

# Crypto Insolvency

**Ten things every director of a crypto firm needs to know when things start to go wrong**

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Whilst the crypto ecosystem continues to make considerable progress in building out its infrastructure and ‘institutionalising’ the space, many crypto players are facing challenges due to a broad range of issues, from a fall in cryptoasset prices to more regular start-up challenges. This is forcing many well-intentioned crypto firms into financially distressed situations with the need to urgently restructure their operations or redefine their business strategy in order to stay afloat.

We set out below ten things that any director or senior executive of a crypto entity needs to know:

## 1. When am I considered insolvent?

In many jurisdictions, an insolvency test involving a cash flow and / or balance sheet assessment is used to determine a company's financial status:

- a. Cash flow test – does your company have the ability to service its debts as and when they fall due?
- b. Balance sheet test – are your company's assets greater than its liabilities?

Should your company's finances fail to meet one or both of these tests, your company may be deemed to be insolvent.

## 2. How is it different with cryptoassets?

As for any other volatile asset class, cryptoassets with their wide swings in value require extra care when assessing your company's financial viability. Further, the lack of clarity on the accounting treatment of cryptoassets and as of yet, no broad consensus on taxonomy in the crypto world or how to accurately value cryptoassets, means that ambiguity may arise when evaluating the solvency status of your crypto firm.

Given these complexities, we highly recommend that you seek advice from legal and financial professionals if you are in doubt about your crypto firm's solvency status. This [recent publication](#) from PwC on the valuation of cryptoassets could be a useful tool for you as well.

## 3. Can someone in senior management be held responsible for a crypto company's insolvency even if they are not a director?

The short answer is yes, subject to the legislation of the jurisdiction you are operating in.

Even if you are not formally appointed as a director, if you are a member of senior management you may be caught within the responsibilities and obligations of a director if you typically take on roles associated with a director. Whilst this will be assessed on a case by case basis, if you are deemed to be a shadow or de facto director, then the statutory duties of a director apply to you too.

Typically directors are expected to exercise reasonable care, skill and diligence. There is also a duty of loyalty to act in the company's best interests and not for personal benefit. As a director or de facto director, you are expected to be aware of relevant statutory and regulatory rules including corporate governance and anti-money laundering legislation. A breach of such rules may lead to disciplinary procedures including private reprimands, public censure and criticism.





#### **4. When does my fiduciary duty shift from serving my shareholders to serving my creditors?**

As a director of a company in good financial standing, you owe a duty to act in good faith and in the best interests of all its shareholders. However, when a company is in financial distress or becomes insolvent, the onus shifts and the interests of the company's creditors are paramount. You must act in a way to minimise the potential loss to them.

The reason for this is that, if your company is insolvent and goes into liquidation, creditors have priority for repayment before shareholders. Failure to consider the interests of creditors when your company is in financial distress can lead to legal proceedings being brought against you and potentially disqualification from taking on other director appointments in the future.

#### **5. What can I do if I know that my company may be insolvent?**

Time is of the essence to make informed choices when a company is facing financial distress and insolvency. If appropriate actions are not taken there is always a risk that you may lose control of your company if creditors take enforcement actions against it.

If you still have good relationships with your major creditors, you may be able to agree some breathing space (a so-called informal standstill or moratorium against taking action) with them. This period of time could allow you to come up with a restructuring plan and / or to sell non-core assets to satisfy outstanding debts.

However, if relationships with key creditors have deteriorated to a point where there is a lack of trust and open communication, a disgruntled creditor may take enforcement action to initiate formal insolvency proceedings against your company (a 'compulsory liquidation' process) and to appoint a liquidator.

Note that in many jurisdictions, directors and shareholders may have the option to initiate the insolvency proceeding themselves and to place their company into liquidation (a 'voluntary liquidation' process). And don't be put off by the term 'liquidation'. In some jurisdictions companies can be placed into a 'soft touch' liquidation where management can remain in place in order to put forth a restructuring plan.



## 6. What is a liquidator and do I need one?

A liquidator is a person appointed who has the duty to manage the affairs of a company in liquidation. Their main responsibilities are to collect in the assets of the company in order to settle its outstanding debts, but also to investigate the conduct of the directors and eventually dissolve the company. Upon the appointment of a liquidator, the powers of the directors cease but not the duties.

In the case of a compulsory liquidation, a disgruntled creditor will have made the decision to appoint a liquidator through a Court process. Whilst you may be able to put forth a choice of liquidator, there is no guarantee that your named individual will be appointed – in the usual course, the creditors, and or the Court will make that decision.

It is also worth noting that regardless of whether a liquidator was nominated by you or another party, a liquidator in a compulsory liquidation is an officer of the Court and their powers and conduct are governed by the legislative framework of the jurisdiction in which they have been appointed. Their primary duty is to the Court and to the creditors of the company, not to you.

Note that in most jurisdictions, the liquidator is a personal appointment and not the firm for whom he or she works for.

## 7. I operate in many jurisdictions. What rules apply?

Most crypto firms operate in several jurisdictions. In an insolvency scenario, the Centre of Main Interest ('COMI') becomes relevant when considering which jurisdiction's laws take precedence if insolvency proceedings have commenced in different jurisdictions.

Assessment of COMI includes the place where the company conducts the administration of its business on a regular basis. In the absence of proof to the contrary, the COMI may be presumed to be the place where its registered office is located. Insolvency proceedings in the COMI will be deemed as being the 'main' proceedings.

Certain jurisdictions are viewed as being either more 'debtor friendly' or 'creditor friendly'. This distinction enables forum shopping to take place whereby proceedings can be commenced in the most appropriate jurisdiction subject to connectivity to that jurisdiction. Typically, the U.S. is perceived to be debtor friendly due to its Chapter 11 reorganisation regime in which a company's management remains in control of its business operations subject to oversight and jurisdiction of the court.

In contrast, the United Kingdom and Hong Kong are viewed as being creditor friendly as directors typically lose their powers and a liquidator assumes operation and control of the company. Some offshore jurisdictions such as Bermuda and Cayman Islands offer something in between: a liquidator is appointed but does not assume control of the company rather he assumes an oversight role over management who stay in place – 'soft touch'.

Experienced legal and financial advisers can provide you with guidance on how to navigate COMI issues should your crypto firm be heading towards insolvency.

## 8. What is my liability and what do I need to do?

If a disgruntled creditor takes enforcement action to appoint a liquidator, you lose control of the process. There will be a scrutiny of your actions; in particular if and how quickly you took action to preserve value and prevent further losses prior to the appointment of the liquidator.

You will be held to account for both what you did and what you failed to do. Failure to act appropriately and in the interests of creditors and shareholders may expose you to legal proceedings.

It is important to realise that when an external liquidator is appointed, they have a statutory duty to investigate the actions of directors. This may lead to civil and criminal proceedings (rare) against you including fines, imprisonment (very rare), disqualification and exposure to personal liability.

In particular, you run the risk that a wrongful or fraudulent trading claim, also known as deepening insolvency, may be brought against you. Whilst the definitions and thresholds for such claims vary between jurisdictions, essentially the claim is that you knowingly allowed further debts to accrue without a reasonable expectation of payment and hence the threat of personal liability.

## 9. Can I choose which creditors I want to pay off first?

If in the months prior to liquidation you were paying off creditors merely on the basis of who was shouting the loudest prior to the liquidation, such payments may be deemed to be preferential payments and the payments themselves will be voidable.

Simply put, a liquidator may challenge any payments made before their appointment on the basis that a creditor was preferred above others - this so-called lookback period varies between jurisdictions and may depend on the parties involved. If proven to be an unfair preference, then the Court may order a return of the payment by the preferred creditor and directors may be liable for misfeasance.

Note that a liquidator is generally paid from the assets of the company. Such liquidation costs are an expense of the process and rank above creditors for payment.

## 10. Is there insurance coverage to protect me?

If you are a company director or officer you are able to purchase some protection, namely an insurance product known as Directors & Officers Insurance cover (D&O Cover). This can provide you with financial protection against the consequences of actual or alleged wrongful acts when acting in the scope of your managerial duties, i.e. covering defence costs when legal fees can add up. You should be aware however, that commonly D&O does not cover fraudulent, criminal or intentional non-compliant acts nor does it cover you if you obtained illegal remuneration or acted for personal profit. It is also worth bearing in mind that D&O Cover premiums can be hefty.

D&O cover purchased after distress (not possible after formal liquidation) will be expensive and cover will be limited.

It is important for directors to take sensible steps to mitigate the risk of liability, seek appropriate advice and review the company's options and record justifications for your decisions at each stage.



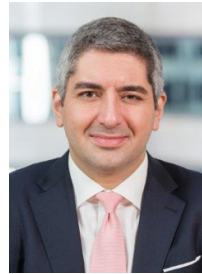
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