Unlocking the crypt: insolvency & cryptocurrency

Despite the UK's intention to be a global leader in cryptoassets, the courts are still wrestling with the basics: **Rachel Coyle** of 36 Commercial explains why it's time to get to grips with the insolvency context

IN BRIEF

- With the courts having confirmed that cryptocurrency is property and can be used in transactions, the door is now open to it being considered as part of an insolvent estate.
- However, the anonymous nature of the ledger recording such transactions means it can be difficult to trace and recover cryptocurrency, and can also pose difficulties when it comes to enforcement.

Hurrah, cryptocurrency has finally been recognised as property in English law; but how does that affect the management of an insolvent estate of companies and individuals?

Perhaps this article is preaching to the converted, but for those of you unfamiliar with cryptocurrency, the first thing you must know is that it is a virtual form of money traded online; it is independent of the traditional banking system and a world that ought to be trodden in carefully for the unwary.

Predominantly, cryptocurrency uses distributed ledger technology (DLT). This is a ledger that records transactions shared across the cryptocurrency network. It is not centralised; there is no one person or entity that controls the network. Once a change or record is made on the ledger, it cannot be amended unless the majority of participants agree to make changes ('immutability'). What makes the cryptocurrency network so fascinating—at least to this writer—is that the transactions are anonymous. This opens up a whole host of problems, as we shall see in this article. What is associated to the user in that transaction is a public key.

Cryptocurrency as property

Conceptually, therefore, cryptocurrency does not easily fit into the usual categories of property in English law: it is neither a pure chose in action nor chose in possession. Cryptocurrency is digital and intangible and there is no physical possession of it. However, the statement of the UK Jurisdiction Taskforce (UKJT) established that cryptocurrency is property capable of recognition in English law because the four-part test in *National Provincial Bank Ltd v Ainsworth* [1965] AC 1175 is satisfied:

i. Definable? Yes;
ii. Identifiable third parties? Yes, via the key number;
iii. Capable in nature of the assumption by third parties? Yes; and
iv. Some degree of permanence? Yes—the 'transaction' itself is on a ledger, albeit a digital one.

The UKJT's statement was adopted by Bryan J in *AA v Persons unknown* [2019] EWHC 3556 (Comm) when Bitcoin was confirmed by the judge to be a form of property that in that matter could be subject to a proprietary injunction. In a criminal context, cryptocurrency can and does fall within s 316(4))(c) of the Proceeds of Crime Act 2002; see *Director of Public Prosecutions v Briedis and another* [2021] EWHC 3155 (Admin), [2021] All ER (D) 08 (Dec) .

Moreover, more recently, Judge Pelling QC in *Fetch.ai Ltd and another company v Persons Unknown Category A and others* [2021] EWHC 2254 (Comm) confirmed that cryptocurrency is property, saying that it is a chose in action. Judge Pelling QC also ruled that when considering the location of the cryptocurrency, which is obviously relevant in insolvency for officeholders, the real question to be asked is where is the owner of the cryptocurrency domiciled.

Very recently, non-fungible tokens (NFTs) have been treated by the court as 'property' in *Lavinia Osbourne v (1) Persons Unknown (2) Ozone Networks Inc trading as OpenSea* [2022] EWHC 1021 (Comm); see 'NFTs as property: what next?', *NLJ*, 13 May 2022, p13 for further analysis of this decision. If cryptocurrency can be construed as property in the above contexts, then surely it is property forming part of an insolvency estate? Well yes, it would seem so when you look at s 436 of the Insolvency Act 1986 (IA 1986).

The courts in England, however, have proved slow to consider cryptocurrency in an insolvency context, but perhaps we can learn from other countries such as New Zealand. In *Ruscoe v Cryptopia Ltd (in Liquidation)* [2020] NZHC 728, the New Zealand High Court confirmed cryptocurrency is 'property' within the meaning of the New Zealand Companies Act, but on the facts of that case concluded that the cryptocurrency was held on trust on behalf of Cryptopia Ltd's accountholders. This meant the cryptocurrency did not become part of Cryptopia Ltd's insolvent estate.

Cryptocurrency in transactions

Given that in England cryptocurrency is now recognised as 'property', it is not inconceivable that a transfer of cryptocurrency by a company would constitute a 'transaction' within the meaning of ss 238 and 423, IA 1986. If that is the case, then the door is open to insolvency practitioners to challenge cryptocurrency transactions as a transaction at an undervalue in the usual way under ss 238 and 239, IA 1986, or to challenge a transaction pursuant to s 423, IA 1986 on the grounds that it is designed to defraud creditors.

For transactions at an undervalue, one must remember that the court does not have to order that the original cryptocurrency ('property') be restored. It can require, for instance, the person benefiting from that transaction to pay the equivalent sums it received to the insolvency practitioner.

No doubt insolvency practitioners are rubbing their hands with glee, safe in the knowledge that such claims will not be struck out on reading this article. Hold your horses! That is all well and good, but can you enforce? You still have one problem: the anonymous nature of the ledger means it can be difficult to trace and recover cryptocurrency. You might be in luck if the cryptocurrency can be traced to an established exchange because the exchange usually holds the personal information of accountholders. Perhaps utilising s 236, IA 1986 is the solution. An insolvency practitioner could compel these exchanges to turn over the information so that the insolvency practitioner can identify the person.

Insolvency practitioners may wish to review bank accounts for transfers involving words or transactions indicative of crypto-exchange, as well as the volume and frequency of cash transactions and bank accounts. They should also look for the presence of software associated with the use of virtual currencies, the use of cloud technology and large files indicating download of blockchain. Such

means of identification was used in *Ion Science v Persons Unknown* (unreported, 21 December 2020) when liquidators obtained a worldwide freezing order and orders against foreign crypto-exchanges.

Ion Science is understood to be one of if not the first initial coin offering (ICO) fraud case heard before the Commercial Court in England. It was the applicants' case that they have been the victims of a cryptocurrency ICO fraud. An ICO is a type of fundraising exercise using cryptocurrencies and is sometimes used to raise money to launch a new type of cryptocurrency. The applicants were induced by persons unknown to transfer the £577,002 (approximately 64.35 Bitcoin) in the belief that they were making investments in real cryptocurrency products. As part of the alleged fraudulent scheme, the applicants also invested in an ICO for a new cryptocurrency called Uvexo. After some persuasion, they also invested in another ICO for a new cryptocurrency called Oileum.

The supposed profits made in relation to the ICOs was not returned to the applicants. With the assistance of asset tracing, the applicants traced the misappropriated funds and applied successfully for a proprietary injunction, a worldwide freezing order and an ancillary disclosure order against persons unknown. They also successfully obtained a disclosure order against Binance Holdings Ltd and Payward Ltd.

In a more recent case, the High Court has confirmed *ION* in *Danisz v Persons Unknown and another* [2022] EWHC 280 (QB). The claimant was persuaded by persons unknown to invest in the form of Bitcoins in a website known as Matic Markets Ltd. The claimant thought, erroneously, that these investments accrued in value, but when he tried to withdraw the Bitcoin and any profit, his request was refused. The claimant sought various orders including an interim prohibitory injunction, a worldwide freezing order and a banker's trust disclosure order. The court granted: the prohibitory injunction following *AA v Persons Unknown*; the freezing order because the court had jurisdiction to hear the substantive claim, as the *lex situs* of a cryptoasset is determined by the place where the person who owns it is domiciled (*Ion Science*) [2]). It also confirmed that 'asset' includes all assets that are held by or controlled by a third party; and the bankers trust order when concluding that it could lead to the location of the Bitcoin.

Lending & enforcement

In crypto-lending, often one cryptocurrency is used as 'collateral' for a loan denominated in another cryptocurrency. If the value of the collateral falls below an agreed threshold, it can be liquidated. It is clear that the value in this context is moving from a debtor to a creditor, and it is hoped that the courts will see such an arrangement operating in this way rather than tie itself in knots because technically, there is no transfer at all; there is no transfer of an asset from one person to another. What actually happens is a new transaction is added to the blockchain.

Enforcement can be difficult. For instance, the 'Part A1 moratorium' procedure introduced by the Corporate Insolvency and Governance Act 2020 (CIGA 2020) prohibits enforcement without the court's permission. CIGA 2020 is silent on whether this applies to crypto-lending arrangements. There is also the question of registration. Security is void against a liquidator or administrator (or other creditors) if not registered within 21 days. Again, due to anonymity, it is unclear how this applies in crypto-lending. Another pitfall is that a creditor enforcing their security has a duty to get the best price. This does not require a creditor to delay enforcement in the hope that prices will rise, but the volatility in cryptocurrency markets could pose challenges.

Directors' liabilities

Directors need to wake up and appreciate the issues surrounding cryptocurrency too. As already stated, cryptocurrency is property, and one can 'transact' using cryptocurrency, so a director can be liable for wrongful and fraudulent trading in a cryptocurrency transaction. As with any transaction, if a director continues with a cryptocurrency transaction during the time when the company is being wound up and the creditors are considered by the court to have been defrauded, and this was the intention behind the transaction, the director can face liability pursuant to ss 213/256ZA, IA 1986.

Similarly, as with any transaction, if the company is known by the director to be hurtling towards insolvency, and the director engages in a cryptocurrency transaction that is not in the best interests of creditors, the director can face liability under ss 214/246ZB, IA 1986.

In come the cavalry

The government has announced that the UK is set to be a global cryptoasset leader, but as the above shows, the courts are still grappling with the basics—time will tell. On 31 May 2022, HM Treasury launched a consultation on managing the failure of systemic digital settlement asset firms. It has proposed including certain systemically important cryptocurrency firms within a modified financial market infrastructure special administration regime so as to slowly bring in some kind of regulation. Perhaps this consultation will shed some light on the above issues, as encountered in insolvency. Watch this space! NLJ

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