The Jam in the Sandwich – the European Insolvency Regulation's Strengths and Shortcomings in a Crypto-asset Market

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1. Introduction

This paper is about new types of debtor who are active in the crypto-asset market and who subsequently face financial distress. In our presentation at INSOL Europe's Academic Forum, we outlined different solutions for dealing with these insolvent undertakings. The underlying research was intertwined with our work of the CERIL Working Party 16 on Crypto-assets in Restructuring and Insolvency, which we chaired in 2022 and 2023. The respective research report has recently been published.[1]

Our paper covers four themes:

First, it explains why we see the European Insolvency Regulation (EIR)[2] as "the jam in the sandwich".

Second, it considers some of the developments in the markets in crypto-assets. As these markets have developed rapidly, we have seen the emergence of new types of debtor. This raises the question as to whether the rules that apply to established types of debtor will also apply to these new types of debtor.

This leads into the third theme of our paper, which looks specifically at insolvency. What happens when these new types of debtor become insolvent? What insolvency regime will, or should, apply to them?

As part of our critical consideration of the appropriate insolvency regime for these new types of debtor, the final section of the paper assesses the strengths and shortcomings of the EIR. It concludes by noting the CERIL recommendations for some relatively minor and entirely feasible amendments which could provide greater certainty in the management of insolvencies involving new types of crypto-debtor.

2. Why "the Jam in the Sandwich?"

In any insolvency, certainty as to process will help to reduce the time and costs of the insolvency and, ultimately, assist insolvency practitioners in maximising returns to unsecured creditors. Ensuring that the right approach is taken in any insolvency is therefore vital to achieving the most successful outcome.

The analogy of the EIR as "jam" in a sandwich draws on two ideas that are relevant in any consideration of the best approach to managing insolvencies in the markets in crypto-assets.

First, that when something is "jammed" or "sandwiched", it is squeezed in amongst lots of other things. As we will illustrate in this paper, since the original iteration of the EIR in 2000, EU insolvency legislation has expanded significantly, particularly with the development of special insolvency measures for credit institutions and investment firms.[3] Choosing the right option from a wide array of possibilities

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[1] Paula Moffatt and Dominik Skauradszun, 'CERIL Report 2023-3 on Crypto-assets in Restructuring and Insolvency' (2023) <www.ceril.eu/news/ceril-statement-2023-3-on-crypto-assets-in-restructuring-and-insolvency#:~:text=In%20CERIL%20Statement%202023%2D3,Recast%20(EIR)%2C%20the%20EU> accessed 2 January 2024.

[2] Regulation (EU) 2015/848 of the European Parliament and of the Council of 12 December 2012 on insolvency proceedings (recast) [2015] OJ L141/19.

[3] Including Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions [2001] OJ L125/15; Directive 2014/59/EU of the European

can make matters more complicated for insolvency practitioners, resolution authorities or supervisory authorities dealing with the insolvency of a crypto-asset service provider (CASP).

The second point is that we should not lose sight of the EIR, sandwiched amongst all this legislation. Instead, we should regard the EIR as the jam in the middle of the sandwich: the point here being that jam is a good and desirable commodity, as we believe that the EIR is, when it comes to choosing the best legal regime for a CASP insolvency.[4]

3. New types of debtor

It is important to understand both why CASPs have developed and how they fit into the current system of EU financial regulation. This is relevant to understanding how CASPs might, or should, be treated in insolvency.

First, the need for service providers for new types of service in the markets in crypto-assets is unsurprising. Crypto-assets are intermediated: they are not physically possessed but exist digitally through the medium of distributed ledger technology (DLT) and require users to be adept at using digital systems for the mechanism by which a consensus is reached, for instance, the proof-of-stake mechanism.

While some holders may choose actively to manage their crypto-assets, others may prefer not to do so. This may be for reasons of convenience, but it could also be a deliberate choice to reduce risk. For example, a holder may worry that they will forget or lose their private key. The risk of this is that they are permanently locked out of access to their crypto-asset and cannot realise its value by exchanging it for, say, fiat currency.

These concerns, among others, have led to the emergence of intermediaries willing to provide crypto-asset services. One type of CASP is the crypto custodian with responsibility for safeguarding and managing the crypto-assets of others or their private keys on a day-to-day basis.

Where a CASP is a credit institution or investment firm licensed under the Markets in Financial Instruments Directive (MiFID II)[5] it will fall *outside* the scope of the EIR if it becomes insolvent or is likely to become insolvent (see Art 1(2)(b) and (c) EIR) and *inside* the EU legal framework consisting

Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council [2014] OJ L173/190; Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 [2014] OJ L225/1; Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency) [2019] OJ L172/18.

[4] Or at least it is our opinion that jam sandwich is better than bread and butter by itself.

[5] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast) [2014] OJ L173/349.

of the Single Resolution Mechanism Regulation (SRMR),[6] the Bank Recovery and Resolution Directive (BRRD),[7] and Credit Institutions Winding Up Directive (CIWUD).[8]

However, while some CASPs will fall within the scope of existing EU banking and financial regulation, some CASPs do not. Instead, many of the crypto-asset market players fall outside its scope, leading to risks for consumers who are without regulatory protection.

Responding to some of these concerns about consumer protection, the EU introduced the Markets in Crypto-assets Regulation (MiCAR)[9], inter alia, to "safeguard the ownership rights of clients, especially in the crypto-asset service provider's insolvency" (Art 70(1) MiCAR).

MiCAR is particularly important when viewed against a backdrop of several, recent high-profile CASP insolvencies. Examples include: FTX, a cryptocurrency exchange platform for buying and selling cryptocurrencies and which provided digital wallets for customers to hold cryptocurrencies in personal accounts;[10] Three Arrows Capital, a cryptocurrency hedge fund, which managed "a few billion dollars"[11]; Voyager Digital, a cryptocurrency broker which "made immense, unsecured loans to Three Arrows Capital"[12]; and BlockFi, a cryptocurrency lender.[13] All of these failures exposed regulatory gaps, lacunas in insolvency law, and resulted in significant losses to creditors.

A matter of real concern is the possibility that some clients view and treat these CASPs as though they are traditional banks and investment firms.[14] The reality is that most of these new CASPs are not created or set up as banks or investment firms and are therefore not subject to the same financial regulation and safety nets as them. This is the case *even if* some of the functions that they take on make them look similar.

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[6] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 [2014] OJ L225/1.

[7] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council [2014] OJ L173/190.

[8] Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions [2001] OJ L125/15. A special regime for resolution of financial institutions is also established in the USA**.** These entities are subject to regulatory frameworks that provide for independent procedures in the event of insolvency, Kara Bruce, Christopher K Odinet and Andrea Tosato, 'The Private Law of Stablecoins' (2023) 54 Arizona State Law Journal, 1073, 1121ff.

[9] Regulation (EU) 2023/1114 of the European Parliament and of the Council of 31 May 2023 on markets in crypto-assets, and amending Regulations (EU) No 1093/2010 and (EU) No 1095/2010 and Directives 2013/36/EU and (EU) 2019/1937 [2023] OJ L 150/40.

[10] Timothy Smith, 'What was FTX? An Overview of the Exchange' *Investopedia* (15 November 2023) <www.investopedia.com/ftx-exchange-5200842> accessed 2 January 2024.

[11] Justina Lee, Muyao Shen and Ben Bartenstein 'How Three Arrows Capital Blew Up and Set Off a Crypto Contagion' *Bloomberg* (13 July 2022) <www.bloomberg.com/news/features/2022-07-13/how-crypto-hedge-fund-three-arrows-capital-fell-apart-3ac> accessed 2 January 2024.

[12] Danny Nelson and David Z Morris, 'Behind Voyager's Fall: Crypto Broker Acted Like a Bank, Went Bankrupt' *Coindesk* (12 July 2022) <www.coindesk.com/layer2/2022/07/12/behind-voyagers-fall-crypto-broker-acted-like-a-bank-went-bankrupt/> accessed 2 January 2024.

[13] Robert Stevens, *'BlockFi's Rise and Fall a Timeline' Coindesk* (30 November 2022) <www.coindesk.com/learn/blockfis-rise-and-fall-a-timeline/> accessed 2 January 2024.

[14] Danny Nelson and David Z Morris suggest that 97% of Voyager's clients stored less than $10,000 on the platform indicating a wide range of individual investors. See Danny Nelson and David Z Morris, 'Behind Voyager's Fall: Crypto Broker Acted Like a Bank, Went Bankrupt' *Coindesk* (12 July 2022) <www.coindesk.com/layer2/2022/07/12/behind-voyagers-fall-crypto-broker-acted-like-a-bank-went-bankrupt/> accessed 2 January 2024.

4. What is the best approach to managing a CASP insolvency?

This takes us to the third theme of our paper. What is the most convincing approach for the EU to take when dealing with the insolvency of a CASP – in particular, a crypto custodian?[15]

On the basis that CASPs may look like banks and undertake bank-like functions, should they be treated in the same way as credit institutions and investment firms under the EU Single Resolution Mechanism (SRM), or should they fall within the scope of the EIR? Or, should they be subject to a different, bespoke insolvency regime?

But first it is important to understand the role that MiCAR plays, or does not play, in insolvency. This requires a consideration of EU insolvency and restructuring legislation, which has increased in complexity since the first introduction of the EIR.

By 2001, the EIR applied to all insolvencies except those of credit institutions, insurance undertakings, investment undertakings providing services holding funds or securities for third parties, and collective investment undertakings (Art 1(2) EIR 2000). Credit institutions and investment firms were covered by CIWUD which provided a means to harmonise private international law rules (cf., inter alia, Art 10 CIWUD) and a system of mutual recognition (cf. inter alia, Art 3(2) CIWUD).

And we had national law – as we still do.

After the banking crisis of 2007-2009, a lot changed. The chaos caused by the financial contagion that ran through the banking systems of the US, the UK and Europe resulted in an overhaul of the EU approach to bank failure with the SRM. The EU's BRRD was introduced in 2013 to provide early intervention and recovery mechanisms for failing banks. It introduced the concept of "regulatory insolvency" – it wasn't just a question of the bank running out of money that could trigger a resolution process: if the regulator thought it needed to step in because a bank might cease to have the requisite regulatory capital for it to maintain its authorisation to act as a bank, it had the power to do so (cf. Art 32(4) BRRD and Recital 40 BRRD). In the event that a bank could not be saved or sold, the bank would be put into resolution proceedings and the bank's viable business would be transferred to a new provider where possible.

2014 saw the introduction of the SRMR with its resolution tools including bail-in provisions enabling write down and conversion of debt (cf. Art 27 SRMR).

At the same time, new rules were introduced in the Capital Requirements Regulation (CRR) in 2013 to ensure that credit institutions and investment firms regulated under MiFID II were adequately capitalised.[16]

More recently enacted legislation includes the 2019 Directive on restructuring and insolvency.[17] Its objective was to follow the ethos of the banking early intervention initiatives and replicate these for ordinary companies and entrepreneurs.

The SRM is technical and must be applied with reference to the CRR and MiFID II rules that credit institutions and investment firms must follow.

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[15] The paper considers crypto custodians in particular, as they are likely to hold the crypto-assets of others for long(er) periods.

[16] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [2013] OJ L176/1; Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast) [2014] OJ L173/349.

[17] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency) OJ L172/18.

Having said this, a CASP set up *solely* to offer services as e.g. a crypto custodian (a "pure" crypto custodian) will not be a credit institution and is very unlikely to fall within the definition of an investment firm. However, determining this will require a forensic consideration of the activities it undertakes with reference to MiFID.[18] In an insolvency situation, the debtor's management needs to act quickly to preserve assets. Having to undertake detailed analysis to determine which legal regime an entity falls into will not be quick. Uncertainty causes delays, and delays increase losses, especially for the unsecured creditors.

We can now turn to MiCAR. Where does it fit into this insolvency framework?

On one hand, MiCAR includes provisions that envisage the insolvency of a CASP (see, for instance, Art 70(1) MiCAR). It requires issuers of asset-referenced tokens to maintain a reserve of assets (Art 36 MiCAR) and requires client assets held by CASPs to be segregated from its own assets (Art 75(7) MiCAR). Both these types of asset pools must be segregated legally and operationally.[19] Although the articles address all clients, in many cases, these rules are consumer protection provisions ensuring that funds cannot fall within the insolvency estate.

MiCAR also draws on terminology used in the SRM,[20] requiring issuers to draw up and maintain "recovery" plans to protect the reserve of assets in case of a "rapidly deteriorating financial condition".[21] Similarly, issuers may be required to draw up and maintain "redemption" plans that could be implemented by the competent authority "in case of insolvency".[22]

On the other hand, unlike the SRM, MiCAR neither introduces a comprehensive legal regime to deal with the insolvency of a CASP nor introduces any specific resolution tools. If at all, these tools are slightly touched upon in Art. 47(2) MiCAR (e.g. the appointment of a temporary administrator). Nor is there a system of mutual recognition in relation to proceedings.[23] Its primary focus is on the authorisation and supervision of CASPs so that consumers are protected (Arts 59 ff. MiCAR).

Further, although MiCAR uses the term "insolvency" and envisages the possibility of a "deteriorating financial position" the conditions for this are not stipulated.[24] A major distinction between the SRM and MiCAR is that the SRM includes insolvency conditions peculiar to systemically important financial institutions (SIFIs) that offer critical services to the public, and whose failure could have global consequences and result in public (taxpayers') money being used to bail them out.[25]

Clearly MiCAR is not (and was never intended to be) insolvency legislation; it is supervisory, regulatory legislation that seeks to protect clients, in many cases consumers (Recital 79 MiCAR), from unregulated

[18] See in detail Dominik Skauradszun and Jeremias Kümpel, 'Crypto custodians in financial distress' (2023) 32, Int. Insolv. Rev., 538 ff.

[19] A similar recognition exists under Art 44(2)(d) BRRD and Art 27(3)(c) SRMR: assets held for a beneficiary and which are protected under applicable insolvency law are excluded from bail-in, as are monies available to the depositors under deposit guarantee schemes; these cannot be used to recapitalise the bank.

[20] The BRRD requires institutions to draw up a recovery plan to cover situations where there is "a significant deterioration of its financial situation" (Art 5) and a resolution plan where conditions for resolution are met (Art 10); the Single Resolution Board must draw up resolution plans for significant financial institutions, those supervised directly by the ECB, and cross-border banking groups Art 7(2) SRMR.

[21] Art 46 MiCAR.

[22] Art 47 MiCAR.

[23] The BRRD harmonises substantive bank insolvency law, which is then subject to a single regime across the EU through the single resolution mechanism, and private rules of international law in relation to banks and investment firms are harmonised through CIWUD. The BRRD and SRMR also include specific tools for bank resolution, including tools to enable banks to be capitalised through bail-in – the point here is to protect the public purse by avoiding drawing on public (taxpayers') money.

[24] Unlike Art 32 BRRD and Art 18 SRMR.

[25] One is where the institution fails to meet the regulatory requirements for authorisation, the other is where "extraordinary public financial support" is required (Art 32(4)(a) and (d) SRMR).

CASPs and has "tacked on" references to insolvency law without itself introducing a comprehensive system.

MiCAR does not resolve the question of whether a CASP falls under the SRM or the EIR, a matter that will now be considered in more detail. This discussion requires an understanding of the reasons for the development of the SRM after the financial crisis, and it is certainly the case that the SRM was not created with these novel kind of debtors in mind.

The SRM was a response to several specific issues. First, the recognition of the special role that credit institutions play in society and in the internal market, such as the provision of deposit-taking and payment services and the importance of maintaining those services for customers even in crisis situations (cf. Recitals 1, 10 SRMR); second, the consequences of allowing SIFIs to become "Too Big to Fail", and the corresponding danger of contagion and the spread of systemic risk across the global banking system (Recital 77 SRMR); and third, the need for non-public financial solutions to bank recapitalisation, such as bail-in.

CASPs are very different. They are not set up to provide essential services to the public, even if some CASPs undertake some functions that are similar to those of banks. They are unlikely to be classified as "Too Big to Fail" as no CASPs are currently SIFIs (Recital 5 sentence 4 MiCAR), although this could change in the future.[26] CASPs are also unlikely to have sufficient assets capable of being bailed-in, particularly where most funds they hold are segregated from own assets and belong to the clients.

On this analysis, the SRM does not seem well-suited to CASPs, even if they become SIFIs.

But is the EIR is a better solution? This requires examination.

First, credit institutions and investment firms licensed under MiFID II which are CASPs are excluded from the scope of the EIR (Art 1(2)(b) and (c) EIR). Determining whether a CASP falls within the scope of the EIR will require a detailed analysis of its business model, which will lead to delays and a corresponding increase in the costs of the insolvency, which is detrimental to creditors. Second, determining the *situs* of crypto-assets for secondary insolvency proceedings according to Arts 3(2), 34 ff. EIR is challenging, leading to further uncertainty. These shortcomings suggest that the EIR may not be the ideal framework for all CASPs.

The alternative to an existing insolvency regime is for the European legislator to create a new, bespoke process for the market in crypto-assets.

This approach has advantages. It would resolve uncertainty by specifying the legal regime to be applied and could address issues such as the location of crypto-assets.

However, a new regime would add further complexity to the already extensive European insolvency and restructuring legislation, and it would be odd for what is a relatively small market to have a bespoke legal regime when other, larger and more widespread industries do not. It is also true that developments in the markets in crypto-assets are not yet settled, meaning that there is a danger of new legislation becoming quickly obsolete.

Furthermore, the analysis so far does not reflect the significant strengths of the EIR in this debate. It is important to say that the EIR has been tried and tested for almost a quarter of a century. It is well understood by a sophisticated body of insolvency experts within the EU insolvency community,

[26] FTX was once valued at US$40bn according to Forbes, whereas in 2022, HSBC Holdings PLC (UK) and BNP Paribas SA (France) were the top banks in Europe valued at €2597.14 billion and €2554.20 billion respectively according to Meaghan Yuen, 'Here are the top 50 biggest banks in 2023' *Insider Intelligence* (1 January 2023) <www.insiderintelligence.com/insights/largest-banks-europe-list/#:~:text=HSBC%20is%20the%20largest%20bank,work%20in%20the%20Banking%20industry%3F> accessed 2 January 2024. Darreonna Davis, 'What happened to FTX? The Crypto Exchange Fund's Collapse Explained.' *Forbes* (2 June 2023) <www.forbes.com/sites/darreonnadavis/2023/06/02/what-happened-to-ftx-the-crypto-exchange-funds-collapse-explained/> accessed 2 January 2023. At the time of writing, US$40bn equates to approximately €36.4bn.

including the judiciary, the courts, insolvency practitioners, insolvency lawyers and academics. The EIR is also relatively short, particularly when compared to the extensive provisions of the SRM, making it easier for busy insolvency practitioners to work with.[27] Many third countries are familiar with its concepts, most notably that of the "centre of main interests" (Art 3(1) EIR), a concept assimilated into the UNCITRAL Model Law which has now been adopted by many non-EU jurisdictions, including the US and the UK.[28] The EIR conflicts of law rules (Arts 7 ff. EIR) are widely accepted and mainly work well, albeit that the legislation does not refer specifically to crypto-assets, or to mechanisms for resolving the particular difficulties caused by DLT.[29] However, it is also true that national laws permitting the general realisation of the debtor's assets applied in conjunction with the EIR, will permit the specific realisation of the debtor's crypto-assets wherever they are situated.[30]

5. Conclusions and recommendations

This paper has illustrated that the EIR has significant advantages when it comes to managing a CASP insolvency, but it could be improved. The CERIL report recommended a few amendments to the EIR, all of which were carefully considered on the basis of their feasibility.[31]

The CERIL recommendations aim to remove or reduce the uncertainties that might slow down insolvency proceedings involving CASPs with a view to reducing insolvency costs and maximising returns to creditors.

The first recommendation is to include an autonomous definition of "crypto-asset" in the EIR, so that all insolvency practitioners, courts, and creditors use the same definition in insolvency matters.

The second is to ensure that pure crypto custodians are not excluded from the scope of the EIR. This can be achieved by narrowly interpreting Art 1(2) EIR.

The third relates to the application of the *lex libri siti* rule to DLT based assets. It is recommended that the *lex libri siti* applies only to those distributed ledgers subject to the supervision of a public authority. This recommendation addresses the issue of permissionless public blockchains which might look similar to traditional public registers, but are not supervised by a state authority. The amendment is recommended to ensure consistency with Arts 14 and 15 EIR.

The fourth is to provide a mechanism for determining where crypto-assets are situated, following the structure of a "waterfall" approach, so that if the first determination rule is not applicable, then the second will apply, if that is not applicable, then the third will apply etc.

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[27] The EIR has 92 articles compared to the combined total of the SRMR, BRRD and CIWUD (over 750 articles) which have to be read in conjunction with MiFID II and the CRR.

[28] The influence of the EC Regulation on Insolvency Proceedings (the predecessor to the EIR) on the development of the UNCITRAL Model Law should not be underestimated. Professor Ian Fletcher noted that the expression "centre of main interests" was "not defined in the Model Law, but has been directly assimilated from the EC Regulation on Insolvency Proceedings, which has the additional advantage of promoting a consistent approach to international regulation". See Ian F Fletcher, *Insolvency in Private and International Law* (2nd edn, Oxford University Press 2005), 458.

[29] Where data is held on a distributed ledger, it is not stored or regulated centrally; instead, data is distributed and shared among all participants of the network simultaneously.

[30] Arts 7, 19-21, 32 EIR.

[31] For a detailed reasoning of the recommendations, see Paula Moffatt and Dominik Skauradszun, 'CERIL Report 2023-3 on Crypto-assets in Restructuring and Insolvency' (2023) <www.ceril.eu/news/ceril-statement-2023-3-on-crypto-assets-in-restructuring-and-insolvency#:~:text=In%20CERIL%20Statement%202023%2D3,Recast%20(EIR)%2C%20the%20EU> accessed 2 January 2024.

Finally, the CERIL report recommended that the EU legislator should make a proper assessment of the correct approach to managing a CASP insolvency. This would avoid unnecessary insolvency costs and delays in determining whether a CASP is an undertaking within the scope of MiFID II.

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