Cryptocurrency exchanges and the challenges of bankruptcy

Crypto has become recently almost an obligatory part of many specialist conferences. It wasn’t any different at the INSOL Europe 2023 Annual Congress in Amsterdam, where panellists Max Mailliet, Pierre-Gilles Wogue, Gwilym Jones and David Orsula as moderator discussed the current developments what happens when a crypto exchange goes bankrupt. Max Mailliet and David Orsula summarize the content of the panel.

A hazy outlook
Despite more entities holding cryptocurrencies, there is insufficient attention to how they are treated in the event of bankruptcy. The lack of clear guidance from bankruptcy courts on classifying cryptocurrencies within insolvency laws increases uncertainty for creditors. Unlike currency, cryptocurrencies operate in a regulatory grey area in bankruptcy proceedings.

Pertinent questions
Cryptocurrency exchange insolvencies, like FTX’s filing in 2022, pose critical questions for the insolvency regime. Adapting the legal framework is essential in order to protect creditors, streamline exchange restructuring or liquidation and maintain the integrity of the financial system.

1. Trading function:
A claim may arise if the exchange fails to execute a transaction instruction due to intervening insolvency. In such cases, the claim typically involves the value eroded by the inability to transact with the cryptocurrency held in the custodial wallet during bankruptcy. This claim might be excluded contractually, as exchange contracts often contain broad waivers from liability.

2. Custody function:
The focus shifts to whether customers with the cryptocurrency in the custodial wallet have a proprietary claim against the insolvent crypto exchange. If so, their claim takes priority over other creditors in relation to their cryptocurrency. Alternatively, customers may have a personal claim, resulting in them sharing in any liquidation distribution on a pro rata basis, potentially incurring a significant loss.

Determining the legal status of cryptocurrencies: implications for the trustee
Clarifying the legal standing of cryptocurrencies holds significant importance as it directly influences the distribution of remaining digital assets by the curator/ trustee/liquidator. In the case of Ruscoe v Cryptopia Ltd (in Liquidation), the New Zealand High Court held that cryptocurrencies are considered property, implying that individuals may hold legal title to them.

Cryptocurrency classification: rights in rem or in personam?
The issue of classifying cryptocurrencies as property or personal rights varies across jurisdictions. Practically, the key...
Navigating cryptocurrency insolvencies: addressing volatility

Insolvency professionals face unique challenges when dealing with businesses immersed in the cryptocurrency world, necessitating a re-evaluation of traditional approaches to insolvency appointments. The inherent intangibility and volatility of digital assets pose complexities in their valuation and realization. Any insolvency professional attempting to realize value will need to carefully consider their statutory obligations when determining whether, and when, transferring assets for funds align with the creditors’ interests or if retaining the cryptocurrency in its current form proves more advantageous in the long run. Given these considerations, seeking Court approval for any cryptocurrency asset realization strategy becomes a prudent course of action.

The general lack of case law on cryptocurrencies in bankruptcy leaves bankruptcy courts with limited guidance on how and when to value these unique assets. This point is exemplified in the case of an infamous Japanese bitcoin exchange, which was handling over 70% of all bitcoin transactions worldwide by early 2014, Mt Gox.

Learning from Mt. Gox: A cautionary tale in cryptocurrency bankruptcy

This major bitcoin exchange filed for bankruptcy in Japan after experiencing a cyber-theft incident resulting in the disappearance of 650,000 bitcoins. At the time of filing, Mt. Gox held around 202,000 bitcoins designated for the bankruptcy estate, intended to address the multitude of creditor claims. During the bankruptcy proceedings, the value of Bitcoin skyrocketed and, by 2018, the trustees found themselves managing funds valued at approximately US$ 1.5 billion. Capitalizing on this significant surge in value, the trustee envisioned valuing creditors’ claims based on the market value of Bitcoin at the time of the bankruptcy filing. This strategy would allow the liquidation of Bitcoin at the current market price, fulfilling all creditors’ claims in full, while still retaining a surplus of US$ 1 billion.

The decision to hold onto the assets proved to be advantageous, showcasing the potential benefits of strategic planning and maximizing the bankruptcy estate for both the debtor and creditors. The Mt. Gox debacle underscored the principle that Bitcoin and, by extension, cryptocurrencies forming the basis for creditors’ claims, should be valued as of the petition filing date. This case also highlights the importance of maintaining a consistent valuation date. If the Court had ruled differently, allowing creditors to amend claims throughout the case to maximize value, it could disrupt the efficient administration of the bankruptcy. Such a ruling might incentivize creditors to delay filing claims strategically, creating uncertainty for the trustee in determining the actual currency value of each claim until the precise moment of distribution.

The European regulatory landscape: MiCA Regulation

Published in the Official Journal of the EU on 9 June 2023, Regulation (EU) 2023/1114, known as the MiCA Regulation, has established a unified regulatory framework for markets in crypto-assets across the European Union (EU). The primary objectives of the MiCA Regulation are to safeguard investors, maintain financial stability, ensure market integrity, all while fostering innovation within the crypto-asset sector.

Despite being drafted prior to the collapse of FTX and the subsequent crisis in the digital asset market, the MiCA Regulation addresses numerous issues encountered during this crisis. It specifically tackles the challenges that contributed to FTX’s collapse by advocating for a strict regulatory framework. This includes imposing high capital requirements, governance standards comparable to the banking sector and a demand for transparency and expertise from regulated entities.

While the MiCA Regulation cannot entirely eliminate fraud, the supervision it establishes, coupled with the resources deployed by European and national supervisory authorities, aims to closely monitor digital asset providers. Notably, the comprehensive regulatory framework mandates that most crypto-asset issuers, traders and exchanges have a registered office or place of management in the EU to obtain authorization for operations. This emphasizes the commitment to effective oversight and regulatory compliance within the European crypto-assets market.