

Mapping Grey Areas in International Legal Approaches to The Failure of Crypto Firms

PRELIMINARY FINDINGS FROM WORKSHOP 2
Held on 8 and 9 July 2024

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Introduction

This report contains the findings of the second workshop in this project. The aim of the project is to identify any grey areas where there may be doubts as to how the insolvency of a crypto service provider would be handled. Crypto services providers such as exchanges and crypto assets developers are international businesses which can be vague as to the country that they operate from. Some will indeed be multinational and decentralised in nature, presenting complex and unprecedented legal problems.

This is an important issue given the growing interest in crypto assets, including in countries where there is a lack of a developed regulatory system to protect customers, and the impacts that failures in this sector have already had. That is why this network, funded by the Arts and Humanities Research Council and in partnership with INSOL International and the Istanbul Bar Association, brings together academic and practitioner representation from major crypto-investing countries, with equal representation from developing countries where there are high levels of crypto investment.

We had a good discussion in the first workshop and the findings from that are available in a separate report, where we outline in more detail the aims of the project. There was an excellent discussion in both workshops, attended by 25 experts from 15 countries. We will build on the findings from both workshops in a face to face event in Nottingham on 12 and 13 August, which will also be broadcast online.

WORKSHOP 1

The first workshops were held online on 17 and 18 June 2024. We divided participants into two groups, “East” and “West” according to time zone. We had very interesting discussions during the 6 hours of the East Group and 6 hours of the West Group. Details are in separate report from that workshop.

WORKSHOP 2 KEY INSIGHTS

Below we set out the questions that were included in the Preparatory Pack as well as key points from the discussions in both the ‘East’ and ‘West’ sessions:

1. **Following the first workshop are there any points that we should revisit? Is there anything you would like to add?**
 - There was a suggestion of looking into tax havens and the possibility that this could be considered briefly as a periphery issue within the context of insolvency. We will discuss this at the August event.
 - There was a suggestion that more focus is needed for DAOs, and some helpful recent developments were provided including but not limited to: Utah regulation, Wyoming, Vermont, Swiss foundations to name a few. We will discuss DAOs again at the August event.
2. **If you have not already done so, can you give us the names of the top 4 or 5 crypto exchanges used in your country.**
 - Thank you to those of you who across the 2 workshops have provided us with a list here.
 - An interesting insight thus far appears to be that there are some more global exchanges that appear across many lists such as Binance. Though there do also appear to be more ‘domestic’ exchanges also as noted specifically in South America (Bitso as an example), Turkey having several domestic exchanges (BtcTurk as an example) and Rain operating in parts of the Middle East.
3. **Do people in your country make use of crypto custodian services? If so, which custodians are popular? How do they keep track of their investments and any private keys if they don’t use custodians, as far as you know.**
 - Noted that in countries such as Turkey, Germany, UAE, Brazil and Mexico, crypto custodians seem to be popular, though recent law in Turkey might change the landscape somewhat due to requirements of registration, as well as the potential liabilities for those involved.

- There was a discussion that self-custody would appear to be generally low within the market due to the requirement of technical knowledge. A range of 'investors' seem more likely to choose crypto custodians for several reasons.
- There was a suggestion that licensed crypto custodians can be key for professional investors as both entities will be supervised and will have public auditing requirements. (Noted in Germany and Brazil).
- There appear to be differences in approaches noted as to whether the centralised banking system will provide such crypto custodian services or not. For example, there appear to be rumours of banks in Turkey focusing on the technical infrastructure to potentially become part of the ecosystem. However, it was noted that Banks cannot fulfill such a role in Mexico for example. There seems to be a policy choice here.
- It is recognised that a key issue here is the type of custodian and whether an omnibus wallet is being utilised or whether there is clear segregation of assets. These issues will determine whether the customer has only a claim in contract or a more valuable claim in property in the insolvency.
- It was also noted that there are other means of storing private keys for example. One suggested was a trusted professional such as a Lawyer or Accountant.

4. Are stablecoins recognised as a distinct category of crypto asset by those in your country? Is it understood that Bitcoin is not a stablecoin and that Tether is only one sort of stablecoin?

- No participants noted any issues with regards to distinguishing between unbacked crypto and stablecoins.
- There was a discussion of the array of stablecoins and the differing types of assets which the coin is 'pegged' to. The choice of asset backing, or algorithmic nature, of some stablecoins will mean that some are not so stable in value. A stablecoin that is backed by a volatile local fiat currency, though, can be for ease of use and practical reasons in a particular jurisdiction.
- There as recognition that in some jurisdictions, regulation seems limited and that there may be a more cautious approach to recognise or accept stablecoins (and broader crypto) (as noted in Uganda, and Nigeria for example). This also fed into a discussion that stablecoins can be a major threat to the centralised banking system if use by financial intermediaries such as banks is not controlled.
- It was noted that in contrast, most MiCAR concerns stablecoins with establishing a reserve and the right of redemption being key elements.
- It was also noted that stablecoins can be a viable alternative to fiat currency (to protect wealth) when the domestic currency is volatile.

5. Which stablecoins are popular in your country?

- Stablecoins such as Tether appear to be broadly popular globally and were noted by the vast majority of participants.
- There do also appear to be examples of stablecoins which are pegged to the domestic currency. (As noted in Turkey, UAE and Czech Republic for examples).
- Reasons for popularity were suggested and included but were not limited to: brand recognition, protection of wealth, requirements of domestic law that transactions must be in the domestic currency, ease of cross-border transactions, cultural and religious aspects in comparison to unbacked crypto.

6. Are there any examples of crypto investments by consumers in your country using funds such as pension funds, family savings, student loans and other sources that would be a major part of an individual's finances?

- There were examples in the US and Czech Republic of investments in this regard as well as this potentially developing into a broader global phenomenon.
- There were examples of crypto investments that were prompted by a friend's/family success stories in jurisdictions such as Kenya for example. (This reflects a broader point noted in Workshop 1 also).
- Discussion of using crypto as collateral for mortgages with the crypto being stored in a vault and the lender using derivatives to mitigate/spread their risk. (Noted in Mexico and Czech Republic for example).

7. How might a DAO be treated under your country's laws? Some will use a "wrapper" such as the Swiss foundation to provide an interface to get around the difficulties of operation without a centralised entity. How might a DAO fit in with business formats in your country e.g. cooperatives or partnerships?

- Various avenues and entities were suggested. These included but were not limited to: Swiss foundations, Utah's Limited Liability Decentralized Autonomous Organization (LLD), Wyoming's extension of Limited Liability Corporations (LLCs) to include DAOs, Vermont's Blockchain Based Limited Liability Companies (BBLLC), Marshal Islands Special Purpose Vehicles, Guernsey/Cayman Islands Special Purpose Trusts, Collective Investment schemes, General partnerships, unincorporated associations, Saccos. A useful source is Paradigm's [DAO Legal Entity Matrix](#).
- Some DAOs will want to remain more pseudonymous and so may not wish to operate under any form of 'wrapper' intentionally.
- There was discussion as to whether DAOs have the necessary intentions or will for a legally binding arrangement – potentially this could be a stumbling block.

- There was also a discussion surrounding the issue of determining the applicable law in the event of a DAO failing. In practice this may inevitably be solved through someone bringing a case and the court determining the relevant principles.¹ A court might well find the business vehicle that offered the “best fit” such as an ordinary partnership. Those involved would run the risk of personal liability in this eventuality and particularly bad news for anyone involved who would be seen as having deep pockets. There was also discussion as to whether common law jurisdictions might more easily be able to adapt existing rules to deal with DAOs.
- It was generally noted that there is no specific regulation on DAOs as such and that there are variances of DAOs which add to the complexity here as well as seemingly limited collaboration across jurisdictions on this point.²

8. Are utility tokens recognised as a separate type of crypto asset in your jurisdiction? Is it understood that these tokens might, as in the Celsius case, be worthless in an insolvency?

- There was discussion on the terminology for utility tokens (and other key terms already mentioned). For example, the EU has a definition of utility tokens. In Singapore it is referred to as a digital payment token.
- Linked to the above there was a discussion as to whether the term ‘utility tokens’ implies that these assets have any underlying value and again a distinction was made here. More ‘governance’ utility tokens and those which are used for e.g. credits in games have no inherent value, though other utility tokens such as ones utilised by exchanges for on and off ramping are in some way linked to a valuable asset. Additionally, there can be tokenisation of credit instruments.
- There was also a discussion of the relevance of the anti-deprivation rule when describing utility tokens as being without value.
- It is also noted that further ‘tokenisation’ is developing and so this may affect clarity further. Linked to this there was a suggestion as to whether the word ‘token’ is right.

¹ Subsequently the Hector DAO entered receivership in the British Virgin Islands and this was recognized by the US Bankruptcy Court for New Jersey under US Code, Title 11, Chapter 15.

² The UK Law Commission’s Decentralised Autonomous Organisations (DAOs) scoping paper was published on 11 July 2024, <https://lawcom.gov.uk/project/decentralised-autonomous-organisations-daos/> contains useful discussion of how DAOs can be characterised, although not discussing insolvency issues in any detail.

9. **“Staking” allows holders of crypto to deposit their “coins” for use in the validation process of a blockchain (such as Ethereum) and, in doing so, to earn additional coins. Staking enables blockchain transactions to be secured and validated. [EigenLayer](#) is among the service providers that allows “restaking”, so that the deposited coins can be used for other purposes. What risks does this present and is a regulatory response needed?**
- There was discussion of what staking entails in blockchains that use proof-of-stake as the core validation method increasing used by blockchains. The stake is intended to keep the validator honest and there will be ‘slashing’ penalties in the event of any problem.
 - Ethereum changed to this proof model recently, for example. Investors can do this themselves if they have 32 ETH (around £86,000 GBP, \$112,000 USD, 102,000 Euro). Those without this level can stake via an intermediary who will pool with the ETH of others.
 - There is a two-pronged regulatory approach in Singapore. There is a restriction for retail consumers to stake/restake through platforms, though they can do so on their own if they wish and accept the relevant risks (overall justification of protecting the consumer). Alternatively for institutional investors there is no such restriction.
 - There can be vast differences in the level of knowledge of those within the market and more protective approaches may be needed for general consumers in comparison to more sophisticated ‘investors’.
 - Intermediaries that enable staking/restaking do not appear to do so on a custodial basis. Potentially the main risk for the customer in insolvency is the risks of slashing penalties for failure to validate.
10. **How should an insolvency practitioner deal with crypto assets held by an insolvent debtor? Should the assets be converted to fiat to avoid price volatility or should they be kept as crypto, recognising that customers may prefer to receive returns in this format?**
- In some jurisdictions claims can only be paid in the domestic currency and so crypto will have to be transferred to fiat (Noted in Turkey for example). There as a suggestion that it made be easier to convert to fiat (as noted in Uganda).
 - Discussion and recognition that this is a very difficult aspect for Insolvency Practitioners and there is likely no one-size fits all approach.
 - Some factors that were noted as making the Insolvency Practitioners role very difficult included but were not limited to: the timing of the sale and volatility. For example the possibility of short-term crash in the market would impact on the value of the estate and the availability of assets for creditors. Conversely, a rise in value after the crypto has been sold, could lead to complaints customers might then complain that they should have been paid in crypto. Valuation issues can impact on voidable transactions. A key difficulty will be

private key access, pseudonymity, decentralisation, tax havens and a current lack of professional guidance for office holders.

- There could be some form of guidance akin to a list of factors which Insolvency Practitioners should consider to provide a more tailor-made approach.
- There could be a 5-step approach concerning: 1. Identifying the assets and their legal status; 2. valuing the assets; 3. taking stock of creditor preferences; 4. customer preferences and 5. If distribution in the form of crypto is legally permissible consider this as it may be preferred by customers. Otherwise sell the crypto at an early stage to fix the value.

11. Are there any other issues relevant to the project that we should be looking at?

- There were suggestions that the type of 'investor' would call for distinct and catered responses.
- There is a need for further focus on stablecoins, market integrity and governance of intermediaries such as custodians and exchanges including listing requirements.

WORKPLAN

We have now held two of the project's three events. The thematic analysis of the terms and conditions of crypto businesses is also almost complete and will enable us to identify where insolvencies might take place and what impacts there might be for customers, as well as any grey areas. The concluding event will be held on 12 and 13 August when we look forward to welcoming participants to Nottingham's Crowne Plaza hotel, or to the online broadcast of the event.

NETWORK

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NTU WT ID: 1766421

Principal investigator: Prof Rebecca Parry rebecca.parry@ntu.ac.uk, Tel: 44(0)115 8486883

Co-investigator: Dr Hakan Sahin hakan.sahin@ntu.ac.uk, Tel: +44(0)1158488037

Co-investigator: Dr Phoebe Gatoto phoebe.gatoto@ntu.ac.uk, Tel: +44(0)115 84 88094;

Co-investigator: Dr Akrum El Menshawy, akrum.elmenshawy@ntu.ac.uk.

All of Nottingham Law School, Chaucer Building, Nottingham Trent University, 50 Shakespeare Street, Nottingham, NG1 4FQ

Project website: <https://crypto-insolvencies.com/>

Thanks to our advisory board: Dr Lorena Carvajal (Pontificia Universidad Católica de Valparaíso), Dr MS Sahoo (former Indian regulator), Prof Umut Turksen (Coventry University), Prof Adrian Walters (Chicago Kent Law School)

Thanks to the Workshop 2 Discussants

Kayode Akintola

Nkem Amadike

Pinar Aksoy

Ayça Aktolga

Susana Dávalos Torres

Gustavo Saad Diniz
Serhat Eskiörük
Nan Gao
Mohd Hwaidi
Adela Kratenova,
Sean Lee
Etienne Luquet
Hamiisi Nsubuga
Dominik Skauradszun
Samuel Tosin Matthew

