DISPUTE RESOLUTION ALERT

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CLIFFE DEKKER HOFMEYR

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The crypto winter: New challenges for insolvency practitioners

It has been a difficult year for the global economy, with reports from the World Bank indicating that countries worldwide are entering what may turn out to be a protracted era of weak growth and high inflation. Companies in almost every sector of the economy have been affected, and those operating in the crypto space have not been immune. In fact, the crypto market saw a 55% decline in market capitalisation at its worst point in mid-June this year. This led to what has become known as the "*crypto winter*", which is essentially a prolonged period of declining cryptocurrency asset prices compared to previous peaks.

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The crypto winter: New challenges for insolvency practitioners

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The crypto winter has led to many crypto exchanges and other companies that trade in or hold cryptocurrencies becoming hopelessly insolvent. Insolvency practitioners are now faced with an array of new and interesting problems when it comes to dealing with the liquidation of these companies. This article looks at certain aspects of the liquidation process that are particularly tricky to navigate when dealing with companies that hold assets mainly, or entirely, in cryptocurrencies (hereinafter referred to simply as "*crypto companies*").

THE MOMENT OF INSOLVENCY

While the date of the winding-up of an insolvent company is easily determinable, it is sometimes more difficult to determine the exact date on which a company actually becomes insolvent. The moment of insolvency (i.e. the moment at which the liabilities of a company exceed its assets), is important for purposes of determining whether certain transactions that were made prior to the winding-up of the company, stand to be set aside by the court on application by the liquidator.

This difficulty is enhanced when dealing specifically with crypto companies, for a variety of reasons. The first issue is that most crypto assets are extremely volatile, with the prices of these assets fluctuating by the minute. It is thus very possible for a crypto company to be balance-sheet insolvent for a few minutes, only to return to solvency depending on the change in the value of the crypto assets it holds. It is in fact very likely that many crypto companies are insolvent one day and solvent the next.

The second issue stems from the unregulated nature of the crypto industry as a whole. Crypto companies (especially exchanges or index funds) are often simply holding money on other people's behalf, and there are no restrictions on people withdrawing their money at any time. If a large investor suddenly withdraws and reinvests the next day, it could result in the short-term insolvency of the crypto company.

It is also possible for a crypto company to be trading whilst insolvent for a while, and it is only once a specific event occurs (such as a large investor trying to withdraw their funds) that anyone realises the fact of its insolvency. This makes it very difficult for liquidators to prove that certain transactions fall within the ambit of a disposition without value or a voidable disposition.

TRACING FUNDS

Once a liquidator has successfully proven that a transaction is voidable (or reversible) from a legal perspective, there are several practical difficulties in tracing the assets/funds that are the subject of the voidable transaction. In spite of the public nature of transactions

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on the blockchain (everyone has access to the ledger which records every transaction), it has become increasingly difficult for liquidators to trace crypto assets.

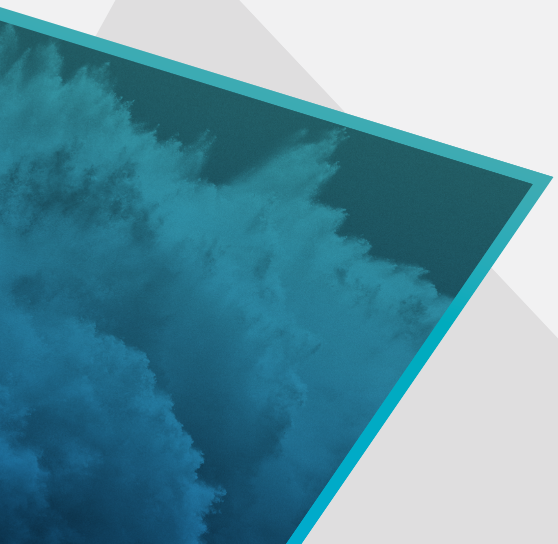
Generally, the first step would be to obtain a ledger containing the history of transactions from a blockchain tracing company. By reading this ledger, it is then possible to determine whether a private key (i.e. the "*account*" to which the money has been sent) is held by an individual, or by another crypto exchange.

If it is held by a crypto exchange, the liquidator can approach the court for an order forcing the exchange to disclose the relevant information relating to the account. However, it is often the case that the holder of the account has already transferred the funds elsewhere by making use of a program that "*mixes*" or "*layers*" the funds, such as Tornado Cash. Alternatively, an account holder could have only made several smaller transactions, which do not require them to provide KYC details to the exchange (apart from an email address).

If the money is held in a private key off of an exchange, then the liquidator would need to try and find a link between the private key (account address) and the real person. This could prove impossible. As a last resort, in the event that the cryptocurrency in question is not completely decentralised (i.e. it is created, managed and/or held by a company), the liquidator could potentially approach the court for a declaratory order. The court could then either order the company that has control over the cryptocurrency to freeze the specific funds or, more drastically, to burn (erase) the crypto that is held in the private key and then mint (create) the same amount of funds and deposit them into the account held by the liquidator. There are of course several potential issues with this approach and it has not been sufficiently tested by the courts.

DEALING WITH THE ASSETS

A common difficulty faced by a liquidator who has taken control of crypto assets, is to decide whether to convert the assets into a fiat currency (such a rands or dollars) in order to protect against the volatility of the coin. On the one hand this would ensure that the value of the assets remains certain, but on the other hand this value has the potential to increase if held in cryptocurrency. A liquidator would most likely have to apply for a court order allowing him or her to convert the assets into a fiat currency.



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The court would have to consider the fact that, if the assets are converted to a fiat currency, this could have massive implications (both practically and financially) for when the funds eventually have to be distributed to creditors. Due to the decentralised and anonymous nature of cryptocurrencies, the majority of creditors (being persons who traded crypto assets on an exchange or invested in cryptocurrencies through the crypto company) would prefer to remain relatively anonymous and are unlikely to consent to their personal *"real world"* bank account details being shared with a liquidator.

A possible solution would be to convert the assets to a stable coin such as tether (USDT), which are generally a lot less volatile than other cryptocurrencies. There are, however, other risks, our article on the crash of LUNA earlier this year being an example.

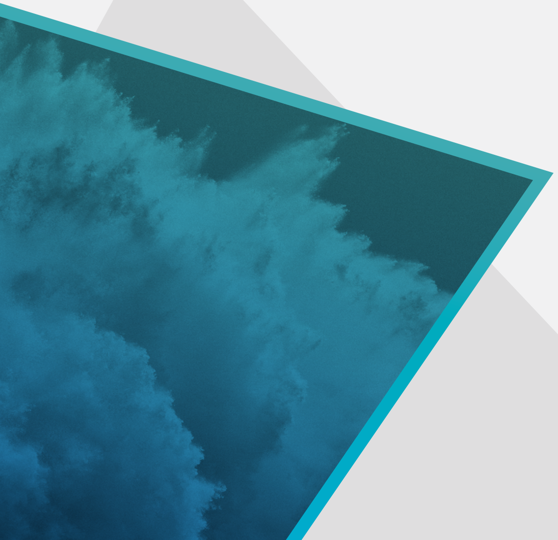
DISTRIBUTION OF FUNDS AFTER LIQUIDATION

Once a liquidator has overcome the difficulties set out above, there is still the issue of distribution of funds to creditors. Due to the typically vast number of creditors, a distribution of the crypto assets could involve sending funds to hundreds of thousands of crypto wallets held on an exchange. It is likely that any crypto exchange facilitating such a distribution would require some form of indemnity in the event that funds are misplaced or incorrectly allocated and the liquidator would essentially have to carry the risk of something going wrong. Alternatively, and if the liquidator had converted the crypto assets into fiat currency, obtaining access to a list of all the bank accounts held by thousands of creditors (even if provided willingly) could prove impractical. Additionally, the potential transaction fees involved in sending money to thousands of bank accounts held in various international countries would be a great concern.

CONCLUSION

The continuing crypto winter is likely to require more and more insolvency practitioners worldwide to grapple with the difficult, albeit interesting, issues discussed in this article. It is essential for young practitioners hoping to set themselves apart from the rest of the market, to gain a solid understanding of these unique difficulties and how to potentially deal with them.

LUCINDE RHOODIE AND KARA MEIRING



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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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