Dealing With Crypto-Assets In A Downturn - Lessons From London And Other Jurisdictions

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Speed Read

The next recession will be the first to occur since Bitcoin and other crypto-assets became prevalent in UK businesses. This Client Alert highlights how UK courts and insolvency officeholders may deal with crypto-assets in an insolvent estate. Recent developments provide insight into the legal assistance available to officeholders in realising crypto-assets for the benefit of creditors.

STATUS OF CRYPTO-ASSETS UNDER ENGLISH LAW

The definition of 'property' in section 436 of the Insolvency Act 1986 is considered by many to be wide enough to be inclusive of crypto-assets, and recent developments in this jurisdiction also support the position that crypto-assets constitute property under English law.

In November 2019, the UK Jurisdiction Taskforce (UKJT), published a legal statement on the status of crypto-assets and smart contracts. Whilst not legally binding, the statement intended to provide market confidence, legal certainty and predictability on the status of crypto-assets – an asset class that is still very much in its infancy when it comes to its treatment by courts.

The UKJT's statement noted that crypto-assets have "all the indicia of property" and that the intangibility of some crypto-assets does not disqualify them from being treated as property. The UKJT statement concluded that crypto-assets are therefore to be treated in principle as property.

The UKJT also concluded that they had no doubt that crypto-assets can be property for the purposes of section 436 of the Insolvency Act 1986. This reinforces the requirement for an officeholder to take possession of and realise crypto-assets as an integral part of their duties. In addition, the UKJT also found that private keys should be treated as information and as such the provisions of section 236 of the Insolvency Act 1986 (*inquiry into company's dealings*) would apply.

In a judgment handed down by the High Court in the case of *AA v Persons Unknown & Ors Re Bitcoin* [2019] EWHC 3556 (Comm) in December, the court appeared to follow the guidance set out in the UKJT's statement. In this instance, the court endorsed the UKJT's analysis that, although a crypto-asset may not be a physical asset, it does not preclude it from being treated as property.

DOOGA LTD (T/A CUBITS) (IN LIQUIDATION) – TRACKING DOWN PRIVATE KEYS

The insolvency of UK-headquartered crypto-asset exchange and storage facility Dooga Ltd (t/a Cubits) (Dooga) may be an opportunity for the English courts to demonstrate how far they are prepared to assist officeholders in respect of realising crypto-assets for the benefit of the creditors of an insolvent estate.

In 2018, the company suffered a series of frauds totalling some £36m prior to the appointment of administrators in December that year. The administrators confirmed in their progress report to 9 June 2019 that, although they had located the digital wallet containing the company's crypto-assets and had visibility of all transactions, they did not have access to the crypto-assets. In order to gain access they required the private keys.

It remains to be seen whether the office holders, who have since been appointed as liquidators of Dooga, will need to call on the assistance of the UK court to gain access to the private keys in order to take control of the crypto-assets.

If access is obtained, the liquidators will then need to ascertain the proprietary status of the assets. Given that the underlying business was a crypto exchange, are the Bitcoins subject to any proprietary claims from third parties who may assert that the crypto-asset is held on trust for their benefit? If no such argument can be successfully advanced, then those investors who had crypto-assets in the exchange may only be unsecured creditors, entitled only to participate in any dividend that may be declared for the benefit of unsecured creditors.

SECTION 236 OF THE INSOLVENCY ACT 1986 EXTRATERRITORIALLY

In September 2019, the High court held in *Philip Stephen Wallace (as liquidator of Carna Meats (UK) Limited) v George Wallace* [2019] EWHC 2503 (Ch) that liquidators' powers of discovery under section 236 of the Insolvency Act 1986 requiring a person to produce information and documents can be used extraterritorially. This, in addition the UKJT statement, is of assistance to officeholders seeking to compel directors, or others who might hold a private key, to hand it over even if such individuals are resident outside of the UK.

There may also be an increased need for officeholders to seek cross-border recognition in order to realise crypto-assets located outside of the UK and, also, potentially, in the EU. We might therefore see an increase in the number of cross-border recognition applications looking both outwardly and inwardly, particularly in circumstances where the location of the asset class (which in the case of crypto-assets lacks a central point of control) is not clear cut.

PLEXCORPS – DRAMA IN THE COURT ROOM AND A LESSON FROM CANADA

Canadian businessman, Dominic Lacroix, believed that behind the creation and launch of crypto-asset "PlexCoin", was compelled by a Canadian court in July 2018 to hand over his Bitcoins to a court appointed receiver.

Whilst not insolvency proceedings, the approach and manner of the court in compelling Mr Lacroix to transfer the Bitcoins to a court appointed receiver is of interest.

Proceedings were brought by the Tribunal against, amongst others, PlexCorps and its subsidiary PlexCoin, Dominic Lacroix (PlexCorps' CEO) and Sabrina Paradis-Royer (Mr Lacroix's partner) in relation to the PlexCoin initial coin offering (ICO).

The Tribunal banned Mr Lacroix, amongst others, from all investment-related activities targeting Quebec residents. This included cessation of the PlexCoin ICO.

Despite the order to suspend of the ICO, Mr Lacroix went ahead with the offering in breach of the ruling and was subsequently found to be in contempt of court, sentenced to two months in jail and his assets were seized.

It is understood from public reports that during a hearing in July 2018, the Tribunal ordered Mr Lacroix to give control of his Bitcoins to a court administrator and to appear before the Tribunal the next day to confirm that he had done so.

On reappearing the next day, Mr Lacroix informed the Tribunal that he had not been able to make the transfer, citing grounds of complexity partly due to the previous seizure of his computers.

In response, the confiscated computer equipment was brought into the courtroom and Mr Lacroix was ordered to immediately enter the private key to make the transfer of the Bitcoin or find himself in contempt and jailed. Mr Lacroix duly complied and circa $3.7m of Bitcoin was transferred to the court administrator.

This case highlighted the difficulties of seizing crypto-assets, which unlike more traditional assets, such as real estate and bank accounts, have no central point of control. It also demonstrates the assistance which a court could provide to insolvency practitioners in order to compel defendants to transfer crypto-assets.

DETERMINING VALUE

If officeholders are successful in obtaining the private key to a company's digital wallet, either with or without the assistance of the court, what happens next in realising the crypto-asset?

First, there will be a question of whether there are any competing proprietary claims to the crypto-asset, meaning that such assets could be said to be held on trust for beneficiaries.

There will also be a question of value to consider, especially given the volatile nature of crypto-assets. Officeholders will need to work out the date at which the value should be determined. Further, what happens to any uplift in the value? Will the distribution be by way of crypto-asset or via a fiat currency?

In the case of Mt Gox in Japan the question of value was considered. Mt Gox was an insolvent crypto-asset exchange in which the court appointed trustee sold some of the exchange's Bitcoin holdings. In the Mt Gox case, the value of the Bitcoin had dramatically increased between the date of the bankruptcy and the sale by the trustee. The liquidation proceedings were subsequently halted and converted to rescue proceedings, meaning that there could be a distribution to creditors by way of Bitcoin, rather than a payment of the cash value of the crypto-asset from 2014.

CRYPTO-ASSET TRANSACTIONS AND OFFICEHOLDERS' CLAWBACK POWERS

Officeholders will also need to consider the extent to which any transfer of crypto-assets might constitute a reviewable transaction within the parameters of the Insolvency Act 1986. However, due to the nature of crypto-assets and their fluctuating value, there may be little scope for orders compelling transfers of the property to re-vest in the estate. Instead, orders to return the value of such property might be a more appropriate alternative.

Due to the privacy inherent in crypto-assets and the decentralised system in operation, there may well be difficulties in tracing any crypto-asset transactions that might otherwise fall within the antecedent transaction provisions, including identifying the beneficiaries of the transactions (as the network is, by design, anonymous). This means officeholders will need to be able to rely upon the co-operation of exchange platforms (which could be in multiple jurisdictions) and, additionally, the expertise of tracing agents with experience in this particular asset class. This could prove costly, which leads to the question of whether litigation funders will be willing to fund cases where the primary asset is crypto-assets, especially given the potential market volatility of this asset class.

CONCLUSION

It is only a matter of time before some or all of these issues come before the English courts.

As crypto-assets begin to appear more regularly in the estate of an insolvent entity, insolvency practitioners and counsel will no doubt have to grapple with the issues presented by this new and relatively untested asset class.

Much remains to be settled in the public eye, but the UK's insolvency legislation, together with the pragmatism of the UK courts, would appear to place this jurisdiction in a prime position to deal with the likely convergence of crypto-assets and corporate failure. The focus now appears to rest more on the practical issues of how to identify, take control of and realise crypto-assets.

A version of this Client Alert was published by the *Global Restructuring Review on 1 April 2020*.

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