

Grey areas in international legal approaches to the failure of crypto firms

Professor Rebecca Parry provides an update on a research project being undertaken into grey areas surrounding the failure of crypto firms



REBECCA PARRY
Professor, Nottingham Law
School, UK

Cryptoassets have grown in popularity in recent years, with 8% of EU citizens reported as having crypto investments. This is also an area of unusually high cross border investment in the EU, with 40% of crypto investments crossing borders.¹

There has been similar or greater interest in many other countries, including in developing countries, often without awareness of the real risk entailed.

When failures happen, they have the potential to be cross-border and legally messy² and studies have highlighted that crypto businesses may not address insolvency issues adequately in terms of service or otherwise.³

Cryptoassets and cryptoasset service providers

To provide some brief context, a crypto insolvency can relate to the cryptoasset itself or to a cryptoasset service provider, ‘CASP’. The cryptoasset can be either a stablecoin, such as Tether, which has an asset backing, or unbacked cryptoasset, such as Bitcoin or Dogecoin whose value depends on market sentiment, rather than any underlying value. There are also utility tokens which operate via smart contracts and are designed to grant to owners’ rights to perform a specific action or claim a particular benefit on a website or to take part in decisions about crypto coins or blockchains.⁴

Originally, this sector developed as an alternative to traditional financial intermediaries. The genius of Bitcoin was to use complex calculations to verify transactions via an immutable blockchain in a way that prevents

double spending. In a decentralised blockchain, anyone can access and solve the calculations. The high energy costs of this approach have seen an alternative ‘proof of stake’ approach being adopted, which uses staked assets as a way of keeping transactions honest.⁵

Cryptoassets enable peer-to-peer transactions, so that traditional intermediaries such as banks do not need to be used, but since this was beyond the technical skills of most CASPs have emerged. Exchange such as Binance have developed, as well as decentred exchanges, DeFi or DEX, such as UniSwap, which developed to facilitate peer-to-peer transactions. Although an individual can hold their own crypto there are also custodian services which have developed to manage crypto wallets.

Crypto-regulation

In recent years, CASPs have enabled greater access to cryptoassets, but this can lead to expectation gaps as some will think that there are consumer protections that apply to other assets, such as bank accounts.⁶ Others will lose out as a result of scams and ‘pump and dump’ schemes. In response to these and other risks, a safe environment for crypto investment is being built in many jurisdictions. The EU has the Markets in Crypto Assets Regulation,⁷ ‘MiCAR’ and other jurisdictions, such as the UK⁸ and Singapore⁹ have strong regulatory approaches. Organisations such as UNIDROIT¹⁰ and the UK Jurisdiction Task Force¹¹ have contributed valuable discussions of insolvency aspects that can be of persuasive guidance in other jurisdictions.

There will be cases that fall outside these well-regulated jurisdictions. Some crypto businesses deliberately operate in light regulatory jurisdictions, potentially to the detriment of customers.¹² In our study, we found that crypto exchanges will include in their terms of service lists of countries from which they would not accept customers. In many cases, this was unsurprising as the countries were subject to sanctions, or local circumstances would have made doing business there difficult. Surprisingly, however, the country whose citizens were most often excluded as customers was the United States. This suggested that many would deliberately exclude customers from jurisdictions with high levels of crypto regulation.

Many crypto firms, particularly those operating memecoins and DeFi exchanges, will also offer little or no indication of legal aspects of trading with them. Terms of service can be difficult to find and, in some instances, non-existent and they can also fail to address matters such as proprietary entitlements that would be important in an insolvency.¹³

Crypto insolvencies

Cryptoassets (other than most stablecoins) and crypto service providers, ‘crypto firms’, operate in a volatile market beset with legal uncertainties, making insolvencies likely, especially where cryptoassets have no intrinsic value and where regulatory changes will bring turmoil. The risks in this sector were clearly illustrated during the ‘Crypto Winter’ of 2022-23, both through the sudden collapse of the algorithmic stablecoin Terra/Luna and through the dramatic failure

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of the FTX exchange.

A significant problem may be identifying in advance where an insolvency might take place. Our study found that any crypto businesses are deliberately vague as to the location of their main operations. Many customers will access crypto services online and relevant websites do not normally give any clear impression as to where the services are based. Even if the customer consults the terms of service this may not help.

Even if a centre of operations can be identified for a firm in one country, its insolvency will not necessarily be handled there. The exchange FTX, was headquartered in one jurisdiction, the Bahamas, but entered insolvency proceedings in another jurisdiction, the United States. There is no indication that this choice of jurisdiction operated unfairly, and this was a highly complex case that presented novel problems. It was arguably best handled in a jurisdiction with sophisticated practices.

Crypto trading is also often international and a failure could lead to diverse crypto investors facing difficulties as proceedings may be opened in another, unfamiliar, jurisdiction. A further problem is that cases can take a long time to resolve. In both FTX and the earlier Japanese case of Mt Gox the companies ended up solvent as the price of Bitcoin had risen significantly and both companies held reserves.

It may be that some crypto firms can clarify their approach from the outset through a statement as to where insolvency proceedings will take place.¹⁴ Such an approach would leave the company with flexibility to move its headquarters around but would offer greater certainty as to what will happen in the event of an insolvency.

A more predictable approach to the insolvency jurisdiction would be important as there can be impacts on creditor entitlements, depending on where the insolvency proceedings are opened, as in other cross-border cases. Most consumer customers will not be aware that they would be in a

strong position if they can establish a proprietary interest. The terms offered by crypto firms will not always be consistent with the existence of a proprietary interest. Some will not address this issue at all, and some may not segregate assets even if the contract terms say they will. Some will use a third party as custodian but the terms of custodians won't necessarily be clear either.¹⁵ Consumers will not know to choose CASPs that clearly establish this. MiCAR and other instruments are addressing this in attending to custodial issues but cryptoassets are not regarded in the same way in all jurisdictions. It would be preferable to see greater crypto industry initiatives to address regulatory gaps.

Future research

Our recent research project is a first step towards this analysis by identifying the issues that are likely to arise in the event of the failure of a crypto firm, mapping the jurisdictions that are likely to be involved, and identifying possible legal responses. The project developed an international network funded by the Arts and Humanities Research Council and in partnership with INSOL International and the Istanbul Bar Association. It brought together academic and practitioner representation from major crypto-investing countries, with equal representation from developing countries where there are high levels of crypto investment. Ultimately, we would like to see the grey areas that we have identified being addressed, bringing greater certainty as to what will happen in the insolvency of a crypto firm, as well as greater industry initiatives leading to better information for consumers. Since not all states are likely to adopt adequate crypto regulation laws we would like to see market-based solutions as CASPs adopt standards voluntarily.

Conclusion

Cryptoassets can offer exciting opportunities for many but also risks and there can be consumer misunderstandings that can be exploited by opportunists. Efforts

are being made to regulate this sector in many jurisdictions and the EU's MiCAR sets a high standard. There are also regulatory grey areas and there is much that the crypto industry can do to bring clarity in cross-border cases and address the other problems that we have identified. ■

Footnotes:

- 1 European Commission, Flash Eurobarometer 509, Retail Financial Services and Products, October 2022, 2.4, available at: <https://europa.eu/eurobarometer/surveys/detail/2666>.
- 2 Aleksandr Alekseenko, 'Model Framework for Consumer Protection and Crypto-Exchanges Regulation' (2023) 16 *J. Risk Financial Manag* 305, available at: <https://doi.org/10.3390/jrfm16070305>.
- 3 See e.g. Ilya Kokorin, 'Crypto Insolvencies and the Limits of a Contract and Contract Law' (2023) 31 *European Review of Private Law* 1245; Dirk Zetzsche and Areti Nikolakopoulou, 'Crypto Custody and Crypto Wallets – An Empirical Assessment' (22 March 2024), available via SSRN at: <https://ssrn.com/abstract=4769396>; <http://dx.doi.org/10.2139/ssrn.4769396>.
- 4 Briefly discussed by Vivian Fang, 'FTX Bankruptcy – A Failure of Centralized Governance in the Name of Decentralized Cryptocurrencies' (Harvard Law School Bankruptcy Roundtable, 28 February 2023), available at: <https://bankruptcyroundtable.law.harvard.edu/2023/02/28/crypto-bankruptcy-series-fix-bankruptcy-a-failure-of-centralized-governance-in-the-name-of-decentralized-cryptocurrencies/>.
- 5 See e.g. Ethereum, 'Proof of Stake', available at: <https://ethereum.org/en/developers/docs/consensus-mechanisms/pos/>.
- 6 See Rebecca Parry and Hakan Sahin, 'Cryptoassets, expectation gaps and consumer protection: The case of Türkiye' (forthcoming).
- 7 Regulation of the European Parliament and of the Council on Markets in Crypto-assets COM/2020/593.
- 8 Financial Conduct Authority, 'Cryptoassets', available at: www.fca.org.uk/firms/cryptoassets-information.
- 9 For an overview, see Osborne Clarke, 'Singapore's regulators set pace for blockchain and fintech ecosystem advances' (17 October 2024), available at: www.osborneclarke.com/insights/singapore-regulators-set-pace-blockchain-and-fintech-ecosystem-advances.
- 10 See UNIDROIT, 'Digital Assets and Private Law', available at: www.unidroit.org/work-in-progress/digital-assets-and-private-law/.
- 11 UKJT Legal Statement on Digital Assets and English Insolvency Law, available at: <https://lawtechuk.io/our-reports/>.
- 12 This was a finding of our study that will be discussed in a forthcoming longer article.
- 13 See Kokorin (above note 3); Matthias Haentjens, Tycho De Graaf and Ilya Kokorin, 'The Failed Hopes of Disintermediation: Crypto-Custodian Insolvency, Legal Risks and How to Avoid Them' [2020] *Singapore Journal of Legal Studies* 526-563; Zetzsche and Nikolakopoulou (above note 3).
- 14 As suggested by Anthony Casey, Aurelio Gurrea-Martinez and Robert Rasmussen, 'A Commitment Rule for Insolvency Forum' (23 January 2024) (European Corporate Governance Institute - Law Working Paper No. 754/2024), available via SSRN at: <https://ssrn.com/abstract=4704029>; <http://dx.doi.org/10.2139/ssrn.4704029>.
- 15 Zetzsche and Nikolakopoulou (above note 3).

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