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DECODING DISTRESS: CRYPTOASSETS, RESTRUCTURING, AND INSOLVENCY UNDER ENGLISH LAW

— THOUGHT LEADERSHIP

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The cryptoasset market has grown enormously since Bitcoin was launched in 2009, reaching an estimated aggregate value of US$3 trillion by November 2021, according to the ECB. But in recent months investors have suffered losses estimated by the ECB at US$1.3 trillion, with the failure of the TerraUSD stablecoin, and the Tether stablecoin that underpins much other trading in cryptocurrencies falling (at least for a time) below its US$1 peg. It is therefore right that market participants, regulators and other stakeholders pay close attention to how cryptoassets may be treated in a distressed scenario.

The UK Government has announced plans to make the UK a global cryptoasset leader, including by developing its legal and regulatory regime. For example, on 31 May 2022, HM Treasury launched a consultation on managing the failure of systemic digital settlement asset (including stablecoin) firms that proposes including certain systemically important cryptocurrency firms within a modified Financial Market Infrastructure Special Administration Regime, as the first step in a "staged and proportionate approach" to cryptoasset regulation. English jurisprudence has in any event been evolving to deal with the distinctive features of cryptoassets as they have arisen in practice. These developments are likely both to be informed by, and play a role in informing, wider international regulatory and jurisprudential developments. It is therefore worth considering how cryptocurrencies and other cryptoassets may be treated in a distressed scenario as a matter of English law as it stands today, what some of the key uncertainties are, and how stakeholders might address them.

Cryptoassets as property

Until relatively recently, there had been a debate as to whether cryptoassets could constitute "property" as a matter of English law. This is an issue of fundamental importance in a distressed scenario: if cryptoassets might not be property, then it would in turn be unclear whether they form part of a debtor's insolvency estate i.e. the property which is to be realised and distributed to creditors. Similarly, it would be unclear whether cryptoassets could be secured to a creditor, or held on trust for third parties i.e. taken out of the general estate and reserved for the benefit of the security holder or trust beneficiary, as the case may be.

It is now clear that Bitcoins (at least) are "property" as a matter of English law. The courts have decided this as a matter of common law[1], following a report from the UK Jurisdiction Task Force that concluded that cryptoassets were capable of being property.[2] "Property" has a broader definition under the UK Insolvency Act 1986, and so it is difficult to imagine the courts taking a narrower approach in the context of insolvency. It is likely that other major cryptocurrencies will be treated in the same manner, and the courts have recently treated NFTs as property[3] (though it is possible to conceive of crypto tokens that might not be treated as property by function of their design).

1 *AA v Persons Unknown* [2019] EWHC 3556 (Comm).

2 UK Jurisdiction Task Force, Legal statement on cryptoassets and smart contracts, The Law Tech Delivery Panel (November 2019).

3 *Lavinia Osbourne v (1) Persons Unknown (2) Ozone Networks Inc trading as OpenSea* (Unpublished).

The starting assumption will therefore be that cryptoassets held by a debtor will form part of their insolvency estate, unless those cryptoassets are validly secured, held on trust, or otherwise removed from the estate prior to the insolvency.

Crypto debts

Whilst it may be clear that cryptocurrencies held on a debtor's balance sheet are property, there is some uncertainty as to how debts ostensibly denominated in cryptocurrency would be treated. Questions arise as to whether a failure to "repay" a cryptocurrency loan constitutes a "debt" or a claim for damages under English law. Further questions arise in the context of insolvency proceedings. For example, where a debtor enters insolvency proceedings, claims denominated in "foreign currencies" will be converted to sterling at the exchange rate prevailing on the date on which the debtor entered insolvency proceedings. The legislation is silent, however, on cryptocurrency "debts". The volatility of cryptocurrencies means that this question has the potential to materially affect both crypto-creditors' and fiat-creditors' recoveries.

Crypto-lending has grown substantially in recent years as holders of cryptocurrencies have sought (among other things) to earn a return on their holdings by lending them to others at interest, or to create liquidity in fiat currencies without wholly exiting their position. The likelihood of creditors needing to prove for debts at least ostensibly denominated in cryptocurrencies in an insolvency will therefore also have grown, and is likely only to become more pronounced if market conditions continue to stiffen. Whilst it is likely that insolvency officeholders would find practical answers as to how to value cryptocurrency debts, and could look to the courts for guidance, clarification in legislation would be welcome. Ideally, this clarification would apply generally rather than in the specific context of systemically important cryptocurrency firms.

Cryptosecurity and enforcement

Whenever one party makes a loan, there is a risk that the borrower will default. A common way of mitigating that risk is (of course) to take security over an asset that can be used to discharge the debt. A creditor will often hope to be able to enforce their security ahead of an insolvency process, or at least to have their priority interest in the secured assets preserved in an insolvency.

In crypto-lending, it is common for one cryptocurrency to be used as "collateral" for a loan denominated in another cryptocurrency. Depending on the nature of the arrangement, if default is made in payment and/or the value of the collateral falls below an agreed threshold, the collateral will often be wholly or partially liquidated – potentially pursuant to a smart contract that self-executes when the trigger occurs.

There are outstanding technical questions as to how these arrangements operate: in many instances, "security" will be taken over cryptocurrencies by "transferring" them to an account with the lender or a third-party custodian. Strictly speaking, this might be said to result not in the transfer of an asset from one person to another, but the elimination of an existing private key and the generation of a new one – with uncertain consequences. Whilst parties should exercise caution, we would not expect the English courts to place excessive weight on a technicality of this type where it is clear that value is (in some sense) moving from a debtor to a creditor, to secure value moving on loan the other way.

There are issues however which, depending on the facts could present real difficulties for an enforcement of crypto-collateral – including the following:

- **Registration:** as a general rule, security given by an English company or limited liability partnership will be void against an administrator, liquidator or other creditors if not registered within 21 days. There are certain carve-outs from this rule (see below) though as a general rule it is at best uncertain that

these would apply to crypto-lending arrangements. Registering the security would (of necessity) de-anonymise the parties to the transaction.

- **Prevention of enforcement:** administration is the most common insolvency procedure for high-value English law corporate insolvencies, and imposes a moratorium on enforcement of security without consent of the administrator or leave of the court. Similarly, the "Part A1 moratorium" procedure introduced in 2020 prohibits enforcement without leave of the court. There is a carve-out for financial creditors, but it is not certain that this would apply to crypto-lending arrangements.
- **Unwind risk:** transactions entered into in the lead-up to an insolvency may be unwound for being a transaction at an undervalue, a preference, or a transaction defrauding creditors. This is a complex area of law, and there are numerous carve-outs and protections which a creditor may seek to avail of – and in general, transactions that result in cryptocurrencies being realised at a market rate are in our view unlikely to be vulnerable to challenge. But each such arrangement would need to be reviewed on its own terms. The mechanics of unwinding a disposal of cryptoassets remains an area of particular complexity and uncertainty, and therefore potential risk.
- **Void dispositions:** where a company enters compulsory liquidation (i.e. the company is wound up pursuant to a court order), any disposition of the company's property between the date on which the court is petitioned to wind up the company and the date on which it makes the winding up order is automatically void with retrospective effect unless the court orders otherwise. There will often be a delay of 5-6 weeks between the winding up petition being presented, and the date on which the winding up order is made. The court can validate transactions, but it will only do so where the transaction has benefited (or at least not harmed) the estate save in exceptional circumstances. Similar considerations apply in personal bankruptcy.
- **Foreclosure:** English law will generally not permit a creditor to "foreclose" on their security i.e. to claim ownership of a secured asset in satisfaction of their debt. Instead, assets are generally required to be sold. Cryptosecurity arrangements need to be reviewed carefully against this rule.
- **Valuation:** a creditor enforcing their security has a duty to get the best price reasonably obtainable. As a general rule this does not require a creditor to delay enforcement in the hope that prices will rise. But the volatility inherent in many cryptocurrency markets could give rise to challenges.

Whilst these issues are felt particularly acutely in the case of cryptocurrencies, they are in many respects not unique: substantively similar issues arise in transactions involving lending of conventional securities, which often move at a similarly fast pace amidst high volatility. Such arrangements are protected by specific legislation (most notably, the Financial Collateral Arrangements (No 2) Regulations 2003 (FCARs)) and there would be a strong case for including at least certain crypto-lending arrangements within a similar or updated framework.

In the meantime, creditors would be well-advised to take the most robust security they can which is proportionate to the transaction involved – a long-term, multibillion dollar equivalent transaction involving significant risk might merit a more involved structure than an arrangement that is short-term, lower value, and lower risk. It is not clear how a court would deal with the types of issues referenced above, and it may be difficult or even impossible for the court to exercise jurisdiction over all relevant parties involved in a crypto-collateral enforcement falling foul of insolvency legislation. However, in a non-crypto context the courts have been willing to order counterparties to turn over moneys

received pursuant to void dispositions, even where this could not be done for all stakeholders. A creditor who is subject to the jurisdiction of the English courts would be foolhardy to rely on practical difficulties alone to safeguard a purported enforcement over cryptoassets.

Cross-border issues

Part of the success of the FCARs has been the prevalence of equivalent regimes in other major financial jurisdictions. Cross-border co-operation will (if anything) be more important for cryptocurrencies than for "conventional" financing arrangements.

Many cryptocurrencies run on distributed ledger technology which (by its nature) means that the blockchain is not located in just one jurisdiction. In a distressed scenario, it is possible that multiple courts would have the potential to accept jurisdiction as a matter of their domestic law. The English courts have considered that cryptoassets are located where the person or company who owns the cryptoasset is domiciled[4], but it is conceivable that other courts would take different approaches and that this will incentivise stakeholders to seek to commence proceedings elsewhere. For example, the fact that security had not been registered over cryptoassets in England may mean that it was invalid as a matter of English law; but a foreign court might still recognise the validity of the security. Even without conflicting proceedings, it may be necessary to enforce judgments across borders, potentially against parties whose identity is publicly connected only with social media accounts (as highlighted by a recent Singaporean case dealing with a crypto loan for which an NFT had been pledged as collateral). Whilst existing rules regarding recognition of judgments and cross-border assistance in insolvency in many jurisdictions will be of assistance, the case for consistent cross-border regulation on such issues is strong.

In practice, and in the absence of clear or specific cross-border rules, *how* the cryptoassets are held may well determine which court is *able* to exercise effective jurisdiction. In the case of *AA v Persons Unknown*, the English court was able to exercise jurisdiction over cryptoassets where the private key was stored on a hard drive in England. And many cryptocurrency users value the convenience of holding cryptocurrencies via an intermediary (i.e. a platform or exchange), in which case the location of their account (and which court is able to exercise jurisdiction over it) may be determinative of where a debtor's interest in cryptoassets is effectively located. This would be a similar position to the "Place of the Relevant Intermediary" approach that has for a long time been adopted where securities are held by a common depositary, with beneficial interests flowing down a chain of custody that typically crosses multiple borders. These intermediaries plainly have the capacity to be systemically important themselves, and any special administration regime will need to be capable of addressing cross-border issues.

What can a crypto debtor do if facing financial stress?

A company that owes cryptocurrencies would be well advised to take note of any uncertainties in their financing arrangements, to consider any negotiating leverage that may result, and moreover to consider who the real beneficiaries of any such leverage may be. It is possible that legislative developments, such as those on which HM Treasury is currently consulting, will bear upon these considerations. But ultimately, the directors of a company facing insolvency owe immediate duties to creditors. For these purposes, a company's creditors would in our view almost certainly include creditors who are owed cryptocurrencies.

Directors risk (among other things) personal liability, and potential disqualification from acting as a director in future, from continuing to trade beyond the point at which they knew, or should have known, that there was no reasonable prospect of avoiding insolvent

4 *Ion Science Ltd v Persons Unknown (unreported, 21 December 2020).* See also *Fetch.ai Ltd and another v Persons Unknown and others* [2021] EWHC 2254 (Comm) (15 July 2021)

administration or liquidation. A defence lies in showing that a director took every step that they ought to have taken to minimise losses to creditors. It is therefore essential that directors of any company facing financial distress take proper advice from suitably experienced legal and financial advisers to establish whether the company still has reasonable prospects, which will often need to be carefully reviewed as a turnaround or restructuring is worked through.

If an insolvency cannot be avoided, the very worst outcome is likely to be a "freefall" with no planning. On the other hand, English law provides a variety of tools to a company seeking to avoid insolvency and – whilst untested in a crypto context – these have time and again proven capable of assisting companies facing novel challenges and needing to restructure.

Conclusions

The digital asset markets continue to be a significant area of investment, evolution and volatility across the globe as investors, governments, regulators, lawmakers and technology developers continue to grapple with both the possibilities and consequences of these fast-changing technologies.

The novel features of cryptoassets present novel challenges, and English law is evolving and adapting to deal with the distinctive features of cryptoassets and smart contracts, alongside other legal systems. Legislative developments have the potential to help that evolution, and the UK Government is taking steps to do so, focussing initially on systemically important firms. But, just as parties have not waited for the law to become settled before engaging in crypto markets, so too parties cannot afford to wait for certainty before considering how to manage the risks of financial distress.

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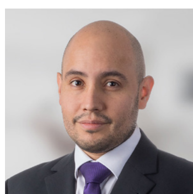

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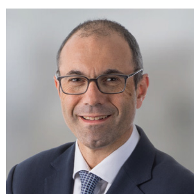

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