INSOL Europe insights: cryptoassets and insolvency

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It's probably becoming a cliché to say that the future is already here, but it's hard to resist. New technology increasingly pervades every professional sector, including that of insolvency.

In a recent report by the Law Society on developing technology, the Chancellor of the High Court, Sir Geoffrey Vos, commented that: "Lawyers face a steep learning curve. They will need to become familiar with [...] cryptoassets – conceptually and functionally."

That learning curve will certainly include challenges for insolvency lawyers, given the complexities of establishing what rights are associated with cryptoassets, and the divergence in their treatment between jurisdictions. But it's not just lawyers who may see cryptoassets playing an increasing role in their work – insolvency practitioners globally are being encouraged to prepare for encountering digital assets in the estates they deal with.

Cryptoassets were the topic of the morning session at this year's INSOL Europe online conference, sponsored by Ogier and presented by Mathew Newman, Guernsey Head of Dispute Resolution.

Experts including keynote speaker Professor Ignacio Tirado, Secretary-General of Unidroit; Lee Pascoe of Norton Rose Fulbright, Australia; Ilya Kokorin of Leiden University in the Netherlands and Dávid Oršula of bnt attorneys, Slovakia provided cutting-edge insight into the legalities and practicalities of cryptoassets in insolvency proceedings, as well as discussing some of the more famous crypto-related insolvency case law.

What is a cryptocurrency?

While cryptoassets, and in particular Bitcoin, are becoming increasingly household terms, they are surprisingly (or not) difficult to define.

Bitcoin has been described as "the record, contained in code recorded on the blockchain (in

basic terms, a digital ledger), of a series of transactions recording the 'creation' and 'transfer' of 'something'." The point is also made that the subject matter of that record, the Bitcoin, is not even a piece of code.

On this view, what the "owner" of Bitcoin has is "the ability to generate a transfer, in return for which the transferee is prepared to transfer valuable consideration, which is likely to be fiat or cryptocurrency, or a real-world asset."

Setting aside the clear questions about what proprietary rights might, legally speaking, be available in relation to this "something" – more on this below – it needs to be stored. This is done in "wallets" which may be "hot" (connected to the internet) or "cold" (offline only).

There are advantages and disadvantages to both. Hot wallets are easier to hack. But if you lose the relevant password, a cold wallet can be impossible to access (even legitimately). A recent salutary reminder of this is the predicament of a German programmer who has used up eight of his 10 password attempts for the key to a Bitcoin cold wallet containing currency now worth around USD$220 million. If he guesses wrong twice more, he will never be able to access the wallet.

One thing that cryptocurrencies have in common with mainstream fiat tender is that they have generally been considered fungible, though recent restrictions on their use imposed by the Chinese government and Tesla's decision no longer to accept them as payment may throw doubt on that fungibility. In any event, it is accepted that existing cryptocurrencies are not mutable – meaning, among other things, that once they are transferred from one wallet to another they cannot simply be returned, in the way that a bank transfer of fiat currency could be. That has become relevant in certain insolvency scenarios.

The practical complexities of managing and using cryptocurrencies are, then, matched by the challenges in analysing them legally, and in particular identifying what, if any, proprietary rights might be associated with them.

While different jurisdictions have devised different solutions for this, it is becoming an increasingly live issue in relation to the treatment of cryptoassets in insolvency estates.

A third type of property?

Courts internationally have had several opportunities in recent years to consider the proprietary status of cryptocurrencies in relation to insolvencies of crypto exchanges (often caused by hacks rather than more traditional issues such as over-leveraging). Often holders of crypto currencies will be keen to demonstrate that they have proprietary rights over these currencies as otherwise they would have to share pari passu with the unsecured creditors in the insolvencies of the crypto exchanges.

In the relatively early case of Mt Gox in 2015, the Tokyo District Court determined that the assets of what was once Japan's largest Bitcoin exchange were not subject to proprietary claims , meaning that Mt Gox's clients only had a contractual claim against it. In the Italian case of Bitgrail in 2019, cryptoassets were determined to be property, but were treated as commingled by the custodian with other assets, resulting in only a contractual claim being available to clients of the custodian.

In the insolvency of Cryptopia, also in 2019, cryptoassets were again considered as mixed with other assets. However, in this case, the New Zealand courts made the assumption that a trust had been created, with an associated proprietary interest in the assets held by Cryptopia for its clients.

The courts of England and Wales have been even clearer on the status of cryptoassets as property. In the 2020 case of AA v Persons Unknown, the English High Court considered whether Bitcoin could be considered property in the context of an application for a proprietary injunction to recover stolen cryptocurrency following a malware attack.

In its deliberations, the Court considered research completed by the LawTech Delivery Panel's UK Jurisdiction Taskforce on this subject, which had concluded that cryptoassets are not precluded from being treated as property, even if they are not a thing in action on a narrow definition, and that they might be better thought of as "a third type of property". Ultimately, the injunction was granted.

It may be the perceived risk of injustice to investors and creditors which has resulted in the apparent lean internationally towards the treatment of cryptocurrency as a form of property. That said, it has also been argued that following the basic universality principle, it may be enough for the purposes of insolvency law that cryptocurrency has value, irrespective of its proprietary status.

Cryptoassets and insolvency – practical and legal considerations

Setting aside the precise legal analysis, there are some immediate practical considerations for insolvency practitioners who think they may encounter digital assets in a debtor's estate. Firstly, they will need to identify any such assets; retrieve access to them; preserve them; value them, realize them and distribute them as appropriate.

Identification of assets

Insolvency practitioners who suspect that cryptocurrencies may be present among insolvency assets will wish to review bank accounts for transfers involving words or transactions indicative of crypto exchange, as well as the number of bank accounts and the volume and frequency of cash transactions, which may also be an indicator. When identifying digital devices, they should look for signs, including the presence of software associated with the use of virtual currencies,

large files indicating download of blockchain, and indications of use of cloud technology.

Court assistance has also been used – in the 2020 UK case of Ion Science v Persons Unknown, liquidators obtained a worldwide freezing order and orders against foreign crypto exchanges.

Preservation of assets

Where cryptoassets are identified, practitioners are recommended to immediately take control of the cryptocurrency by transferring it to a devoted cold wallet. But whether the wallet is hot or cold, and practitioners should beware of hacking, it should be accessible to the relevant, and only the relevant, persons. If anyone else has the key to the wallet, there will be a risk of the asset being dissipated. In the Cryptopia liquidation, there was an allegation that third parties had access to the key to a digital wallet used to store assets, resulting in significant losses. Care should also be taken to transfer it to the correct wallet – because it is immutable, it cannot simply be returned. In the liquidation of Canadian currency exchange Quadriga, cryptoassets were allegedly transferred to the wrong cold wallet, again resulting in significant losses.

Indeed, in some jurisdictions, insolvency practitioners are recommended to have a devoted cold wallet available from the start of proceedings with a trusted crypto exchange or wallet service provider in the same jurisdiction as the debtor, as well as separate wallets for different currencies.

Again, the courts have intervened where a debtor has proven unwilling to disclose cryptoassets. In 2018, the Moscow Arbitration Court ordered bankrupt Russian citizen Ilya Tsarkov to provide information about the balance of his cryptocurrency holdings while the Court decided whether they should be included in the bankruptcy estate or not. (Ultimately, on appeal, they were included on the basis that creditors could not be deprived of the value of the cryptocurrency unless that value were expressly excluded by law.)

Valuation and realisation of assets

Again, where a significant amount of cryptocurrencies are identified, practitioners will wish to consider the means of valuing and realising them.

After the Trustee of Mt Gox successfully recovered 200,000 Bitcoin and Bitcoin Cash (a spin-off of Bitcoin), tranches of these cryptocurrencies were sold between December 2017 and 2018. In total those sales generated approximately JP¥44,000,000,000, equivalent to USD$ 401,247,216.

This was, clearly, a very significant realisation – indeed, the number of Bitcoin was so huge that there were allegations, among others, that the sale had triggered the Bitcoin bear market around the same period. Perhaps fortunately, the Trustee had obtained prior court approval on the timing and method of the sale and had sought expert opinion and considered market prices. As of April 2021, the Trustee continued to hold 141,686 Bitcoin (USD$8,477,455,932) and 142,846

Bitcoin Cash (USD$99,483,668).

Distribution of assets

Taking up the original theme of what exactly constitutes a cryptoasset, practitioners and their lawyers will wish to consider what rights investors and creditors can assert in a crypto-related insolvency – what is the legal status of the asset, how will an investor or creditor prove their claim, and how will distributions be made?

While we might expect greater harmonisation as the sector develops, this currently depends to a good degree on what jurisdictions are involved, and lawyers in areas where the law of England and Wales is persuasive may welcome the clarity being provided by those courts in judgments such as AA and Ion Science, as well as the findings of legal researchers. One thing is certain – the future won't be boring.

Mt Gox, Judgment of Tokyo District Court, August 2015

Decision of the 9th Appellate Court of Moscow, 15 May 2018, Case No. A40-124668/2017

'Bitgrail' – Court of Florence, Bankruptcy Docket Nos. 178/2018 and 205/2018, Decision No. 17/2019 from January 2019

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

Ion Science v Persons Unknown (unreported, 21 December 2020)

Ruscoe v Cryptopia Ltd (in Liquidation) [2020] NZHC 728

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