credit underwriting challenge.

The legal challenge

First, some history. The very early days of fund finance had its genesis in offering banking solutions to funds of funds. Industry veterans who worked on structuring those facilities followed a tried and tested pattern of lending to funds for liquidity management purposes, providing credit lines mainly to fund redemption obligations, with the loans being collateralized by security over the fund's custody accounts.

Back further still in history, the *Re Charge Card Services Ltd* [1987] case involved a conceptual debate in common law jurisdictions such as the Cayman Islands over whether a bank can take security over a bank account held by its own customer, given that the customer is actually the bank's creditor in respect of the account. It was argued by some parties that such a security interest was a 'conceptual impossibility'. Helpfully, this view was rejected by the UK House of Lords[1] and it is now clear that enforceable security may be taken by a bank over a borrower's accounts. A similar 'conceptual impossibility' analogue arises today in the context of virtual assets.

The obvious legal challenge is how to conceptualize the legal nature of virtual assets; are they personal property in the same way as shares, limited partnership interests, loan receivables or other claims are? The answer dictates whether an effective Cayman Islands law security interest can be granted and perfected in virtual assets and, perhaps more importantly, dictates the exact legal form that such security interest would take. Cayman Islands law recognises various forms of security interest such as fixed charges, floating charges, equitable mortgages, legal mortgages and assignments by way of security. Each has its own nuances and applicability to different types of property.

[1] *Morris v. Agrichemicals Limited [1996].*

Important decisions in the English courts have already confirmed that certain virtual assets (namely Bitcoin and USDT) constitute legally recognised property, on the basis that they are definable, identifiable by third parties, capable of assumption by third parties and have some degree of permanence or stability[2]. English law is highly persuasive in the Cayman Islands and it is likely that these authorities would be followed unless there was an overriding public policy reason not to do so. However, despite clearing the first hurdle it remains unclear exactly what *type* of property a virtual asset is. In most common law jurisdictions, personal property is generally divided into choses *in action* and choses *in possession*. English courts have held that virtual assets are neither, but rather a distinct form of property in its own class[3]. This poses a question as to what type of security interest ought to be used to create and perfect security over any given virtual asset.

Unlike other jurisdictions such as the United States, Canada and Australia, the Cayman Islands does not have a codified system of security creation, perfection and priority rules for personal property. This fact comes with both upsides and drawbacks. On the one hand, it does make it more difficult to simply provide a codified position around security-taking via legislative amendment[4]. On the other hand, courts are free to adopt existing rules around security interests in personal property arising under common law, leaning on jurisprudence in other Commonwealth jurisdictions as it evolves.

One legal advantage which may smooth the path to bankable virtual assets held in custody is that under Cayman Islands law, the usual security package for such facilities would include an equitable assignment (an 'assignment by way of security' in Cayman Islands legal parlance) over the contractual rights in the agreement governing the terms of the custody account. This allows the custody arrangement to function as normal in the ordinary course and sidestep, for the time being, conceptual questions as to the exact legal nature of the underlying virtual assets. It also allows the financing bank to step into the rights of the borrower as against the custodian. However, this may not work in all cross-border transactions where the governing law of the account contract is different from the location of the custody bank, and conflict of laws issues (for instance, under the Hague Securities Convention) will come into play. It also leaves open credit risk in the event of insolvency of the custodian itself, as relying on an equitable assignment of contractual rights alone may have little value if the custodian is bankrupt. All things being equal, a lender will want a proprietary, first-ranking claim on the virtual assets which elevates it above the custodian's other creditors. In a cryptocurrency context, the ultimate protection for a lender would involve controlling (in a practical sense) the sole private key necessary to execute transactions in relation to the underlying asset. A borrower is unlikely to hand over their private keys, but a level of practical control could be obtained via a multi-signature arrangement between the custodian, the borrower and the lender.

The credit underwriting challenge

The obvious credit underwriting challenge stems from the inherent volatility of some virtual assets when compared to other types of investments. Traditional NAV testing, collateral valuation periods and margin mechanics may not be sophisticated enough to keep pace with swings in virtual asset prices. In other crypto lending contexts outside of fund finance, this is addressed mainly in two ways: through substantial overcollateralization and use of smart contracts. To protect against unacceptable loss given default, loans backed by virtual assets are often heavily overcollateralized and margin call triggers are often set at very early stages when compared to more traditional investment securities. A smart contract meanwhile, is a digital contract embedded in the blockchain which contains an established set of rules governing 24/7 without reference to traditional market open and close timeframes. A smart contract can be set up to operate without the need for action by third parties such as broker dealers, administrators, banks or insolvency officials. This has obvious advantages in removing friction within the system, but from the borrower's perspective, the risk is that a smart contract built into a virtual asset-backed loan could trigger immediate liquidation into a falling market with almost no time for intervention or negotiation with the lender, creating a cascading effect and amplifying losses.

In the next instalment of this series, we will examine the development of tokenized investment funds in a fund finance context.

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[2] *Tulip Trading v. van der Laan & Ors* [2023] EWCA Civ 83.

[3] *Fabrizio D'Aloia v. Persons Unknown Category A & Ors* [2024] EWHC 2342 (Ch).

[4] Such as the approach taken in the United States through amendments to the Uniform Commercial Code dealing with 'Controllable Electronic Records' and allowing for perfection via control.

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