Distressed digital assets – surviving a crypto winter

With more than $2 trillion in losses in 2022 already and several crypto businesses in insolvency, many consider the state of digital assets to be in a crypto winter. Several major players in the digital asset space, including FTX, Three Arrow Capital, Celsius, have filed for bankruptcy protection leaving customers, creditors, lenders, investors, contractual counterparties, regulators and other governmental officials out in the cold.

In response to this growing state of affairs, Dentons' and its global Restructuring, Insolvency and Bankruptcy (RIB) Group has compiled a list of 10 top legal, commercial and practical issues that should be considered when addressing issues of distressed digital assets. These considerations may differ from jurisdiction to jurisdiction so seeking specific input for the applicable jurisdictions where assets, borrowers or court proceedings are pending is important.

1. Check your space: are your digital assets secured and segregated?

When preparing for winter, one should check their closet, assess their equipment and assess whether they are prepared for the weather to come. Surviving a crypto winter is no different. One initial action a party should take is to assess their potential exposure, including understanding how their digital assets may be stored and used. For example, to the extent your digital assets are held in a segregated custodial account or "wallet," they should, in theory, be better protected in the event that digital platform fails. In contrast, digital assets stored in communal or omnibus wallets will prove more difficult to trace or obtain if the digital platform fails.

2. Do you *really* own and hold the digital assets or did you lend them out?

Imagine believing you own a snow shovel only to learn during a blizzard that you lent it out to a neighbor who has since moved from the neighborhood. In theory you may still own it, but little good this does you. In crypto cases, including Celsius, something similar may occur with respect to digital assets. In fact, certain usage agreements may expressly provide that you are surrendering ownership in digital assets or otherwise allowing the platform to use/borrow them. The result is that you may be an unsecured creditor in such a circumstance. Sure, you may have a claim, but if the debtor's assets may by insufficient to pay claims in full or at all, you may be standing in the cold without a clear path to recovery. Uncertainty may also arise as a result of a lack of clarity on the accounting treatment and legal status of digital assets. Their historic volatility in particular poses difficulties in accurately valuing those assets.

3. Check the weather and look out for the early warning signs of trouble

Before marching forward and assuming the weather is fine, a smart winter traveler checks the weather map and looks for signs of potential trouble. The same is true for those facing the crypto-winter. Warning signs may include the company breaching or being about to breach its financial covenants or overdraft limits or suddenly requesting new facilities or an extended repayment timetable or drawing down on a line of credit. The company may be under increased creditor pressure (including statutory demands, trade suppliers wanting to be paid down or other debt collection or winding up procedures) or subject to litigation, insurance claims or rent reviews, diverting management time away from the business. Management may be unresponsive to the stakeholder's questions or reluctant to share information with its stakeholders.

Other warning signs include the company:

- losing a key customer or supplier;
- suddenly losing or changing its management team, in particular the finance director;
- having a sudden change of auditors or trouble signing off its accounts;
- late delivery of information;
- supply chain disruptions;
- asking its bankers to send cheques for round amounts or postpone/push forward certain payments; or
- deferring any planned or regular capital expenditure.

Also, in the current banking climate, if a company with a previously good working relationship and without warning makes a spurious or unmeritorious complaint about an interest rate hedging product, that could be an attempt to draw attention away from more fundamental problems with its financial position.

Be prepared: information is key!

If a stakeholder spots any early warning signs, the stakeholder (or the company proactively) should consider:

- meeting with the company at regular intervals to open a dialogue and discuss strategies and options
- getting up-to-date financial information from the company, in particular monthly management accounts and cash flow statements as key indicators of expected future financial performance;
- asking your lawyers to review your security and priority position;
- instructing independent accountants to review the company's business, financial position and prepare accurate financials;
- carrying out regular lien, insolvency and other company searches against the company or its affiliates;
- instructing an expert to value important assets and determining whether the stakeholder has key current information about assets, such as accounts receivables and customer contact information, detailed inventory, passcodes and contact persons for electronic records and systems at the company, etc.; and/or
- assessing the company's out of jurisdiction presence, assets and creditors as this may impact on the choice and jurisdiction of any enforcement options later.

4. Talk to other stakeholders

Stakeholders may consider contacting other lenders and investors, and opening a dialogue with them to discuss a common strategy and information sharing. Take legal advice on any confidentiality restrictions first. Also review any existing intercreditor or subordination agreements including required notices and/or standstill periods or other provisions impacting remedies.

Once a stakeholder has identified and contacted other stakeholders its advisers can help the stakeholder put a standstill or other forbearance agreement in place to prevent others from taking action which would frustrate the overall strategy for the company. Depending on the number of other financial stakeholders and other important creditor groups the stakeholder may need to establish an ad hoc or other committee amongst the key creditors to simplify the day to day decision making process.

5. Decide on an initial strategy

Whether alone or part of a group of stakeholders, is the stakeholder going to support the company or consider taking action to minimize the stakeholder's exposure through enforcement mechanisms? Is the stakeholder planning to sell the asset to another financier or distressed fund (either as a one off strategy or part of the stakeholder's current strategy or risk policy)? Stakeholders can only make these decisions if armed with the right information.

A supportive strategy might include:

- providing new money (combined with taking new security) subject to pricing risk vs. reward;
- restructuring existing lending arrangements, giving time to pay, emergency short-term funding;
- considering new credit enhancement, for example, taking guarantees from directors, shareholders or group companies;
- standstill/forbearance agreements in conjunction with other lenders/investors; and/or
- other financial, operational or capital restructuring (see below).

A risk mitigation/enforcement strategy might include:

- identifying and calling events of default;
- accelerating loans or putting them on demand;
- cancelling existing commitments; and/or
- enforcing security and/or appointing an insolvency office-holder, receiver, chief restructuring officer or similar person.

6. Is some form of restructuring necessary?

A financial, operational and/or capital restructuring of the company and its business may be required alongside support.

A financial restructuring could include writing off debt, swapping debt for equity; or a loan restructuring. Operational changes could include giving the company time to implement its business turnaround plan; or facilitating a change in management (including a chief restructuring officer or stakeholder appointed director specialising in restructuring), or a change in business direction. The company may also look to restore distributable profits or balance sheet solvency by issuing new shares or reclassifying existing share capital.

7. Whatever the plan, consider the stakeholder enforcement options and potential future insolvency proceedings

A stakeholder's legal advisers will typically review security and credit documentation to establish defaults and enforcement methods open to the stakeholder, including a review of any inter-creditor terms to see if this restricts the stakeholder's options or affects priority of payment on enforcement. There may also be temporary regulatory or internal policy restrictions on the options normally available to the stakeholder (e.g. restrictions on the ability to enforce where a company remains subject to the review of the sale of interest rate hedging products or other items where applicable) and these need to be factored in and advice sought if there is any uncertainty. The stakeholder's legal advisers can also help to consider any cross-default issues; or investigate further the pros and cons of the various enforcement mechanisms.

Also the stakeholder and company will typically consider whether any alternative lending or funding for cash flow shortfalls and any insolvency proceeding is needed, either from existing lenders or investors or from new distressed funding sources, including potential priming or rescue loans. Having up to date appraisals of key assets/collateral of value may be important for pursuing or objecting to any potential priming financing.

8. Is the company insolvent?

In most jurisdictions, insolvency is determined by looking at either a company's cash flows – whether the company is able to pay its debts as and when they fall due, or a company's balance sheet – whether the company's assets are worth more than its liabilities. Uncertainty may arise as a result of a lack of clarity on the accounting treatment of digital assets. Their historic volatility in particular pose difficulties in accurately valuing those assets and therefore the ability to determine the solvency of a company holding or dealing in such assets. Financial or digital asset expert advice may be necessary to determine the true financial state of the company to answer the question of whether the company is in fact insolvent.

9. Prepare for more trouble: Did you receive a preference or avoidable transfer?

In many jurisdictions, payments to creditors to the detriment of other creditors where a company is insolvent or becomes insolvent are likely to be set aside and payment clawed back in favour of the company. Such transactions may be known as unfair preferences. However, there is currently some uncertainty on the accounting treatment and legal status of digital assets, whether they can properly be construed as being trust assets and whether their withdrawal or transfer close to or during insolvency would be deemed to be transactions that would trigger provisions on the setting aside of unfair preferences or similar. This is particularly relevant where, for example, customers make withdrawals of digital assets during or around the time the company becomes insolvent. These issues need to be carefully considered before digital assets are transferred or withdrawn where there is a risk doing so would lead to the company becoming insolvent.

10. Cross-border insolvency

In many jurisdictions, a company's centre of main interests (COMI) becomes relevant in determining the correct jurisdiction to govern that company's liquidation. COMI is determined according to certain criteria including the location of the company's registered office and the location from which control and direction was administered. COMI will have a material effect on the law that will be applied to govern an insolvency and therefore the rights and obligations of an insolvent company and its stakeholders. Many digital asset companies operate in multiple jurisdictions with complex corporate structures. An in depth analysis of a company's COMI will likely be necessary to determine where insolvency proceedings should be commenced to avoid approaching an inappropriate forum leading to additional cost, time and possibly the loss of opportunity to have control over the insolvency.

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