

Weathering the Crypto Winter: Tools for Insolvency Practitioners

October 20, 2022

Cryptoassets are particularly unique assets that are sources of deep and rapid innovation in global financial markets. Given the volatility of the crypto market, their value can dramatically rise and fall. Insolvency practitioners (IPs) seeking to restructure or rescue crypto firms in distress or otherwise dealing with virtual assets face a unique set of challenges. These have been brought to the fore by the global crypto market crash earlier this year and the so-called 'crypto winter'. We discuss below recent crypto insolvencies and issues for IPs to consider when locating, recovering and realising cryptoassets.

Origins of the Storm

The description 'crypto winter' suggests that an extended period of trouble may (again) be settling over the crypto market, with prices likely to contract and remain low for some time. This is not the first crypto storm, a downward cycle having taken place between January 2018 and December 2020 when Bitcoin (and other cryptocurrencies including Ether and Litecoin) fell sharply. 2021 then saw strong growth for cryptocurrencies until, in May 2022, the stablecoin TerraUSD and its sister token Luna collapsed, triggering a domino effect of crypto insolvencies.

The collapse contributed to the crash of Singapore-based crypto hedge fund Three Arrows Capital (3AC) (who had heavily invested in Luna). 3AC defaulted on its obligations to its lenders in late June 2022, certain of which exercised rights to liquidate over \$400 million of 3AC's cryptocurrency positions. Distress for other crypto firms followed, including 3AC's lenders, with some filing for bankruptcy in July 2022.

Financial distress in this crypto winter has been more significant and widespread than previously. Various factors have contributed. Participation in crypto markets has increased. With the rise of decentralised finance (DeFi) markets and lending platforms since 2018, there has been a broader range of debt and leverage. Crypto funds and lenders have been able to take on high levels of debt from retail customers, offering high yield returns (for example, Celsius was offering yields of up to 18 percent on cryptoassets deposited with them in early 2022). Financial interdependency between firms has increased, causing the 'domino effect'. The current economic climate, with ever-increasing inflation, will also have played a role and will continue to.

So, how can IPs navigate the storm?

Locating, Recovering and Realising Cryptoassets in Insolvency Processes

As cryptocurrencies constitute 'property' under English law¹, IPs are required to secure and realise such assets for the benefit of creditors. Cryptoasset holdings (including assets in the form of claims concerning cryptocurrency)

¹ As held in various cases, including by the English High Court in: *AA v Persons Unknown* [2019] EWHC 3556 (Comm) (in granting a proprietary injunction), relying in part on the UK Jurisdiction Taskforce Legal Statement on Cryptoassets and Smart Contracts in 2019 (which argued in favour of the recognition of cryptoassets as property); *Fetch.ai Ltd. v Persons Unknown* [2021] EWHC 2254 (Comm) (in granting Bankers Trust and Norwich Pharmacal orders); and in *DPP v Briedis* [2021] EWHC 3155 (Admin) (in granting a freezing order). We also note the consultation published by the UK Law Commission containing provisional law reform proposals with respect to digital assets, including a proposal for a third category of property – see <https://www.lawcom.gov.uk/project/digital-assets/>. Under English law, property is defined by reference to two categories, choses in action or choses in possession, but digital assets do not fit neatly into either category as they are virtual, not tangible, and so cannot be possessed and do not embody any right capable of being enforced by action.

may significantly impact returns to creditors. While IPs will face unique challenges in locating, recovering and realising cryptoassets, there are tools available to assist:

- **Identifying, tracing and recovering assets:**
 - **Information.** In all insolvencies, IPs should enquire expressly as to whether the estate has cryptocurrencies or other forms of digital assets, such as non-fungible tokens (NFTs)². If so, sufficient particulars of quantities and values should be provided to enable realisations. IPs can seek assistance from specialist forensic blockchain analytics partners to help with identification, tracing and recovery.
 - **Insolvency Act (IA) 1986 powers.** If it appears that company directors, advisors or third parties with knowledge of the company's property are withholding information, an IP can consider relying on Section 236 of IA 1986 to seek to compel the individual to deliver company books, papers or other records and/or attend oral examination (for example, necessary passwords).
 - **Court orders.** Absent cooperation or faced with other difficulties (e.g., crypto fraud), an IP could seek proprietary injunctions and freezing orders over cryptocurrencies (including worldwide freezing orders, given cryptoassets can be held anywhere in the world and by unknown persons), disclosure orders³ and/or third-party debt orders⁴.
 - **Claims.** The English High Court has indicated that cryptocurrencies can be held on trust⁵ (though it is not clear whether this applies to all cryptoassets), so proprietary claims may be available. There may also be claims to cryptoassets that form part of a person's estate or company's assets – these could be claims against exchanges and platforms or bilateral claims against counterparties to transactions (for example, for mis-selling of assets or misrepresentations).
 - **Taking control.** The practical steps required to be taken by an IP to secure control of identified cryptoassets depend on how the assets are held and by whom. If assets are held by a third-party custodian (e.g., exchange or institutional custody service), the 'owner' does not control the assets directly and may only have a contractual right against the custodian for their delivery. The IP will need to contact the custodian to obtain control of the account and key(s). If assets are held by the 'owner', the owner will have an alphanumeric private key needed to make transactions using the account recorded on the blockchain. This may be in the form of a software wallet (e.g., phone or computer app) or hardware wallet (e.g., USB drive). IPs should transfer crypto held in this way to accounts controlled by them as soon as possible for security.
- **Security and insurance:** Once an IP secures control of cryptoassets, it is imperative to store them safely, where they cannot be hacked. There are custody firms offering institutional-grade security who can assist. IPs should also insure the asset(s) with a specialist insurance provider.
- **Valuation and realisations:** If an IP is able to identify and recover cryptoassets, further challenges will likely arise in seeking to realise the assets, given the market can be illiquid and is often volatile. Caution will be needed in determining when to sell cryptocurrency, considering the risk of potential losses, especially given the present crypto winter and depressed prices of cryptoassets. IPs may need to decide whether to sell assets or hold them (awaiting potential recovery of prices) and whether to sell in bulk or tranches. Guidance should be sought early. For assets of significant value, IPs may also consider using a crypto brokerage and over-the-counter services to realise value.

² NFTs are unique digital files stored on a blockchain ledger.

³ In *Ion Science Ltd. v Persons Unknown* (unreported, 21 December 2020), the claimants successfully applied for a proprietary injunction, a worldwide freezing order and an ancillary disclosure order against persons unknown who had committed fraud; and disclosure orders pursuant to the Bankers Trust jurisdiction and/or CPR 25.1(g) against cryptocurrency exchanges out of the jurisdiction. In *Fetch.ai Ltd. v Persons Unknown* [2021] EWHC 2254 (Comm), the applicants successfully obtained Bankers Trust and Norwich Pharmacal orders against fraudsters and companies that maintained their accounts.

⁴ In *Ion Science Ltd. v Persons Unknown* (unreported, 28 January 2022), the English High Court granted the first third-party debt order over cryptocurrency in an application involving allegations of fraud related to a cryptocurrency initial coin offering.

⁵ In *Wang v Darby* [2021] EWHC 3054 (Comm), the English High Court held cryptocurrencies can be subject to a trust. The New Zealand High Court has also held that stolen cryptocurrencies are capable of being 'property' under New Zealand law and held on trust (*Ruscoe v Cryptopia Ltd.* (in liquidation) [2020] NZHC 728).

- **Seeking guidance:** Taking guidance early, including on designing a sound disposal strategy may limit an IP's exposure to claims for breach of duty, risk of negative publicity and reputational risks. It may be appropriate to seek court approval of a proposed approach and any decisions to sell (or not). Keeping abreast of regulatory and legal developments will also be key.

Reviewable Transactions and Claims Against Directors

With insolvencies involving cryptoassets on the rise, alongside the English courts' recognition of cryptoassets as property, it seems likely that office-holder claims involving cryptoassets (e.g., for transactions at an undervalue or transactions defrauding creditors) will increase⁶. IPs should also consider cryptoassets when assessing claims against directors or others: *'inability to pay'* is often raised as an argument by defendants and illiquid cryptoassets may be used to hide wealth. However, recent English law cases indicate that the High Court is taking a proactive approach and practical solutions for the tracing and recovery of cryptoassets have been found. Similar relief may be granted for tracing and recovery, for example, from a director's account or personal assets.

Global Regulation and Legal Developments

While there is currently very limited regulation on the treatment of cryptoassets in insolvencies globally, key legal questions (including on valuation methodology and classifying cryptoassets in a restructuring) are front and centre in the recent crypto insolvency cases.

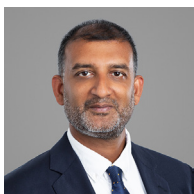
The *Financial Times* reported recently that the relative stability of crypto tokens in September (with prices having plateaued) has "*fuelled debate among speculators about when the so-called 'crypto-winter' can be deemed to have melted into spring.*"⁷ Nevertheless, it remains to be seen how far-reaching the current 'crypto winter' will be and the extent to which regulation on the treatment of cryptoassets in insolvencies and restructurings will increase as a result of the string of recent cases.

⁶ Given the recognition of cryptoassets as 'property', it is likely that transfers of cryptoassets would constitute a 'transaction' under Section 238 and Section 423 of IA 1986.

⁷ "Is the 'crypto winter' melting into spring?" Scott Chipolina, Kate Duguid and Valentina Romei (9 October 2022) (<https://www.ft.com/content/ceee127d-26f2-4a15-b7f7-904e1c33d1c9>).

CONTACTS

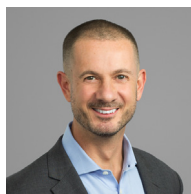
For further information, please contact your Katten lawyer or any of the following:



Prav Reddy
+44 (0) 20 7770 5213
prav.reddy@katten.co.uk



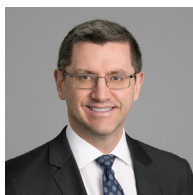
Sonya Van de Graaff
+44 (0) 20 7770 5221
sonya.vandegraaff@katten.co.uk



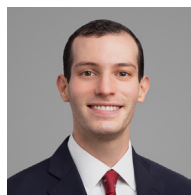
Neil Robson
+44 (0) 20 7776 7666
neil.robson@katten.co.uk



Mark Johnson
+44 (0) 20 7770 5214
mark.johnson@katten.co.uk



Daniel Davis
+1.202.625.3644
daniel.davis@katten.com



Ethan Trotz
+1.312.902.5516
ethan.trotz@katten.com

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katten.com

Paternoster House, 65 St Paul's Churchyard • London EC4M 8AB

+44 (0) 20 7776 7620 tel • +44 (0) 20 7776 7621 fax

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