

Crypto exchanges in crisis

Acquisition and restructuring opportunities



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Crypto exchange bankruptcies have become a hot topic due to the spate of recent high-profile bankruptcies, capped off with the FTX bankruptcy in November.

Arvin Abraham and **Sunay Radia**, partners in McDermott Will & Emery's London office, explore relevant considerations for acquiring a distressed crypto-exchange, ways to monetise claims against and recover assets from distressed crypto exchanges under English law.

Abraham and Radia also consider why the UK is a compelling jurisdiction for a crypto exchange to restructure in.

Distressed acquisitions of crypto exchanges

The considerations for acquiring a distressed crypto exchange will differ depending on whether the exchange has filed for bankruptcy or is in a pre-bankruptcy zone of distress.

In bankruptcy, the considerations will be largely influenced by the mechanics of the bankruptcy regime's process for asset acquisition.

Pre-bankruptcy considerations

Where an exchange is troubled, but has not yet formally filed for bankruptcy, a major consideration for a potential acquirer is to stem the bleeding, in particular to avoid a 'run-on-the-bank' type scenario where customers of the exchange start to withdraw funds en-masse, and to avoid liquidity issues that could cause the exchange to tip over into a formal insolvency process.

Key aims in this period would include ensuring solvency and maintaining reputation and credibility.

Ensuring solvency of a crypto exchange in the zone of distress is, at a high-level, no different than for any other form of business.

A business at this stage would often be counting on incoming revenue to pay debts and other outgoings as they are due. Any delay or failure to get paid on amounts due to the exchange could jeopardize its ability to make payments that it owes.

Unlike businesses with significant amounts of receivables, crypto exchanges make money largely through fees to use their services, which are generally paid on a spot basis, including transaction fees, withdrawal fees, deposit fees and listing fees.

Therefore, a crypto exchange generally won't have a significant dependency on its own

debtors (parties who need to pay receivables owed to it) to pay its creditors. Revenues are usually not lumpy, although heavily dependent on trading activity in the market.

Cash management and forecasting crunch points in liquidity should be easier given the business model.

An interested acquirer who is evaluating purchasing a distressed exchange should consider providing rescue financing, which could be in the form of a line of credit or a loan, to help the exchange avoid tipping over into formal insolvency proceedings.

Avoiding a perception of liquidity issues that could spark a bank-run type scenario is also key.

Rescue financing that can keep the exchange stable until an acquisition is completed will go a long way to addressing this risk.

The acquirer should also work with the exchange to ensure messaging to the market portrays confidence. Ideally the entire acquisition effort can be kept secret until the deal is fully negotiated and signed and can be appropriately messaged to the market.

Post-bankruptcy considerations

In a formal bankruptcy scenario, the main things to consider for an acquirer are what they are actually getting and what they want from the bankrupt entity.

The exchange post-bankruptcy is no longer the same entity it was before. It will have lost all of its customers. Its brand name value may be irreparably tarnished. Contracts with third parties may have terminated as a result of the bankruptcy or be terminable.

Most acquirers of crypto exchanges in a bankruptcy setting are interested in securing the

exchange as a technology platform. No matter what has happened to the brand or customers, the underlying technology will still have value. For acquirers in synergistic business, e.g. a neo-bank that lacks crypto trading capability, that technology will be incredibly valuable and can be monetised very quickly once integrated to an existing technology platform with its own user base.

The exchange's regulatory permissions are another major consideration.

Depending on the jurisdiction, the exchange may have lost permissions to operate due to the bankruptcy filing. A would-be acquirer needs to consider whether it has equivalent permissions in the jurisdictions where it wants to leverage the exchange's capabilities or can readily obtain those permissions.

Obtaining regulatory permissions may, on occasion, lead to a significant delay before the exchange can be put back into operation.

On the other-hand, though less likely, the exchange may have regulatory permissions that will persist through the bankruptcy and can be valuable for the right acquirer.

If an exchange is a larger global enterprise it is very common for the business units of the exchange to be auctioned off separately. We have seen this in the recent FTX bankruptcy where the process has first entailed the auction of LedgerX and FTX Japan and will progress subsequently to FTX International and FTX Europe.

Where a global exchange business is being parcelled off, it is important also to consider what aspects of the technology platform, regulatory permissions, and prior user base were associated

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with the different business units to determine which piece of the business to pursue.

Assessing and maximising claim value in crypto bankruptcies under English Law

We now consider certain issues of which creditors and debtors involved in crypto exchange insolvencies should be aware when assessing the value of their claims and maximising value in a crypto exchange insolvency under English law.

Much has been written about the difficulties in determining jurisdiction for opening insolvency proceedings in respect of crypto exchanges given the decentralised and intangible nature of the business.

The majority of large crypto exchange bankruptcies have played out in the US: it is traditionally a relatively low bar to establishing jurisdiction in the US which together with the ability of debtors to raise debtor in possession financing (DIP) (effectively the ability to raise financing in a bankruptcy which ranks in priority to existing secured creditors) and the worldwide automatic stay on enforcement afforded by Chapter 11 filings make the US an attractive forum for restructuring larger crypto exchanges.

However, jurisdictional issues are by no means settled and there is a possibility that we may see a crypto exchange insolvency be filed in the English courts.

English courts have applied an approach whereby for the purposes of cryptoassets the relevant jurisdiction for determining the law governing proprietary claims is the place where the person or entity that owns the asset is domiciled (*Ion Science v Persons Unknown* (2021) and *Danisz v Persons Unknown* (2022)).

The recent spate of crypto insolvencies has seen the emergence of claims against crypto exchanges and operators being traded as an asset class: the founders of Three Arrows Capital (a failed crypto hedge fund) have recently launched Open Exchange, touted as “the world’s first public market place for crypto claims trading and derivatives”.

Trading a claim against an insolvent crypto

exchange allows the seller to monetise its position much faster than it would if it had to wait to be paid a dividend out of an insolvency, whilst allowing the buyer to benefit from the upside of the claim in the event that the dividend received from the insolvent estate exceeds the purchase price for the claim.

Investment decisions into crypto claims will be driven by the buyer’s assessment of its expected dividend from the insolvent estate.

Investors should consider and ensure they conduct due diligence on the following issues when assessing potential return from a claim against an insolvent crypto exchange.

• Status of claim

It is now clear that crypto assets are considered ‘property’ as a matter of English law and as such can (a) form part of the insolvent estate to be distributed for the benefit of creditors generally; (b) be subject to security which would be available to the secured creditor in priority to any unsecured creditors; or (c) be held on trust for the benefit of a third party beneficiary in which case such asset would not be deemed to form part of the estate assets and held on a proprietary basis for such beneficiary.

The status of a claim will be determined on the facts; however, it is clear that a claim’s classification in an insolvency of a crypto exchange is a key driver of value. A number of crypto exchanges have customer terms and conditions which provide that any invested assets would be deemed owned by the exchange and no longer property of the investor, in which case the asset forms part of the estate and would be not subject to any trust claims for the investor/ depositor.

The UK Government is consulting on whether to extend the special administration regime which is applied to insolvent banks and other systemic payment systems to ‘digital settlement asset’ firms, for instance crypto exchanges.

Further certainty on key questions, in particular on the question of how assets will be deemed held, in other words whether on trust as client monies or as part of the crypto exchange’s asset, will likely be provided through the regulatory framework and developing case law.

• Asset recovery

A further determinant of claim value is the ability of an English insolvency officer holder to recover assets of the benefit of the insolvent estate so that they can be available for distribution to creditors.

English law provides office holders with wide-ranging tools to recover assets which have been dissipated within a certain time period before the company becoming insolvent to the estate.

The difficulties of recovering crypto assets are well known and recent case decisions have demonstrated the willingness of the English courts to assist parties in recovering assets from third parties (whether through injunctions preventing dissipation of assets or granting third party disclosure orders to parties to enable the identification of assets). Office holders and underlying creditors can take some comfort that the courts are seeking to assist them in asset recoveries in insolvencies.

Conclusion

Legal and regulatory frameworks the world over continue to develop to try to keep up with the innovations in the crypto market.

Whilst much of this is playing out in the US, the English courts have shown their willingness to apply existing regimes and asset recovery tools to the crypto space.

Restructuring pre-insolvency in England is as yet untested. However as this area of law develops the certainty provided may make England an attractive forum for a restructuring, therefore creditors and debtors alike should continue to familiarise themselves with the English regime.