

ELECTRONIC TRADING DOCUMENTS: POSSESSION IS 9/10THS OF THE LAW

The UK Law Commission has published its much anticipated report and draft Bill on electronic trade documents. At just seven sections long, the Bill is very short. However if it becomes law, it could herald a seismic shift in international trade because it will enable trade documents in electronic form to be used in the same way as their paper equivalents under English law.

The problem

The problem that the UK Law Commission set out to address is well-rehearsed: international trade has found it hard to move from a paper-based to a digital format because most legal systems of relevance to international trade do not recognise electronic trade documents as having the same functionality and validity as the long-established paper trade documents. As a result, and despite the best efforts of the fintech industry, much international trade is still carried out using paper documents, with all the cost, inefficiency and risk of fraud that entails.

Key to this is the problem of possession. Under English law, a paper document is a "tangible asset" which is capable of possession. This means that where the holder of a physical document has the right to performance of an obligation recorded in it (for example delivery of goods or payment of money), they can use the document to evidence that right and also to transfer it – by transferring possession of the document. There are other legal implications important for international trade too: a possession can be subject to bailment or a lien for example. By contrast, an electronic document is an "intangible" asset under English law and therefore not capable of possession. Neither does it allow the same functionality. The other problem is that English law recognises transfer of paper negotiable instruments by wet ink signatures known as "indorsements," but there is no equivalent recognition of the indorsement of electronic documents.

Solutions have been devised using multi-party contractual frameworks in which the parties agree to treat electronic documents as capable of possession. But these have yet to be tested in law and are inevitably limited in application to those who sign up.

The solution

The UK Law Commission's approach has been to deal with the problem of possession whilst changing as little as possible. It recognises that current English law is well-established, well-regarded and therefore widely used, describing it as having "*pre-eminent status as the law of choice in global commerce*" (although at the same time, recognising the need for English law to evolve in order to maintain that status).

What is in the Bill?

In essence the Bill proposes that if an electronic document meets the criteria to be considered an "electronic trade document" ("**ETD**") under English law, it will then be capable of being possessed and of being transferred by way of electronic indorsement and the handing over of electronic possession, in exactly the same way as its paper equivalents are currently indorsed by wet ink signatures on paper and handed over physically.

What is an ETD?

The Bill works in stages, first by identifying the group of equivalent paper documents, or "paper trade documents" which are the intended subject of the legislation. These are described as documents, possession of which "*is required as a matter of law or commercial custom, usage or practice for a person to claim performance of an obligation.*" The following examples are listed in the Bill:

1. Bills of exchange
2. Promissory notes
3. Bills of lading
4. Ship's delivery orders

5. Warehouse receipts
6. Mate's receipts
7. Marine insurance policies
8. Cargo insurance certificates

Some of these documents have requirements as to the information they must contain in order to qualify as a particular type of trade document. The Bill provides that a document in electronic form must contain the same information as its paper equivalent. Where it does so, it will be a "qualifying electronic document."

A qualifying electronic document will achieve ETD status if there is a "reliable system" in place to meet certain criteria. These criteria are aimed at encouraging trust in the system, minimising the opportunity for fraud and avoiding the risk of "double spending." They are:

- Identification of the document - so that it can be distinguished from copies in the same way as a paper original can.
- Integrity of the document – so that it cannot be changed without authorisation.
- Document is capable of exclusive control – so that only one person can exercise control over it at one time.
- Identification of those who can exercise control – the person who is able to exercise control over the document can demonstrate this.
- Divestibility – it must be possible to transfer both the document and the ability to control it so that there is no opportunity for concurrent control.

"Exercising control" is defined in the Bill as using, transferring or otherwise disposing of the document, whether or not there is a legal right to do so. Simply reading or viewing it is not sufficient. The UK Law Commission deliberately included a definition because it sees the concept of control as fundamental. This is firstly because it is one of the two common law requirements for possession (the other is intention) and secondly, because it was considered necessary for a secure, trustworthy and effective system that an electronic document was amenable to exclusive control.

Once an electronic document qualifies as an ETD, the Bill recognises it as entirely equivalent to a paper trade document, capable of possession, indorsement and transfer, with all the legal consequences flowing from that.

The Bill also provides a way for ETDs to be changed into paper form and vice versa. Failure to follow this statutory process would render any change of form invalid.

What is not in the Bill?

Although the Bill requires a "reliable system" to be in place in order for a qualifying electronic document to constitute an ETD, it does not specify what constitutes a "reliable system." It does however suggest matters that can be taken into account when assessing whether a system is reliable. This is in line with the approach in the MLETR¹ and is intended to strike a balance between the need for trust in the system and the need for flexibility to allow for future technological developments, as well as avoiding the burden that full accreditation would impose.

Possession is not defined in the Bill either; this is left to English common law, just as it is for a paper document.

In relation to indorsement, a paper document is typically indorsed by writing on the back of it. Whilst the Bill specifies that an ETD is capable of indorsement, it does not specify how. Again, the UK Law Commission indicated that this was deliberate, to allow for flexibility.

Lastly, the Bill does not seek to address wider issues that are in play, in particular the fact that there are outstanding issues to be addressed in relation to digital assets under English law. These include the complexities around moving from paper systems, where the physical location of a paper document is easy to ascertain, to electronic systems, where determining the "location" of an electronic document created by distributed ledger technology is anything but straightforward. The UK Law Commission has indicated that it will deal with these challenges as part of its [digital assets project](#). A consultation is expected to be launched in mid-2022 and the UK Law Commission has laid down a marker that a different approach may be needed to address these wider issues.

Compatibility

Another significant challenge in the transition from paper to digital cross-border trade is the fact that not all jurisdictions treat electronic documents in the same way. Whilst the approach taken under English law is influential, because London is a key centre for international trade and because many of the world's trading hubs are common law jurisdictions whose legal systems are influenced by English law, a change to English law does not offer a total solution. English law does not directly govern many international trade instruments; for example, bills of exchange do not have governing law clauses and each party's obligations are typically assumed to be governed by the laws of their place of incorporation or the place of performance. Similarly, warehouse receipts are governed by the law of the jurisdiction in which the warehouse is located.

¹ UNCITRAL's Model Law on Electronic Transferable Records

To alleviate this somewhat, the UK Law Commission's intention was for the Bill to be as compatible as possible with legal developments on digital trade elsewhere. It has aligned as far as possible with the aims and policy of the MLETR and specifically recognised developments in Singapore and the US in its report. The MOU on digital trade facilitation, signed by the Singapore and UK governments in December 2021, is indicative of significant intent to facilitate the move to digital trade. (Having said that, there are some differences with the MLETR in the Bill, including that there is no requirement for an electronic document to be in writing or signed.)

The UK Law Commission was also keen for the Bill to be "technology neutral". Whilst digital ledger technology ("**DLT**") is acknowledged in the report as likely to be widely used in digital trade, the Bill is intended to have application to any form of technology and to be light touch enough to have continued application as that technology evolves.

When will it become law?

The UK government has indicated its intention to introduce legislation "when parliamentary time allows," possibly as soon as May 2022.

HFW comment – least said, soonest mended?

The UK Law Commission's minimalist approach could perhaps be said to come at the price of certainty. Some key questions are left unanswered by the Bill, including in particular what constitutes possession of an electronic document, how it should be indorsed and what is a "reliable system" to make an electronic document capable of possession.

The UK Law Commission has backed the robust and reliable nature of the English legal system here, affirming that it will be for the English courts to decide these questions, based on existing case law. In theory, it should be possible to predict outcomes, at least to a certain extent, because of the reliance on precedent (where precedent exists). The hope is that this approach will offer greater longevity because the advantage of the English common law system is that it can evolve and adapt by applying existing principles to new circumstances and, in this case, developing technology.

The English judiciary is certainly live to the challenge. Earlier this year, at the launch of new guidance on blockchain published by the Law Society,² Sir Geoffrey Vos, Master of the Rolls commented, "*Major developments are imminent. They will mean that every lawyer will require familiarity with the blockchain, smart legal contracts and cryptoassets.*"³

The UK Law Commission's twin aims of disrupting as little as possible a tried and tested system and building in flexibility for the future seem sensible. In our view, the majority of electronic trading platforms developed by the fintech industry should be able to qualify as "reliable systems" and the electronic trade instruments on those systems should be able to qualify as "ETDs". This could be transformative as, for the first time, English law will support, rather than block, the validity of electronic negotiable instruments. Two key questions remain: first, whether commerce is prepared to accept that the elements of uncertainty which using new electronic trade instruments necessitates are worth the obvious benefits that digital trading offers and second, how smooth the transition to digital cross-border trade will be in reality, particularly given the lack of a uniform approach globally. Whilst this will be a challenge, there is cause for optimism, particularly with the level of co-operation on digital trade between key hubs such as the UK and Singapore.

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² Blockchain: Legal and Regulatory Guidance, 2nd edition

³ Law Society Gazette, 11 January 2022.

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