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Cryptocurrencies: Practical Considerations in Insolvencies

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In a recent report by INSOL International, only 5% of insolvency practitioners ("IPs") said that they had a "comprehensive or practical/working or understanding" of crypto-currency.

So with over 4,000 types of cryptocurrency now available and as payment technology continues to develop, we look at some issues facing IPs, including

- How to identify cryptocurrency
- How to categorise it
- How to take control of it and sell it; and
- What value does it have

What are cryptocurrencies?

The issue with the umbrella term "cryptocurrencies" is that it includes a wide range of features, many of which are technologically and conceptually complex. Helpfully, the Merriam-Webster dictionary defines the word as, "any form of currency that only exists digitally, that usually has no central issuing or regulating authority but instead uses a decentralized system to record transactions and manage the issuance of new units, and that relies on cryptography to prevent counterfeiting and fraudulent transactions".

Simply, cryptocurrencies are an electronic cash.

Cryptocurrencies are stored and transferred between users digitally, typically using a new technology known as Blockchain.

What is a block chain?

Blockchain is decentralised – there is no central authority recording the movement of cryptocurrency between users. Instead, each user's account independently verifies and records each transaction that occurs across a network, keeping a record of the amount of currency that existed in each account before the transaction, the date and time of the transaction, the amount of cryptocurrency transferred and the amount in each account after the transaction.

Each record is known as a "block" and each account in the network adds this block to the chain of records of previous transactions, hence "blockchain".

Advantages and disadvantages of cryptocurrencies

Information recorded in a blockchain is encrypted, protecting the identity of each user and the details of the transaction. This allows the database to be exceptionally accurate and secure, whilst keeping anonymity and transparency across the network.

Cryptocurrencies are currently unregulated in the UK.

Because they are not asset-backed or linked to the price of government-issued currencies such as the pound – their value is determined exclusively by consumer demand.

This leads to volatility in price as demand rises and sinks (or soars and plummets as demonstrated by Bitcoin), unlike traditional currencies. This is more reminiscent of stock markets; which bring us on to the initial issue with cryptocurrencies – what class of asset are they?

Categorising cryptocurrencies

Cryptocurrencies are a new development with many features that don't sit comfortably with traditional definitions:

Are they a currency as their name suggests?

Cryptocurrencies do share some similarities with cash – they can be exchanged for goods and services with a (albeit non-universal and exclusive) community.

However, they are not recognised as legal tender by any country and unless they are, and are accordingly regulated as such, they are not legally recognised as a currency.

A financial instrument?

Again, cryptocurrencies bear a resemblance to securities – they can be traded on exchanges and their value is based exclusively on demand.However, they are not recognised by any government as a "financial instrument" (across the EU, as per the Markets in Financial Instruments Directive) and until they are regulated by the FCA or another applicable regulatory authority, they cannot be legally accepted as such.

Are they a commodity?

Perhaps the most practicable treatment of cryptocurrencies is that they are a commodity, similar to gold.

They can be bought and sold with legal tender, traded with those limited dealers who accept them and their inherent value lies in their increase in cost.

Although it is currently uncertain how future legislation or judicial treatment will classify them, the Bank of England has commented in their Financial Policy Committee Statement in March 2018:

"Their values are currently too volatile to be widely used as a currency or a store of value and, with transaction costs high and settlement times slow, they are an inefficient media of exchange. Their use in payments is minimal in the United Kingdom. They should be considered as assets rather than currencies. However, as assets, they establish no claim on any future income streams or collateral. They have no intrinsic value beyond their currently limited potential to be adopted as money in the future, and hence could prove worthless."

Dealing with cryptocurrencies in insolvency

So what issue might an IP encounter when dealing with cryptocurrencies in an insolvent estate?

How do you identify cryptocurrencies as assets of the company?

The starting point is information received from the directors of the company and so, to an extent, a practitioner's knowledge will be reliant on their existence being disclosed to them.

Further information may be obtained from the Company's books and records, with accounts and stock/asset lists possibly indicating the presence of cryptocurrencies.

Other records of the company might also help to identify ownership of cryptocurrencies, with the IP being advised to investigate bank statements to identify transfers from company accounts to sites that buy/sell cryptoassets.

How does an IP take control of cryptocurrency?

Cryptocurrencies are stored in electronic "wallets" (similar to online banking) which are accessed through publicly-available software, and require a passkey to access.

There is no public register of ownership of cryptocurrencies and, thanks to the cryptography which protects the integrity of the cryptocurrency and the identity of the users, it will be impossible to identify ownership without external assistance.

Anyone with access to the widely-available software and the passkey will be able to transfer cryptocurrencies to other accounts, or to sell them for cash, with no record of the transfer being available.

This will rightfully raise concerns to any IP who has experienced uncooperative directors and acting quickly to identify and take control of any cryptocurrencies will be important in that scenario.

How can cryptocurrencies be realised?

Realising cryptocurrencies will require a working knowledge of the software for that specific cryptocurrency and access to the exchange on which they are traded.

Whilst most software should be user-friendly to people familiar with computers and technology, IPs may have to engage specialist agents in order to realise any value.

With an uncooperative director, the nature, location and value of the cryptocurrency may not be easily ascertained and the IP may have to incur the expense of engaging a forensic specialist without certainty that the realisation from the cryptocurrency will return value to creditors.

What value can cryptocurrency achieve?

Cryptocurrencies are traded on exchanges similar to the London Stock Exchange or NASDAQ, and the value of cryptocurrencies should be easily identifiable from the exchanges, which show a price per unit of cryptocurrency.

However the value of cryptocurrencies is incredibly volatile and the price achievable is highly dependent on the timing of the transaction. For example, the value of Bitcoin dropped from $13,880 on Wednesday 26th June to $11,200 just 15 hours later..

The timing of the sale is therefore critical to the realisation of maximum value of cryptoassets and this raises the issue that IPs will potentially be exposed to criticism for selling at an undervalue.

Taking advice from a specialist on the best time to sell will help to reduce that risk, however this may cause problems with IPs prolonging insolvencies waiting for the market to rise.

Antecedent transactions

In the event that an IP discovers that a challengeable transaction involving cryptoassets has occurred prior to insolvency, how can a transaction be challenged to recover the cryptocurrency, or the value of the cryptocurrency, into the insolvent estate?

The antecedent transaction provisions in the Insolvency Act appear to be be drafted widely enough to cover cryptocurrencies as an asset of the estate, however there are an array of problems that occur generally in litigation that apply specifically to cryptocurrencies.

For example, how will the IP obtain any evidence? Although all the transfer information is stored in the blockchain, this is encrypted and will require specialist assistance to uncover the information, if this is even possible.

Depending on the claim brought, the IP might need to prove there was cryptocurrency in the estate previously; that the cryptocurrency was transferred; when the cryptocurrency was transferred and who the cryptocurrency was transferred to.

These will all be in addition to the usual hurdles to an Insolvency Act claim.

An IP will likely need to engage a forensic specialist to uncover this evidence, however funding these investigations might prove difficult, particularly when there are no funds in the estate and no guarantee that an action will result in a recovery.

Conclusion

Currently, these issues will only affect the few company/individual insolvencies that invest in cryptocurrencies.

In the short term, unless an IP is appointed over an estate where trading in cryptocurrencies is the principle business, an awareness of cryptocurrencies and a basic working knowledge of them should be sufficient, given the relatively narrow spread of their use. However, this is likely to change.

With the rise in prevalence of cryptocurrency, we expect cryptocurrency to become more prevalent in insolvencies too.

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