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Crypto Complexity in Insolvencies

Cryptocurrencies are exerting growing influence on traditional international financial systems. In the US in October 2021, the SEC approved the first bitcoin ETF and, in doing so, gave investors exposure to cryptocurrencies in a regulated environment. In Gibraltar, the financial regulator is considering a deal which would give investors the ability to purchase conventional stocks and financial products with cryptocurrencies. As of April 2022, the total value of cryptocurrencies in circulation internationally was an eye-watering $2 trillion. That is more than the gross domestic product of all but the world's seven richest nations. $91 billion in cryptocurrency trades are now being carried out daily.

The ascent of cryptocurrencies to the mainstream is in large part due to their intrinsic benefits—being weightless, digital and facilitating almost instant global exchange at a high level of confidentiality without the need to involve expensive intermediaries. However, these same advantages can also present challenges for insolvency practitioners where cryptocurrencies are involved in insolvency proceedings—whether for businesses with cryptocurrency-related service offerings or for more traditional organisations holding digital assets including cryptocurrencies.

The fundamental steps and processes for the liquidation of a company holding digital assets are not materially different from those of the liquidation of companies holding traditional assets, namely identifying and securing the assets, necessary (and commensurate) investigations, adjudication of claims and distributions to creditors. The primary aim remains to maximise returns to creditors. In the case of crypto assets, these guiding principles are the starting point of a more complex exercise.

Identifying and securing crypto assets

The existence, location and value of digital assets may not be easily identifiable from the company's financial statements. It is therefore important that, immediately following the appointment of insolvency practitioners, they quickly identify and work with directors and officers of the company, service providers and other stakeholders in the liquidation and ask them questions relating to the existence of any digital assets and their whereabouts.

In order to identify and secure crypto assets, it is important to ensure the cooperation of the individuals holding the private encryption keys to the associated cryptocurrency wallets. Where digital assets are held on private addresses (as opposed to service/exchange-controlled accounts), the first priority should be to move those assets to addresses that the Liquidators, and only they, control the private keys to. Otherwise, there is a risk that others may know the private keys to addresses and be able to move the funds without their knowledge.

What happens when the owner of the private key refuses to cooperate?

Under these circumstances, the insolvency practitioner will need to work with their legal counsel (and any leverage available to them) to push for compliance. The powers and tools available to liquidators to secure and control assets and legal remedies available in the winding up of traditional companies may also be helpful. Similarly, the powers of the company's directors and officers cease upon the appointment of liquidators to the company; they and their representatives no longer have any power to hold or use the private encryption keys to the cryptocurrency wallets belonging to the company and are required to deliver those keys and wallets to the liquidators.

Any non-disclosure or obstruction adopted by these parties will likely constitute a breach of relevant law and regulations. By way of example, for liquidations in Hong Kong, such conduct is likely a violation of the Companies (Winding Up and Miscellaneous Provisions) Ordinance, and they shall be liable to imprisonment and a fine. It is also conduct that entitles the liquidators to the assistance of the Court — such as to obtain an order for delivery of the keys and associated information.

In some cases, the existence of crypto assets can be established through third-party records accessible by liquidators — such as bank statements which may have recorded payments in fiat money to a cryptocurrency exchange for the purchase of a cryptocurrency or otherwise deposits of fiat money from a cryptocurrency exchange upon the sale of crypto assets, or records of instructions to legal / financial advisors for any (for example) unusual or sizable over-the-counter trading, i.e. private deals.

If there is evidence of dissipation of a company's assets, insolvency practitioners may apply for injunctions or similar orders against the beneficiary party holding the digital assets or associated information, freezing the assets from any further transfer. This includes cryptocurrency exchanges where the crypto assets may be temporarily parked.

No matter how hidden or remote any crypto asset may seem to be, it is likely that at some point it will be connected to mainstream financial systems and so will leave a trace of evidence.

Investigations

Investigations in insolvency matters involving cryptocurrencies include interviews with management to establish the flow of funds and any relevant transfer processes, systems and controls, however limitations in the available data sets can result in significant challenges to the investigations of the liquidator in forensic analysis and asset tracing.

Blockchain analytics has provided major breakthroughs in investigations by facilitating an immutable understanding of the flow of funds and establishing, for example, the recipient wallet addresses of misappropriated assets. This is increasingly a prelude for insolvency practitioners to pursue active recovery strategies and to pursue disclosure from exchanges as to the identities of those wallet owners.

Dealing with creditors and adjudication of claims

In a recent case, thousands of customers across numerous jurisdictions had transferred cryptocurrencies to an exchange where the exchange's online trading platform was subsequently shut down. Many creditors did not keep good (or any) records of their account balances and transaction history with the exchange and so were not able to submit or substantiate claims in the administration. Consequently, there were significant challenges in registering, reviewing and adjudicating creditors' claims.

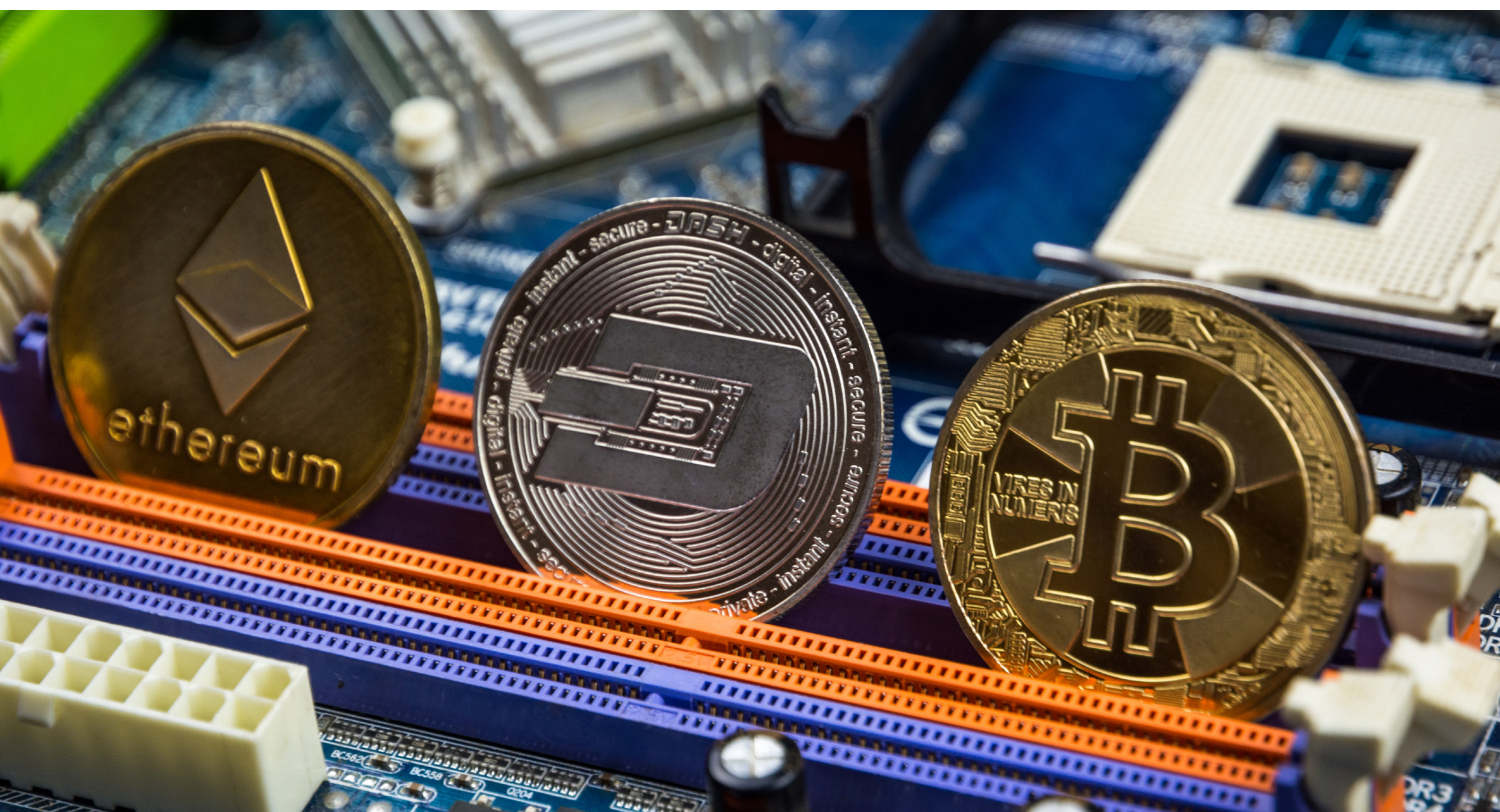
Data and information recovered by the liquidators and shared (appropriately) with creditors enabled many of them to confirm their account balances and supporting information and documents to prove their claims.

Distributions to creditors

The volatile nature of many cryptocurrencies means that value in fiat money terms can vary significantly from one day to another. By way of example, the value of bitcoin has increased over the past five years from just over $1,000 to more than $50K today, with a significant level of volatility along the way.

This volatile nature of cryptocurrencies can be a challenge for insolvency practitioners when paying proceeds to creditors. In certain jurisdictions, due to the need to comply with statutory notice requirements, there can be at least a two-month gap between determining the amount of the dividend and the date of distribution where due to volatility, the cryptocurrency prices may have changed substantially. This can require an element of judgement in balancing the risk arising from the volatility of pricing on one hand and compliance with the relevant insolvency laws and regulations on the other.

Overall, new challenges arising from a new class of assets requires insolvency practitioners to combine traditional skills, knowledge and experience with specialist expertise and technological support to work efficiently and effectively to deliver the right result—which is nothing really new for insolvency practitioners!



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