Tales from the Crypt: Lessons Learned While Recovering Cryptocurrency

International Insolvency Institute
USA/Canada/Caribbean Regional Committee

19 May 2021

Panelists / Moderator

Sharon Hamilton
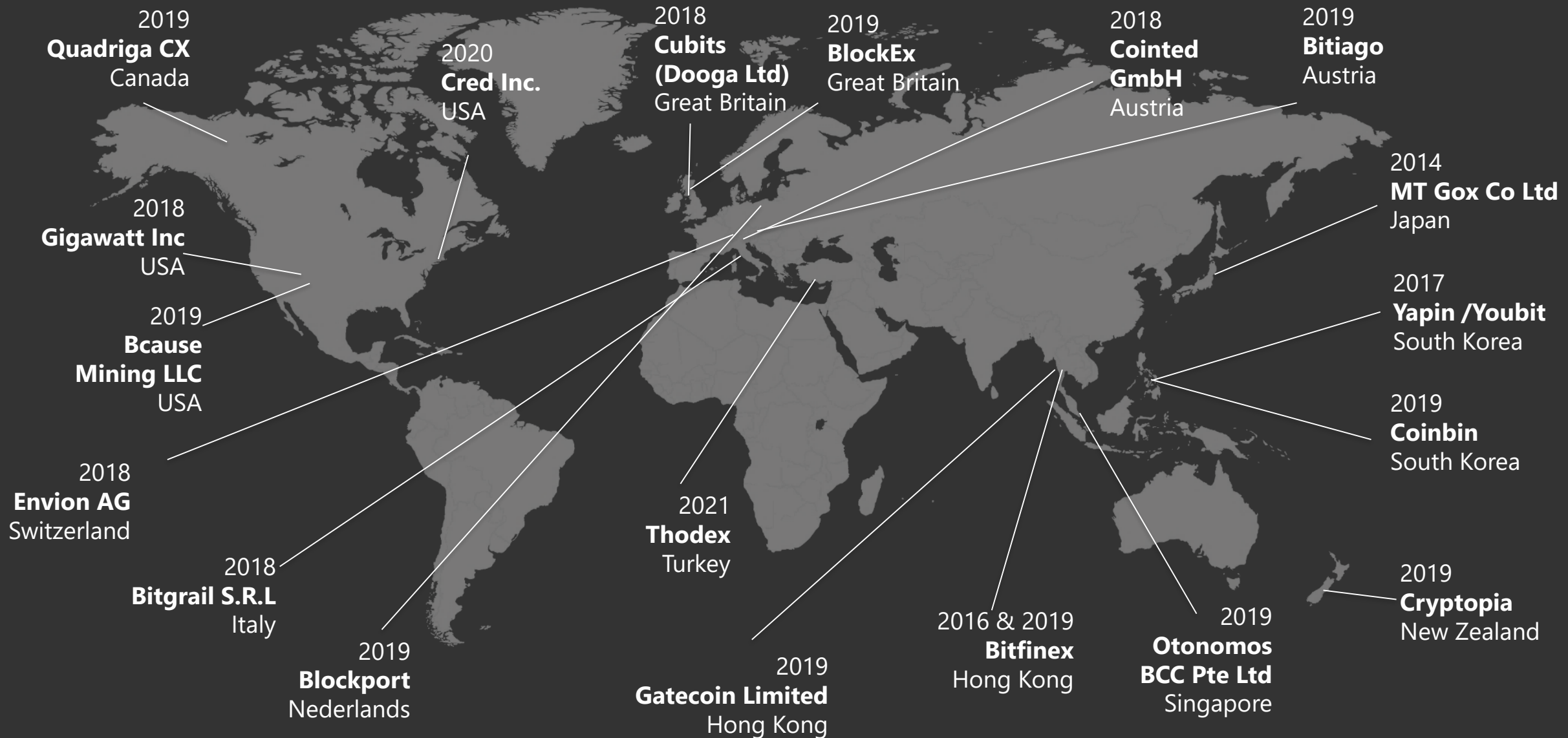**Ernst & Young Inc.**
Panelist

Jason Corbett
Silk Legal
Panelist

Timothy Graulich
Davis Polk & Wardwell LLP
Panelist

D.J. Miller
Thornton Grout Finnigan LLP
Moderator

Global Cryptocurrency Insolvencies
A number have occurred all in the last couple years

2019
Quadriga CX
Canada

2020
Cred Inc.
USA

2018
**Cubits
(Dooga Ltd)**
Great Britain

2019
BlockEx
Great Britain

2018
**Cointed
GmbH**
Austria

2019
Bitiago
Austria

2014
MT Gox Co Ltd
Japan

2018
Gigawatt Inc
USA

2019
**Bcause
Mining LLC**
USA

2017
Yapin /Youbit
South Korea

2019
Coinbin
South Korea

2018
Envion AG
Switzerland

2021
Thodex
Turkey

2018
Bitgrail S.R.L
Italy

2019
Blockport
Nederlands

2019
Gatecoin Limited
Hong Kong

2016 & 2019
Bitfinex
Hong Kong

2019
**Otonomos
BCC Pte Ltd**
Singapore

2019
Cryptopia
New Zealand

What is cryptocurrency?

➢ Fundamentally, it is an intangible digital asset - <u>property</u>
  - ➢ that uses cryptography to secure its network and transactions, and
  - ➢ that exists on a blockchain (a network of computers that lend their computing power to run special programs to record and confirm transactions) – the blockchain is an open, distributed ledger.

➢ However, it is meant to be an item of inherent value – to be used as a <u>currency</u>
  - ➢ but it lacks certain essential elements of a currency – it is not government backed, nor is it a stable store of value

➢ Cryptocurrency is described as a currency that provides anonymity, decentralized governance and protection from double spending

What is a cryptocurrency exchange?

➢ It is a business that allows customers to deposit and trade cryptocurrencies for fiat or other cryptocurrencies

  ➢ Holds cryptocurrency on the user's behalf vs. the user managing his / her own digital wallet

  ➢ Typically an online business

  ➢ May be viewed by some users as similar to an online securities brokerage

  ➢ But…. currently not regulated the way brokerages are and lack many of the protections of a regulated broker dealer

Is there any regulation of cryptocurrency?

➢ Cryptocurrencies do not fit within the paradigms of traditional currency or securities and therefore have slipped between the cracks of existing regulatory regimes

➢ Many countries are just starting to look at specific regulation of cryptocurrency and cryptocurrency exchanges

➢ But…efforts to regulate have been hampered by lack of understanding by governments and the public

➢ Strong anti-regulation bias by many cryptocurrency holders – history of cryptocurrency being used to conduct illegal transactions and / or hide assets

Overview of US Regulation of Cryptocurrency

➢ The SEC regulates the offering and trading of "securities" under the Securities Act of 1933 and the Securities Exchange Act of 1934

    ➢ Bitcoin is likely not a security (although SEC has not yet definitively stated this)

    ➢ Other digital tokens, particularly those issued in ICOs, may be securities

    ➢ SEC's recent statements and actions have shown increased willingness to enforce the US securities laws where necessary

➢ The CFTC has been very active in the regulation of virtual currencies

    ➢ In 2014, the CFTC declared virtual currencies to be a "commodity" subject to CFTC oversight under the Commodity Exchange Act

➢ FinCEA generally administers the Bank Secrecy Act, which requires certain financial institutions to register, implement anti-money laundering programs, file suspicious activity reports, and keep certain records in addition to other requirements

    ➢ In 2013, FinCEN issued guidance that anyone in the business of "administering" or "exchanging" virtual currency for real currency, funds, or other virtual currencies must register as a money services business

➢ Most state money transmitter statute require those involved in transmitting virtual currency on behalf of others or acting as exchanges to acquire a license

    ➢ Some states have determined that virtual currency to virtual currency transactions do not constitute money transmission

Key Issues for Lenders and Insolvency Professionals

➢ How to identify cryptocurrency assets?

➢ How to take possession of those assets?

➢ Jurisdictional issues and cross-border co-operation

➢ Preservation of cryptocurrency assets

➢ Realizing on cryptocurrency assets

➢ Creditor and customer claims and distributions

Identification of Assets

➢ Lenders and insolvency professionals are used to dealing with assets that are either:

➢ Registered in the name of the debtor

➢ Physically in the possession of the debtor

➢ Cryptocurrency often doesn't fit either of the above

➢ Cryptocurrency wallets do not have named owners - Identities are kept anonymous by design.

➢ Cryptocurrency wallets are electronic – the concept of physical possession may not exist.

➢ Cryptocurrency may be held with an exchange but exchanges are not like banks – they vary in terms of whether they maintain user identity information and to what level.

➢ Cryptocurrency exchanges are virtual and therefore global - parties often move cryptocurrency between exchanges without regard to territorial borders or central bank / government restrictions.

➢ As a result, uncooperative debtors have many tools to hide cryptocurrency assets

Identification of Assets – cont'd
Recommendations for Lenders and Customers

➢ Identification of assets will be difficult in an insolvency situation

➢ Lenders should plan for this and consider steps that can be taken at time loans are advanced – for example:
  - ➢ Debtors to regularly disclose whether they hold cryptocurrency and where
  - ➢ Debtors undertake to provide co-operation and not to convert significant cash assets to cryptocurrency without notice to lenders
  - ➢ If cryptocurrency assets are significant, require debtors to take steps to safeguard assets – perhaps spread holdings amongst different wallets or exchanges, obtain cryptocurrency insurance
  - ➢ Consider novel solutions such as debtor placing passwords with legal counsel in trust

Identification of Assets – cont'd
Recommendations for Lenders and Customers

► Customers of exchanges should seek certain protections in case of a failure of the exchange in order to maximize the possibility of obtaining the return of the cryptocurrency

► Protections to include:

    ► Prevention of commingling or the hypothecation of the cryptocurrencey

    ► Hold the cryptocurrency assets in trust

► Customer may nonetheless only be an unsecured creditor

    ► What happens if the cryptocurrency increases in value post-filling – who benefits from the increase in value?

EY

Taking Possession of Assets

➤ Legislation often provides support to insolvency professionals to take possession of traditional assets

  ➤ i.e. Trustees can use court orders to seize physical assets or have banks or other custodians of assets freeze and transfer assets to control of insolvency professional

➤ In cryptocurrency world, this is not always possible

  ➤ Without the private key, retrieving cryptocurrency from a wallet is impossible

  ➤ With uncooperative parties – forcing a party to disclose a password is difficult and usual remedies for seizing assets do not help

➤ Informal / Private recovery?

➤ Case Examples: Mt. Gox / PlexCoin

➤ Is taking possession of cryptocurrency held on an exchange easier?

  ➤ Maybe with those cooperative exchanges with high levels of governance

  ➤ But in many cases, exchanges will not co-operate, cannot co-operate (because they don't have the data to ascertain ownership) or will require recognition orders

Taking Possession of Assets – cont'd
What happens when we do find assets?

➢ Insolvency Professionals need to be proficient in how to take possession of cryptocurrency
  - ➢ Parties have lost cryptocurrency due to lost passwords, bad smart contracts, hacking etc.
  - ➢ Insolvency Professionals will need to decide how to take possession of cryptocurrency
    - ➢ By creating a new wallet and holding the cryptocurrency in this offline wallet?
    - ➢ By creating an account on an exchange and holding it with the exchange?
    - ➢ Both methods have different risks associated with them
➢ Recommendation for Lenders – Where a debtor is known to have cryptocurrency assets, ensure Trustee selected has expertise and experience in this area.

➢ What about fiat held by insolvent cryptocurrency exchanges?
  - ➢ Most cryptocurrency businesses cannot open bank accounts to hold fiat – banks will not deal with them due to challenges complying with Anti-Money Laundering and Know-Your-Client legislation
  - ➢ TPPPs are therefore used to receive, hold and disburse fiat
  - ➢ However, many TPPPs used by cryptocurrency exchanges have been alleged to have employed questionable business practices and recovery of funds has been difficult

Jurisdiction
What is appropriate jurisdiction for filing?

➢ The laws of many jurisdictions focus where the debtor is located, does business or where its "center of main interests" is located

    ➢ Cryptocurrency business often have no physical place of business and cryptocurrency assets are virtual so how do we determine jurisdiction?

    ➢ Case example - Quadriga initially filed in Nova Scotia and was transferred to Ontario, some thought it should be BC – what were the considerations?

➢ Other jurisdictions (like the United States) allow companies to file that simply have property (like a bank account) in the jurisdiction

    ➢ Where is cryptocurrency located?

    ➢ Recognition issues when a company files in a jurisdiction other than where its COMI lies

Cross Border Recognition
Given the nature of cryptocurrency, is cross border recognition required?

➤ Past Cases:

  ➤ Mt Gox – cross border recognition sought in US and Canada to stay $500 million class action

  ➤ Cryptopia – cross border recognition sought in US to prevent US based data host from terminating services making data inaccessible to the New Zealand liquidator

➤ Other potential reasons:

  ➤ To stay actions against non-crypto assets in foreign jurisdictions

  ➤ To obtain cooperation of foreign third party payment processors, other exchanges when information or assets are held with these parties or other service providers

➤ Key issue – establishing COMI

  ➤ Many cryptocurrency exchanges are run virtually – how will COMI be determined? Will courts in other countries have issues with COMI?

Preservation of Cryptocurrency Assets in Insolvency

➢ Insolvency Professionals need to decide whether to immediately sell or hold the cryptocurrency

   ➢ Typically, Insolvency Professional realize on all assets and convert them to cash – should Insolvency Professionals therefore immediately sell cryptocurrency or is it acceptable to hold cryptocurrency?

   ➢ If cryptocurrency is considered "money", is holding it in conflict with local law requirements that an Insolvency Professional hold all money at a bank in guaranteed deposits?

➢ What about safeguarding of cryptocurrency?

   ➢ Will Insolvency Professional's insurance cover any losses to cryptocurrency assets?

   ➢ Can Insolvency Professional obtain adequate insurance for cryptocurrency as required by insolvency legislation?

   ➢ Does Insolvency Professional have appropriate protocols and governance in place to manage wallet passwords so as to fully safeguard cryptocurrency?

   ➢ How does Insolvency Professional protect against risk of insolvency if cryptocurrency is held in an exchange?

Realization of Cryptocurrency
What are considerations when converting to cash?

➢ May vary depending on different types of cryptocurrency – some are more liquid than others

➢ Trading prices are volatile – how does Insolvency Professional determine the appropriate time to realize?

  ➢ *In last year, Bitcoin has ranged from a low of approximately $10,000 USD to a high of approximately $60,000 USD. Currently, it sits at about $45,000 USD (thanks Elon Musk!)*

➢ Case examples:

  ➢ Mt Gox: Trustee liquidated such a large amount of bitcoin that it significantly and negatively impacted the global price

  ➢ Cred Inc.: customers given a choice to receive distribution in cash or in the applicable cryptocurrency

Creditor Claims and Distributions

➢ How will claims of cryptocurrency exchange users be made?

> ➢ Typically, many claims processes provide for claims to be made in local currency – claims in other currencies or measurements must be converted to local currency
>
> ➢ Should cryptocurrency be an exception where claims are made in cryptocurrency units?
>
> ➢ Case examples:
>
> > ➢ In QuadrigaCX, claims process designed for users to file in number of cryptocurrency units
> >
> > ➢ In Cred Inc., claims based on a form of cryptocurrency must be converted to USD to calculate the amount of claims

➢ Could distributions ever be made in cryptocurrency?

> ➢ In Cred Inc., customers were given a choice to receive cash or cryptocurrency distribution
>
> > ➢ But the Plan deferred the question of whether customers could require the return of "their" cryptocurrency
>
> ➢ Goes back to question of whether cryptocurrency is money
>
> ➢ Would it be feasible for Insolvency Professional to facilitate a mass distribution in cryptocurrency?
>
> ➢ Would lenders be willing to receive cryptocurrency as payment or would they require Insolvency Professional to first convert it to cash?

Cred Inc.'s Chapter 11 Case

➤ Cred Inc. is a company that operates a global cryptocurrency transfer platform. Cred Inc. filed for chapter 11 on November 7, 2020 due in part to theft of its assets and mismanagement by former management.

➤ The chapter 11 plan of liquidation was confirmed on March 11, 2021, which contemplates the transfer of all assets into a liquidation trust for distribution to creditors, including customers.

➤ Valuation of Claims: Customers are treated as general unsecured creditors and their claims, including claims based on cryptocurrency transactions, are valued as of the Petition Date and converted into USD using then prevailing conversion rate.

  ➤ Petition Date value of Bitcoin: $15,565 USD (approximately 1/3 the current trading price)

➤ Distribution: The distribution will be made in cash or, if a cryptocurrency election is made on the proofs of claims, in cryptocurrency on a good faith efforts basis, based on the holders' pro rata share of the distributable assets.

➤ Paragraph 43 of the confirmation order expressly reserved the holders' right to assert their claims should be valued as of a date other than the Petition Date.

Take-Aways

➢ We are going to see a lot more cryptocurrency assets

➢ Cryptocurrency is unique – lenders and insolvency professionals need to understand it

➢ Some issues discussed today could be improved with more regulation
  ➢ But full regulation is likely not practical or possible

➢ Insolvency legislation may need amendments to accommodate cryptocurrency

Questions