

FTX/SVB collapses, insolvency and D&O insurance issues

Tuesday 6th June 2023

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Speaker – Ryan Rubin

Senior Managing Director at Ankura, Head of Cybersecurity for EMEA.



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Common Causes of Insolvency

Potentially a **fraud** by the owner or insiders within the company?



It could have been as a result of a **major a system failure** ?

Previous/recent **regulatory or law enforcement action**.

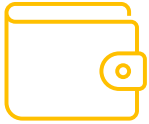


Lack of confidence could lead to a **run on the exchange?**

Finding the Keys to the Kingdom

Our primary goal is to gain access to the private keys that hold the exchange's remaining funds.

But what are these wallets / private keys?



Holds public and private keys



Public Key – Crypto equivalent of a Bank Sort Code and Account number

Private Key – Crypto equivalent of a Bank PIN number, generates public keys

An exchange maintains a variety of keys and wallet addresses for a variety of commercial purposes.

Private Keys, Relevant Evidence and Where To Find Them

Where are these keys?

- Can be Physical or Virtual devices.
- Phones, Computers & Laptops
- USB devices, crypto hardware devices
- Servers, Cloud storage
- Emails
- Messaging Applications
- Exchange Accounts
- Password Managers
- Paper (Private Keys & Recovery Seed phrases)



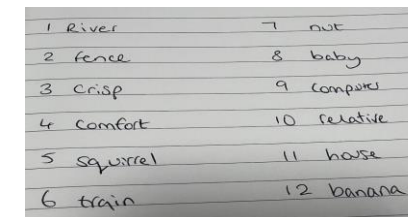
1Password



Google Authenticator



LastPass...



Investigation Overview – Fact Finding (list of questions)

Asking the Right Questions to Unlock the Truth

Early formal interviews of stakeholders helps to document evidence of fraud and cross examine people later once hard evidence has been obtained.

During interviews we want to verify:

- The existence of any **recent independent accounting audits** ?
- Is there an **inventory of keys** owned by the entity?
- Does the **entity own other crypto entities**?
- **Who has control and custody of the keys**?
- **How do payments get facilitated**?
- Is there an **internal ledger for the exchange**?
- **How are client deposits and withdrawals are managed**?
- Does the exchange **hold underlying assets or where they using another exchange**?

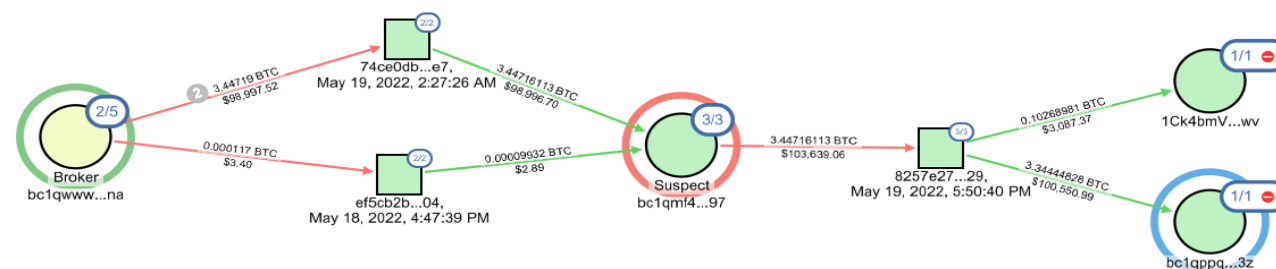
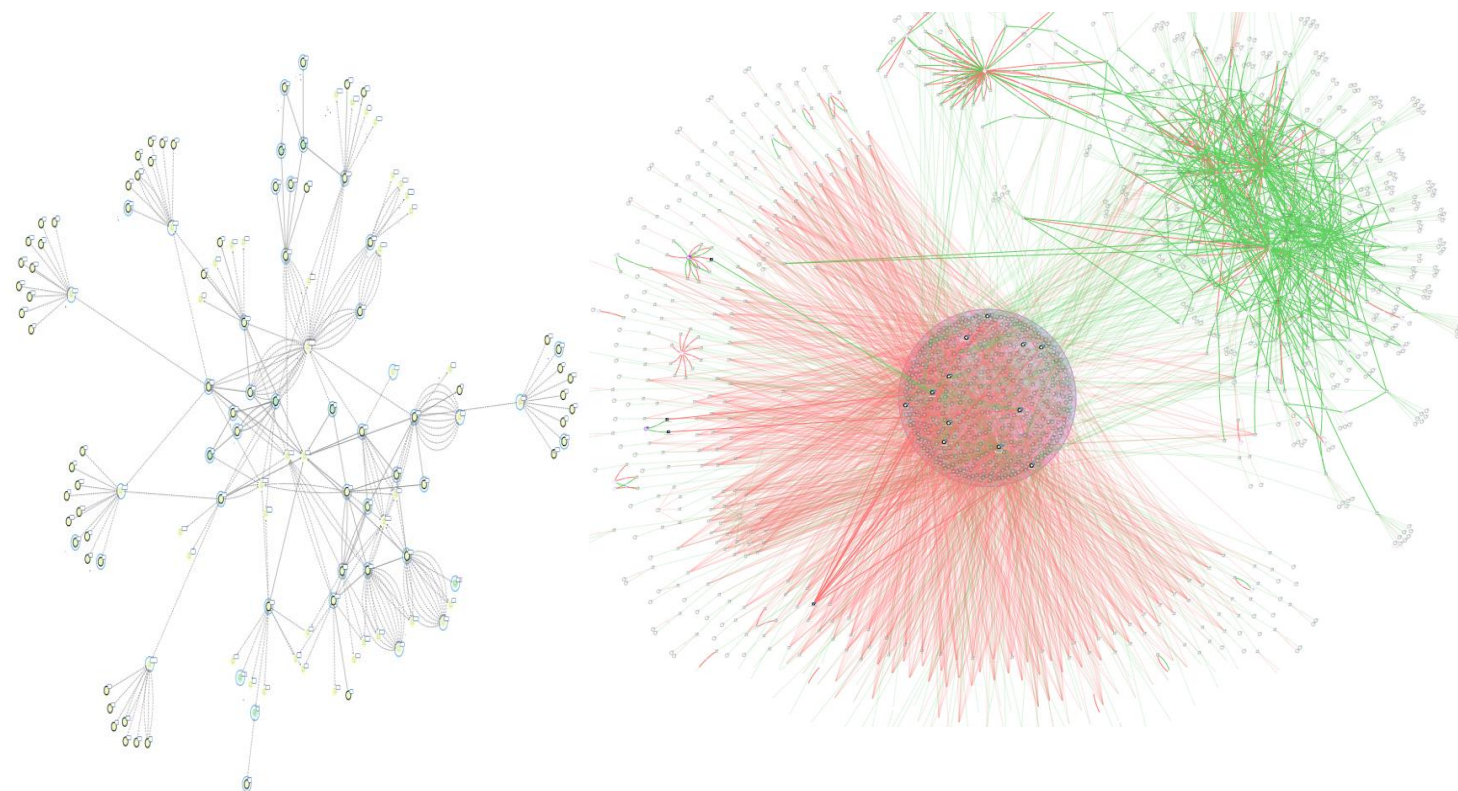
The Art of Tracing

Blockchain tracing and forensic accounting correctly applied allows us to follow the trail of funds which may lead to further recoveries.

Managing expectations on crypto asset tracing/recovery is important

Hosted v Unhosted Wallets – what happens **when funds end in an unhosted address?**

Exchanges are more cooperative, though not all are in friendly jurisdictions



Avoid Red Flags Found in FTX

“Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here.”

- John J. Ray III, New FTX CEO

- Comingling funds
- Lack of Board Meetings
- Inability to provide a list of employees
- Lack of audit trail / auditors
- Funds being used as “casino” money
- Lack of segregation of duties
- Fund flows between FTX and other companies with preferential loans etc.

Proactive steps for Consumers



Routinely maintain reports of balances to prove ownership of funds



Withdrawals of priority assets – a failing exchange may prevent trading of certain coins



Considerations for fiat balances – may hold slightly different rights than crypto assets.



Come together with other creditors to put pressure on the liquidators



Formally lodge request for funds to ensure inclusion in the creditors list.



Is crypto held within the exchange the customers or part of the exchange's estate



Obtaining legal advice is key

Finding is One Thing, Recovery Another.

If we are **fortunate to find value**, what happens next? We need to look at the legal realm for answers:

- Who do the funds legally belong to?
- How do we deal with the funds if the exchange, customers and owners are in different jurisdictions ?
- If there is value in deposit addresses can Clients claim these directly ? Do these belong to the wider estate?
- How do wider funds recovered that have been co-mingled get allocated to clients?
- What happens if funds identified are linked to sanctioned entities? Can they be reallocated?
- How would insurance be considered (liquidator, owner, customers of exchanges)?





FTX, Insolvency and D&O Insurance

BRIDGET WILLIAMSON – BARRISTER, ENTERPRISE CHAMBERS

CELSO DE AZEVEDO – BARRISTER, ENTERPRISE CHAMBERS

CRYPTOCURRENCY IN INSOLVENCY

The officeholder's duties

- Collection and realisation of the company's assets
- Distribution to the company's creditors
- Section 143, Insolvency Act 1986 ("the Act")
- See also section 305 of the Act in relation to insolvent individuals

Are cryptocurrencies assets?

- The two classes of personalty in English law
- Choses in possession
- Choses in action
- Are they comprehensive?

What have the courts said?

- *AA v Persons Unknown, Re Bitcoin [2019] EWHC 3556*
- *National Provincial Bank v Ainsworth [1965] 3 WLR 1, HL*
 - definable
 - identifiable
 - capable of assumption by third parties
 - having some degree of permanence

What is property for the purpose of the Act?

- Section 436 defines property as “*including*”:
- *“Money, goods, things in action, land and every description of property wherever situated and also obligations and every description of interest, whether present or future or vested or contingent, arising out of, or incidental to, property”*

Cryptocurrency - property subject to trust

November 2019 - UK Jurisdiction Taskforce's "Legal statement on Crypto assets and Smart contracts"

*"...whether the many statutory and common law rules applicable to property apply also to crypto-assets and, if so, how. Of particular significance are the rules concerning succession on death, **the vesting of property on personal bankruptcy, the rights of liquidators in corporate insolvency, and tracing in cases of fraud, theft or breach of trust. It would, to say the least, be highly unsatisfactory if rules of that kind had no application to crypto-assets.**"*

Cryptocurrency - property subject to trust

- Wang v Darby [2021] - *"transfer of digital assets...could constitute a trust"*
- *Ruscoe v Cryptopia Ltd (in Liquidation) [2020] NZHC 728*
- *Re Gatecoin Limited [2023] HKCFI 91*

The problem of access

- Wallets and keys?
- What powers does the officeholder have at his disposal?

Section 234 of the Act - getting in the company's property

"(2) Where any person has in his possession or control any property, books, papers or records to which the company appears to be entitled, the court may require that person forthwith (or within such period as the court may direct) to pay, deliver, convey, surrender or transfer the property, books, papers or records to the office-holder."

- Note *"... to which the company appears to be entitled"*
- How are questions of ownership decided?

What is the *lex situs* of a cryptocurrency?

- *Danisz v (1) Persons Unknown (2) Huobi Global Limited [2022] EWHC 280 (QB)*
- the *lex situs* is the jurisdiction where the owner is domiciled

What if section 234 does not apply?

- Section 235 – the duty to co-operate

"(2) Each of the persons mentioned in the next subsection shall—

(a) give to the office-holder such information concerning the company and its promotion, formation, business, dealings, affairs or property as the office-holder may at any time after the effective date reasonably require, and

(b) attend on the office-holder at such times as the latter may reasonably require."

Who are the relevant persons?

Officers (directors, secretary, managers), employees, anyone involved with the formation of the company if this occurred within a year before the start of the insolvency

Section 236: inquiry into a company's dealings

- *"(2) The court may, on the application of the office-holder, summon to appear before it—*
- *(a) any officer of the company,*
- *(b) any person known or suspected to have in his possession any property of the company or supposed to be indebted to the company, or*
- ***(c) any person whom the court thinks capable of giving information concerning the promotion, formation, business, dealings, affairs or property of the company.***
- *(3) The court may require any such person as is mentioned in subsection (2)(a) to submit to the court an account of his dealings with the company or to produce any books, papers or other records in his possession or under his control relating to the company or the matters mentioned in paragraph (c) of the subsection."*

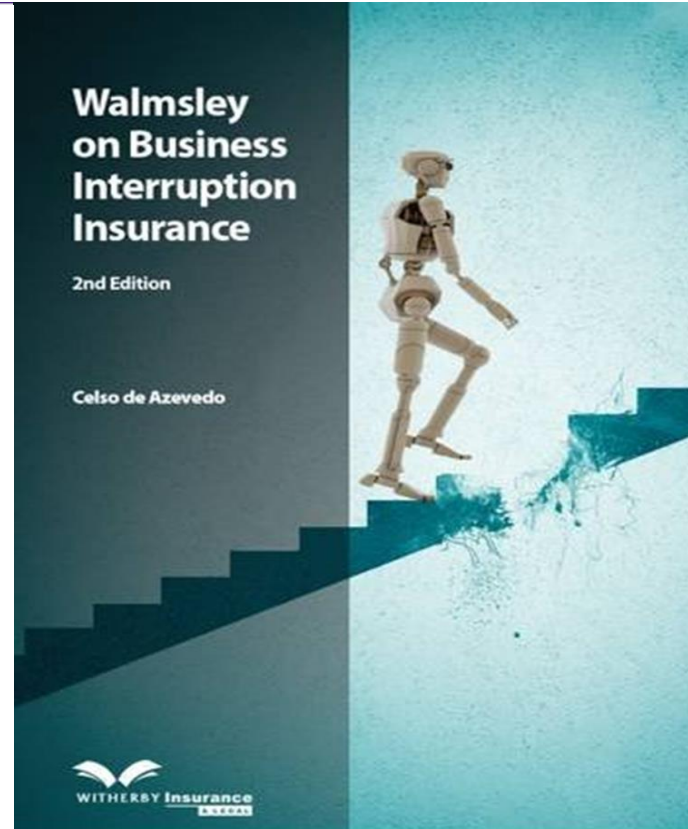
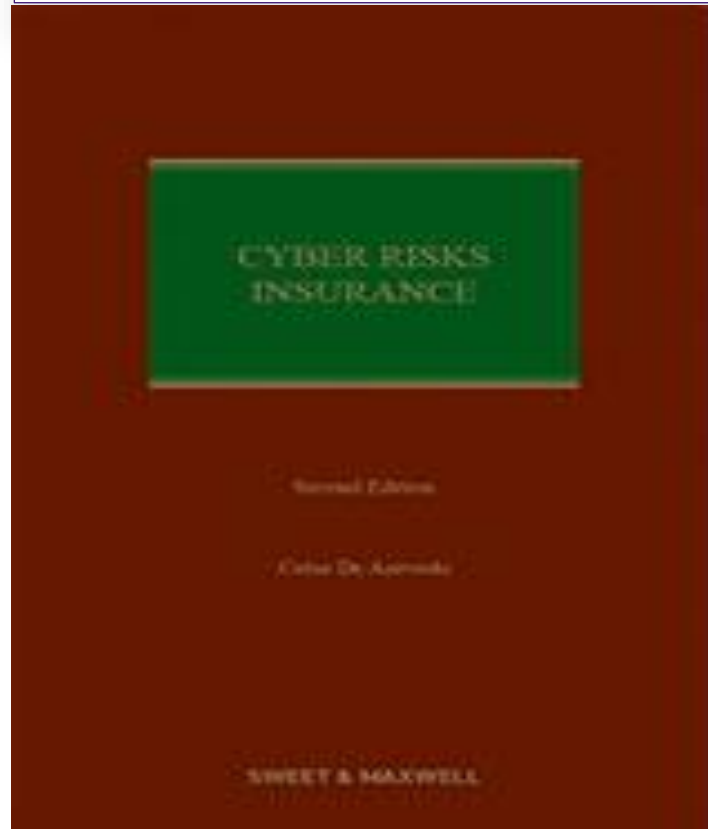
Do the sections operate extra-territorially?

- Conflicting lines of authority
- *Re Carna Meats Ltd (In Liquidation); Wallace v Wallace [2019] EWHC 2503 (Ch)*
- A note of caution

Speaker

Celso De Azevedo

Barrister, Enterprise Chambers



CRYPTOCURRENCY IN INSOLVENCY – MULTIJURISDICTIONAL ISSUES

Cryptocurrency and foreign insolvency issues

- S. 221 of IA 1986 - wind-up of foreign companies
- Debtor's COMI - 'centre of main interest' within the jurisdiction (?)
- R.14.1 of IR 16 - Proof of crypto-debt in insolvent estate as a 'liability to pay money or monies worth'
- R.14.21 of IR 16 – convert cryptocurrency as if foreign currency (?)
- Service of Petition by NFT (?) – cf: *Osbourne v Persons Unknown & Ozone* [2022]

Cryptocurrency in insolvency

- Dooga Ltd (t/a Cubits) (In Liquidation) [2018] – hack and theft of £29m
- Administrators for the UK-based cryptocurrency exchange and storage facility had:
 - i. located the digital wallets containing the company's cryptoassets;
and
 - ii. verified all transactions

Cryptocurrency in insolvency

- *Dooga (cont...)*
- But Ad/ors could not transfer back – no access to the private keys
- No English Court Order to secure access to the *private keys* from foreign-based parties (hackers, recipients and exchanges)
- Assistance of California Bankruptcy Court (2020/2021)
- Cf.: Miracle World Ventures Limited (In Liquidation) operating as “Globix” or “Globix Cash” (BVI)’ – freezing and disclosure orders in Gibraltar

CRYPTOCURRENCY INSOLVENCY AND INSURANCE

Claims against office holders

- Freezing and Disclosure orders
- Knowing receipt, dishonest assistance, unjust enrichment, deceit, fraudulent misrepresentation and constructive trust proprietary remedies
- Shareholders - Failure to maintain adequate cyber security and/or obtain cyber insurance

Claims against office holders

- Insolvency
 - Misfeasance (IA 1986, s 212), Fraudulent trading (IA 1986, s 213 or s 246ZA), and Wrongful trading (IA 1986, s 214 or s 246ZB)
 - Adjustment of prior transactions - transactions at an undervalue (IA 1986, s 238), preferences (IA 1986, s 239) and transactions defrauding creditors (IA 1986, s 423)

Cryptocurrency – insolvency and D&O insurance

- Aggregate limit of indemnity and claims made
- Prior knowledge or acts exclusions
- Wilful Misconduct; Wrongful acts; criminal acts; and fraud exclusions – before final adjudication or prior consent (implied reasonableness ?)
- S. 174(1) of the CA 2006 - director's duty to 'reasonable care, skill and diligence'

Cryptocurrency – insolvency and exclusions

- Prior consent for settlement and/or for defence costs exclusions - liability reduction basis / implied reasonableness (?)
- 'Other insurance' exclusions – e.g. Professional Indemnity and E&O insurance - Restitutionary claims exclusion
- Financial mismanagement/insolvency; and Insured vs Insured exclusions
- Contractual liability; professional services; and retirement or resignation exclusions

CRYPTOCURRENCY RECOVERY

Proprietary Freezing Injunction

- AA v Persons Unknown, Re Bitcoin [2019] – (Westdeutsche)
- Toma & True v Murray [2020] (Damages)
- Ion Sciences Ltd v Persons Unknown [2020]
- Fetch.AI Ltd & Anor v Persons Unknown Category A & Ors [2021]
- Cf.: Ion Sciences Ltd v Persons Unknown, Binance Holdings Limited, Payward Limited and Miriam Corp LP [2022] (third party debt order)
- Law v Persons Unknown & Huobi Global Ltd [2023] (transfer of crypto-assets' value to the jurisdiction)

Proprietary Freezing Injunction - Against Exchange

- Sally Danisz v Persons Unknown and Huobi Global Ltd [2022]
- Jones v Persons Unknown [2022]
- LMN v Bitflyer Holdings Inc & Binance & ors [2022] (disclosure)
- Osbourne v Persons Unknown & Ozone [2022] and [2023] (NFT treated as property)
- C.f.: Piroozzadeh v Persons Unknown Category A & Ors [2023]

Any Questions?

Contact us

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