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Cryptocurrency and insolvency: a guide for insolvency practitioners

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INTRODUCTION

There is much noise around the fortunes made – and lost – in the virtual world of cryptocurrency. In this guide we explain more about cryptocurrencies and include what you need to consider if you find yourself dealing with virtual assets. We also set out a checklist for IPs which we hope you will find a useful precedent when administering any insolvent estates.

Cryptocurrency as an asset

Insolvency Practitioners ("IPs") spend much of their working lives dealing with the property of others. Usually this is in the form of cash, shares, real property, cars and other tangible assets. However, attention is increasingly turning to non-tangible assets such as cryptocurrency and non-fungible tokens ("NFTs"). This is in part due to their surge in popularity amongst both institutional and retail investors, as well as their inherently unregulated nature which makes them an attractive store of wealth.

Whilst cryptocurrency and NFTs, and the blockchain technology that underpins them, are still not entirely understood by everyone (including many professionals), the courts now recognise that, at least in the case of cryptocurrency, it falls within the broad definition of 'property'[1] under the Insolvency Act 1986. The UK Jurisdiction Taskforce ("UKJT"), a panel of eminent judges, barristers and professionals in the blockchain space, has also lent its hand to developing a legal statement on this question and concludes that 'cryptoassets possess all the characteristics of property'.[2] Accordingly, as with traditional assets, IPs have a duty to realise the value of any cryptocurrency, where possible. Whilst as far as we are aware there has been no similar statement made concerning NFTs, it would be prudent for IPs treat these as property, as well.

What is cryptocurrency?

"A cryptocurrency is a digital or virtual currency that is secured by cryptography, which makes it nearly impossible to counterfeit or double-spend. Many cryptocurrencies are decentralised networks based on blockchain technology—a distributed ledger enforced by a disparate network of computers. A defining feature of cryptocurrencies is that they are generally not issued by any central authority, rendering them theoretically immune to government interference or manipulation."

– Investopedia [3]

The UKJT identifies cryptocurrency as possessing the following characteristics: [4]

1. **Intangible**
2. **Authenticated by cryptography**
3. **Based on a distributed transaction ledger**
4. **Decentralised**
5. **Ruled by consensus.**

Take Bitcoin, for example.

Bitcoin is a digital currency and is therefore intangible.

As it is intangible, the only way ownership (or control, at the very least) of a Bitcoin can be determined is by access to the private key address. The private key address is one of two data parameters, the other being the public key address. It is these two data parameters that represent what we know as Bitcoin. The public key address identifies the unique Bitcoin and can be shared publicly (like a bank account number) and the private key address enables the transfer of that unique Bitcoin (like the password to access your bank account). Thus, it is authenticated by cryptography.

When, for example, X wishes to transfer 1 Bitcoin to Y, the transfer occurs on a digital ledger (known as the blockchain) which is a public record of every single transaction taking place with Bitcoin, meaning it is a distributed transaction ledger.

Transactions on the blockchain are recorded by the successful completion of algorithmic puzzles by thousands of participants of the blockchain known as 'miners'. Because there is no central repository or single administrator that records these transactions, it is decentralised and ruled by consensus.

The underlying value of a cryptocurrency is what people are willing to pay and like anything else, is determined by its scarcity and the effort required to be expended in order to obtain it.

Bitcoin has to be 'mined' by the 'miners' referred to above. Miners use computers (and significant power) to solve algorithmic puzzles associated with the blockchain. This is what fundamentally maintains the blockchain ledger and facilities the ecosystem that the cryptocurrency relies on.

In exchange for their efforts, miners are rewarded with a coin, or a portion of a coin.

To further illustrate the underlying value of a cryptocurrency, we can look more closely at Bitcoin:

Bitcoin is finite; there will only ever be 21 million Bitcoin in circulation. As more miners 'mine' more Bitcoin, the reward for mining the Bitcoin halves every 210,000 blocks. This drives the 'value' of the Bitcoin higher, particularly in circumstances where liquidity increases and more and more transactions are required to be verified by the miners.

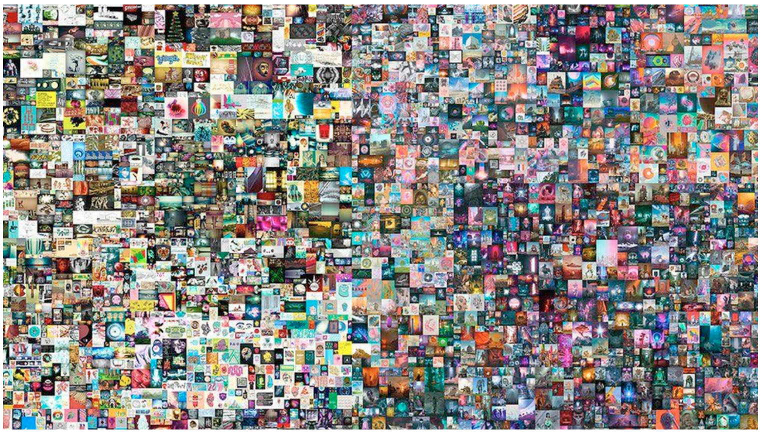
However, not all cryptocurrencies are finite. For example, Ether and Dogecoin (which started as a parody – a "memecoin") are infinite. Yet, despite being infinite, both continue to grow in popularity, with the latter growing 400% in the space of one week in April 2021.

What is a non-fungible token?

A non-fungible token, or 'NFT', is a unique digital file that is stored on the blockchain ledger. The digital file serves as a 'certificate of authenticity' of the work it represents. The work can be anything such as photos, videos, GIFs, audio or any other type of digital file.

On 11 March 2021, Christie's sold a digital artist's collage titled **Everydays: The First 5000 Days** by Beeple for over $69M (USD).[5] A copy of the work is shown right.

The underlying value of the NFT is not in the work itself, a copy of which anyone on the internet can access, but in the ownership of the original file that underpins the work, and the ability to on-sell that ownership to others.



CHRISTIE'S IMAGES LTD/BEEPLE

No different to the collection of art, NFTs offer wealthy investors with an alternative store of wealth and the opportunity for further capital growth. For creators, NFTs are attractive because they open up a new revenue stream where, depending on how the original smart contract is coded, the creator may continue to earn commission on every subsequent sale of the artwork (or more correctly, the ownership of the underlying unique digital file).

Why is it important for IPs to know about cryptoassets?

It is of course the case that IPs are under an obligation to realise any insolvent estates' assets and further, to investigate the cause of insolvency. In light of the growing popularity and prevalence of cryptoassets, an IP cannot properly discharge these duties without having regard to this class of asset. It is not enough to just explore the conventional assets of cash, properties, cars, stock etc. An IP also has to take care to assess whether a company or individual has cryptoassets and where they do, manage and realise any cryptoasset held.

Knowledge of a cryptoasset holding can make all the difference to an insolvent estate and can materially impact the return to creditors. An IP's failure to properly identify, assess and realise a cryptoasset exposes an IP to a claim by creditors. In circumstances where cryptoassets are more commonly held by companies and individuals, the risk to IPs who do not fully understand cryptoassets and the steps required where a cryptoasset exists, are ever increasing.

IPs should also consider cryptoassets when assessing claims against directors or third parties. Commonly, "inability to pay" is a key negotiation tool utilised by defendants. When an IP is assessing the merits of an "inability to pay" argument, questions should be raised regarding whether the defendant possesses cryptoassets. Increasingly, individuals are using cryptoassets to hide wealth.

CASE STUDY

By way of example, Francis Wilks & Jones were instructed by joint liquidators to pursue a claim against directors of a company for breaches of fiduciary duty. The directors presented an inability to pay argument, stating that they had no savings and were relying on family and friends to fund a settlement offer. Francis Wilks & Jones required the directors to complete a sworn statement of financial position to test the merits of their pleas. Our standard statement of financial position asks for disclosure regarding cryptoassets held. Upon receipt of the completed statements, the assertion made by the directors of having minimal cash was revealed to be correct, but the statements revealed that the directors held cryptocurrency to the value of six digits which they could draw on. This made a significant difference in the negotiation of settlement of the claim and the return to creditors. Had this question not been asked, the return to creditors would have been very different.

Finally, where cryptocurrency is part of an insolvent estate, the time costs and disbursements associated with identifying, valuing and disposing of the asset can be material. The involvement of cryptocurrency can substantially increase the complexity of a case and will ideally be addressed by the IPs at engagement stage given the impact these factors will have on the IP's overall costs. IPs should look to ensure that their standard engagement letter addresses cryptocurrency both in terms of costs but also, the potential need for expert advice on tracing, valuation, safeguarding, insuring and disposal. The involvement of cryptocurrency will inevitably lead to an increase in the remuneration approval sought from creditors and may also influence the basis for calculating an IPs fees. For example, where there is cryptocurrency, it may be less desirable to agree a fixed fee given that cryptocurrency will increase the complexity due to the increased variables in administering the estate.

How do you spot cryptocurrency?

STATEMENT OF FINANCIAL POSITION

An IP should expressly ask the question in all insolvencies – do you / the company have any cryptocurrency or non-fungible tokens? If so, provide sufficient particulars (including the public and private keys), quantities and values to enable the asset to be realised. Standard precedents should be updated to include this question.

EXAMINING THE BOOKS, PAPERS AND RECORDS

When reviewing books and records, IPs should keep an eye out on the following things:

Wallets

A wallet is a secure digital location used to store, send and receive cryptocurrency.

A wallet does not physically contain any cryptocurrency. Neither can it receive or send any cryptocurrency. It is purely a collection of private and public key addresses. Some wallets may contain other information, such as transactions, user preferences and/or balances.

There are several types of wallet options for storing cryptocurrency, which offer different degrees of security:

- **Software wallets**
  Some wallets are software wallets such as: Bitcoin Wallet, Mycellium, Xapo, Blockchain, BitWallet. These are used on desktops or mobile phones and are similar to an online bank account for cryptocurrency.
- **Hardware wallets**
  Other wallets are hardware wallets such as: Ledger Nano S, Trezor Wallet and Keepkey. These are devices specifically designed to store cryptocurrencies and offer high security from digital hacking (but require additional physical security measures to be undertaken).
- **Hot wallets**
  These wallets are hosted by third parties such as online cryptocurrency exchanges such as Coinbase, Binance or Bittrex.
- **Cold wallets**
  These wallets are not connected to the internet and may be held on paper or a USB drive.

Passwords

These should be requested from company directors or relevant individuals in the first instance. In addition to this, IPs should look for handwritten or typed notes with long numbers and letters, as this could be a private key address. Forensic investigators familiar with cryptoassets should be used to analyse electronic records where it is suspected that cryptoassets are held.

QR Codes

The presence of seemingly random QR codes may also indicate the presence of cryptocurrency.

Computers

In addition to a search for a Wallet, Key or QR Code, a search of electronic records for company board minutes, emails and correspondence that reference cryptoassets, internet search history and financial records of transfers to and deposits from the relevant crypto-exchange (such as Revolut, Binance, IG.com etc.) may assist to identify cryptocurrency.

The internet is also your friend as there are ‘block explorers’ which you can utilise to obtain information about cryptocurrency (public) addresses and transactions.

By way of example, BitRef[6] is a free online tool which anyone can utilise to identify the current balance of any bitcoin address and the last 50 transactions associated with that address.

Failure to co-operate or deliver up books and records

If an IP suspects that company directors, advisers or third parties with knowledge of a company's property etc. are deliberately withholding information concerning cryptoassets (for example, the information necessary for the IP to access and realise a cryptoasset), an IP can of course rely on section 236 of the Insolvency Act 1986 in order to seek to compel an individual to deliver up company books, papers or other records and / or undertake an oral examination regarding the company's property. The term 'other records' is wide enough to extend to the production of information surrounding cryptoassets, and importantly, the private key address required by an IP to unlock and realise the asset.

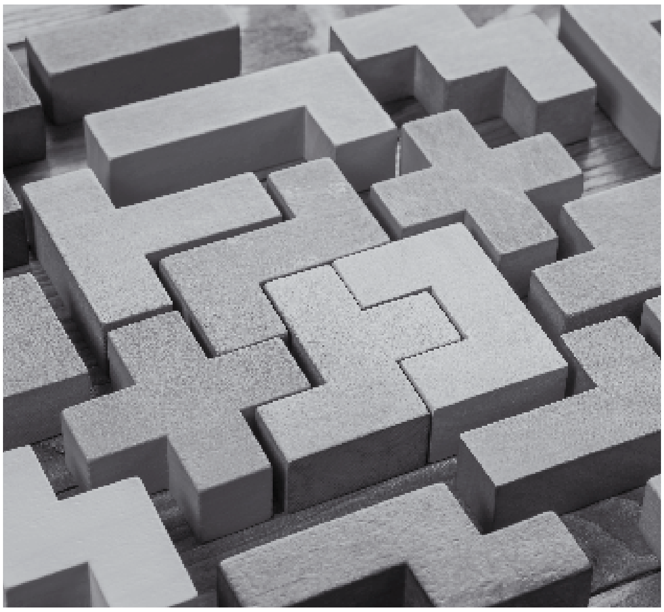
If an IP suspects that a bankrupt, their spouse, partner or advisers etc. are deliberately withholding information concerning cryptoassets (for example, the information necessary for the IP to access and realise a cryptoasset), an IP can of course rely on section 366 of the Insolvency Act 1986 in order to seek to compel an individual to deliver up books, papers or other records and / or undertake a private examination regarding the bankrupt's estate. The term 'other records' is wide enough to extend to the production of information surrounding cryptoassets, and importantly, the private key address required by an IP to unlock and realise the asset.

How do you recover cryptoassets?

Once an IP has established that a cryptoasset exists, steps should be taken to obtain all the information needed to access the wallets holding the cryptoasset from the relevant parties. In the absence of this co-operation, IPs should take steps to freeze any identified cryptoassets where there is a risk of dissipation of the estate asset. For example, where the IP knows that there is a cryptocurrency but the information necessary to access the asset has not been disclosed and is still held by a third party. Because cryptocurrencies are decentralised and held across the distributive ledger, there is no bank to receive service of the Freezing Order. However, a freezing order can be served on cryptocurrency exchanges.

Cryptoassets can be held anywhere in the world and therefore, a Worldwide Freezing Order may be required to protect the asset.

An IP must be proactive in taking steps to protect the insolvent estate's asset. Failure to do so could lead to the cryptoasset being sold without an IPs knowledge.



Once an IP has been able to gain sufficient control over a cryptoasset, steps must be taken to insure it using a specialist insurance provider. Steps must also be taken to carefully secure the cryptoasset and consideration should be had to whether this should be via an exchange, custodian or by securing the wallet in the IP's safe. An IP should check the requirements of any insurance provider being used to insure the cryptoasset as the insurer may stipulate how the cryptoasset should be secured.

Valuation and realisation of cryptoassets

The cryptocurrency market is volatile and as a result of this, the value of cryptocurrency can drastically rise or fall. An IP needs to be cautious about the timing of any sale of cryptocurrency given the risk of loss to the estate. Where an IP is dealing with the sale of a large amount of cryptocurrency, advice should be taken regarding whether all currency should be sold at the same time or in tranches, given the volatility of the market it is difficult to predict whether the better return to creditors would be to sell the cryptoasset in one large disposal i.e. dumping, or in a series of tranches to reduce the impact that a large disposal can have on the value of the asset.

Failure to adopt a credible disposal strategy will leave the IP exposed to a claim for breach of duty, as well as at risk of negative publicity and reputational risk. Depending on the value of the cryptoasset, an IP may seek the court's approval of an intended disposal or indeed, of a decision to retain cryptocurrency so to limit their exposure to criticism by creditors of the steps taken to value and dispose of the cryptoasset.

Can we help you?

For legal advice, Maria Koureas-Jones or Tom Serafin would be happy to assist.

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ABOUT US

Francis Wilks & Jones ("FWJ") is a friendly firm of experienced lawyers who provide specialist advice to insolvency practitioners, SMEs, directors and shareholders, private clients and banks and financial institutions, across the UK. We are people focused, giving every client tailored commercial support, and we use our bespoke systems to ensure our work is cost effective and efficient, and our clients get the results they need to get on with business.

Opus Business Advisory Group assists businesses and individuals to take command and gain control of financial and operational challenges that are being faced as well as supporting change and growth opportunities. Our Partners work with clients to present all options available, ensuring that compliance requirements are met, and the best path forward is followed. Divisions include business advisory, business rescue, corporate finance, equity, forensic accounting and restructuring & insolvency.
The Group has thirteen offices across the UK with more than 60 staff, including 25 partners, each with a wealth of experience.

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INSOLVENCY CHECKLIST:

Letter of engagement – ensure that this specifically covers crypto assets and how they will be dealt with, both by the directors and the IP.

AML checks – ensure that the appointment complies with relevant AML regulations.

Insurance – ensure that your insurer is prepared to insure crypto assets and understand any particular restrictions or requirements of the policy.

Access to crypto assets – ensure that all passwords, private keys and other security information are provided at the outset of the appointment.

Security of crypto assets – ensure that you have agreed with the Directors how the assets will be transferred to your control; how the assets and private keys will be held (digital wallets should be set up in advance – these may be held by a third party custodian or by the IP on a physical wallet, laptop, USB stick, etc, but appropriate measures need to be taken to ensure that physical storage is safe and secure).

Security of Private Keys – ensure that you have appropriate security access to private keys: it may be prudent to have two or three key-holders, all or most of whom are required to sign in, simultaneously, to access the assets.

Books & Records – ensure that you receive the transactional records of the business in relation to the trading of any crypto assets. Transactions on the blockchain are anonymised, so a list of all the company's own and client accounts should also be obtained. You may also need to understand how the trading information can be cross-referred against the customer account data, so that you can identify and trace transactions.

Agents / valuers – ensure that your independent agent has appropriate experience and understanding of crypto assets. Use a specialist firm, if necessary.

Realisation / conversion strategy – ensure that you take professional advice regarding whether to hold or convert crypto assets into FIAT currency (and when to convert). Crypto asset prices can be extremely volatile, so getting this wrong could leave you open to criticism from creditors and other third parties.

Investigations – try to identify instances where crypto and other assets may have been syphoned off to directors and other third parties by checking trading accounts (and bank transactions) bearing their names / the names of known relatives.

Disclaimer:

If you do need advice on any particular issue or require representation, please contact:

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[4] See note 2 above at [31].

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