

Web 3.0 and M&A Transactions— Emerging Issues

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The crypto asset and blockchain sector has often been called a “living laboratory” for its rapid evolution, innovation and growth. That growth has led to a corresponding increase in mergers, acquisitions and other strategic transactions, while the unique and innovative aspects of this sector have required attorneys advising on these transactions to confront new challenges.

Many of these involve seeking to apply principles from transactions in traditional industries to transactions where crypto assets are often not only the most important asset held by transaction participants but are also potentially used as acquisition consideration and incentive compensation for ecosystem participants.

Economic Significance of Tokens

Perhaps the most fundamental new challenge posed by transactions in the crypto sector is the economic importance of the tokens that are at the heart of most blockchain companies’ business models, relative to the traditional equity of the acquiring company.

The successful launch of a token for a new blockchain protocol or decentralized application (dApp) can be extremely lucrative for the management teams that developed the project as well as other employees and investors that are early recipients of tokens.

Often, the value of a token is independent of the equity valuation of the company that developed the related project, creating economic relationships that



can be very different from those in the traditional non-crypto context. Acquirers of a company that developed a blockchain project face the challenge of continuing to incentivize the project team, when the team’s opportunity to acquire substantial wealth is perceived by them to hinge much more on the success of a token, rather than the acquirer’s traditional equity business.

There are no simple solutions to this challenge. But two possibilities include: having the company hold substantial reserves of the relevant token, thereby tying the equity value to both the underlying business and the token; and revesting existing tokens held by members of management. The latter strategy can be effective if token grants to management are subject to time-based or performance-based vesting, requiring years of additional work at the company.

This conflict also presents a challenge regarding the fiduciary duties of the management of these companies. Does management's duty to its shareholders conflict with their own interests to maximize the value of their token holdings?

In a sale transaction, would management be inclined to push for a transaction with a counterparty with more favorable go-forward token economics at the expense of the consideration payable to shareholders? In some instances these interests will be aligned, but advisors need to be alert to the potential conflicts of interest in this area.

Due Diligence

Due diligence in the blockchain sector draws from numerous disciplines. In some cases, there are commonalities with evaluating companies in the financial services industry. For example, where the development company manages a "front end" that allows access to the protocol or dApp, regulatory compliance is crucial, especially with respect to anti-money laundering laws and sanctions compliance. But diligence in the blockchain sector also presents new challenges because of the unique structure of many blockchain ventures.

Typically, a non-profit memberless foundation is formed in a hospitable jurisdiction, such as the Cayman Islands, to "steward" the project, acting on behalf of the token holders.

The target company, which generally provides development services to the foundation, is a separate entity and does not own or control the foundation or the smart contract code underlying the project. Understanding the often complex relationship between the target company and its foundation is a crucial element of due diligence.

Tokens as Consideration in Transactions

The use of tokens as consideration for acquisitions and other strategic transactions presents challenges that are not present when acquirers are using their own equity or cash. IRS guidance generally treats tokens as non-stock property, which means that

when a token holder disposes of tokens to acquire the stock of a target.

In this case, the token holder generally recognizes taxable gain equal to the difference between the basis the token holder has in the tokens and the fair market value of the equity acquired in the transaction.

This taxable gain recognition could potentially be avoided by structuring the transaction as (i) a contribution of tokens (and possibly other property) to a U.S. domestic corporation by one or more persons who, immediately after their contribution, own at least 80% of the voting power and value of each class of stock of the recipient corporation or (ii) a contribution to a partnership in exchange for partnership interests.

But the ability for parties to avail themselves of these alternatives may be more limited in the context of the blockchain sector where the target is often organized as an offshore corporation. In that case, the requirements for non-recognition of gain on appreciated property contributed to the target will not be met.

Acquirers will also sometimes include their own equity so that the transaction may be treated as a tax-free reorganization under Section 368 of the Internal Revenue Code. However, this path has its own challenges. For example, it typically requires the target's shareholders to receive at least 40% of their consideration in the form of the acquirer's equity, which might be difficult to value.

When acquiring start-ups or growth companies in the blockchain sector, acquirers will often encounter management incentive compensation arrangements that involve token grants subject to vesting.

This raises the issue of whether, as is common with venture-backed companies, the target company and its management may rely upon Section 83 of the Internal Revenue Code to grant tokens at an early stage in a project when the tokens have a low value. In this case, managers elect to take the then-current value of the tokens as income upon grant, deferring recognition of any additional income until

sale (despite the occurrence of vesting events) and obtaining capital gains treatment upon their sale.

Practitioners who have examined these issues have concluded that the same principles commonly applied to grants of equity to management teams subject to vesting are likely applicable to the use of tokens as management incentive compensation. This opens an important avenue for compensation of management teams of target companies.

The application of the U.S. securities laws to the offering and sale of tokens as well as to the holding and management of tokens, presents novel issues for attorneys. There remains no broadly agreed test as to when a given crypto asset, or transactions in such crypto asset, should be treated as a “security.”

For example, when transferring tokens as acquisition currency, should the acquirer require that the recipients abide by a holding period to ensure the transfer does not become treated as a wider distribution of securities potentially resulting in an unregistered public offering? Some attorneys have concluded this is necessary.

Recent Rise of Digital Asset Treasury Companies

Numerous transactions have occurred recently to form “digital asset treasury companies” or “DATs.” A DAT is a publicly traded company, the primary asset of which is a particular token.

A transaction for the formation of a DAT typically involves a sponsoring organization (often an investment advisory firm active in the blockchain sector) identifying a very small (less than \$10 million) market capitalization public company and working with the management of that company and investors interested in a particular token to raise hundreds of millions of dollars in the form of a private investment in the public equity of the target (PIPE).

The proceeds of the PIPE (often in the range of \$300 million to \$500 million) are then used to acquire a large position in the token which is the focus of

the DAT. The DAT also hires an “asset manager” to manage the crypto asset reserves to be acquired with the proceeds of the PIPE. Dozens of DATs have been launched in recent months.

These transactions present securities law issues including but not limited to:

(i) Is the subject token a “security” for purposes of Rule 10b-5 under the Exchange Act? Some advisers have answered this question in the affirmative, requiring an assessment of whether knowledge of the pending DAT formation is potentially material non-public information with respect to the subject token;

(ii) Is the subject token a “security” for purposes of the Investment Company Act? This requires an analysis of whether a public company holding more than 40% of its consolidated assets in the token (and other securities) would cause the DAT to be treated as an “inadvertent” investment company. It is a commonly held view that most tokens themselves are not securities, though transactions in tokens could be securities.

Today, DATs are primed for consolidation as large premiums to net asset value (mNAV) become unsustainable, driving additional transactions in the crypto asset sector.

As crypto asset-oriented companies continue to serve as a “living laboratory” of innovation, many more issues will emerge in the areas of tax, securities law and corporate law. Expect to see the sector’s mergers and acquisitions to function as a living laboratory as well, requiring creativity to adapt existing legal structures to this rapidly growing and evolving new sector.

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