

A Brave New Crypto World

Liquidating Cayman Islands Companies holding Crypto Assets

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1. Introduction

Blockchain technology has provided us with new creative opportunities. From alternative democratic and creative funding models to revolutionary information storage/maintenance solutions and applications, the list is almost endless. 2016 and 2017 saw the emergence and popularisation of blockchain technology's ability to create Crypto Assets¹ through the Crypto Asset issuance process known as "Initial Coin Offerings" ("ICOs"), though this is by no means the only way to create Crypto Assets using blockchain technology. The Cayman Islands is one of the leading ICO jurisdictions based on funding volume given that the availability of high quality service providers, the predictable legal system and the stable yet progressive political climate all complement and encourage the development of innovative business. Nevertheless, many issuers of and investors in Crypto Assets and many advisors have exclusively focused on legal and regulatory compliance when creating and issuing Crypto Assets. This front-ended focus has led many to overlook the potential challenges that may arise when things don't go according to plan. This could be of particular relevance if Cayman Islands issuers of tokens and Cayman Islands custodians of Crypto Assets become insolvent since, considering their day-to-day business and operational needs, they may hold a substantial amount of their value in Crypto Assets (each such asset having differing degrees of liquidity and worth). This article aims to: (i) highlight some of the technological hurdles that liquidators may face when confronting the technology that underpins this new asset class; and (ii) outline some of the options available to Cayman Islands liquidators when liquidating a Cayman Islands company² that holds, or held, Crypto Assets.

2. Technological Hurdles

2.1 Foresight and Planning

In circumstances like those surrounding recent developments regarding QuadrigaCX,³ one of Canada's largest cryptocurrency exchanges, where due to a lack of diversified storage protocols the death of its founder, who had exclusive access to the encrypted cold wallets holding over US\$100 million in cryptocurrency, left the exchange with no way to access the cryptocurrency, liquidators will face enhanced difficulties in retrieving information and applying the tools traditionally available (see Section 3 below). It remains to be seen whether the development of technology and quantum computing can one day provide a solution in accessing the currently inaccessible. If QuadrigaCX had used, for example, multi-signature wallets to hold its cryptocurrency, or structured the storage of its cryptocurrency such that its existence was not entirely reliant on the consciousness of a single person, the inevitable pitfalls for QuadrigaCX could have been avoided. This further stresses the importance of engaging legal and technical advisors who are knowledgeable in this space from the outset.

¹ For the purposes of this article, the term Crypto Asset refers to distributed ledger products like cryptocurrency (i.e. Bitcoin, Ether), tokens and other Crypto Assets that share similar technological properties.

² Reference to companies and liquidators in this article are limited to Cayman Islands companies and liquidators.

³ See the recent case of QuadrigaCX, one of Canada's largest cryptocurrency exchanges that serviced over 92,000 customers, which recently filed for creditor protection in Nova Scotia after its founder, Gerald Cotton, who had exclusive access to the encrypted cold wallets holding over US\$100 million in cryptocurrency, died in India leaving the exchange with no way to access the cryptocurrency. Recent reports have since confirmed that the cold wallets were emptied prior to Gerald Cotton's death.



2.2 Alternative Relief?

Blockchain's irreversible and immutable nature will present challenges to Cayman Islands liquidators. For example, under Cayman Islands law, liquidators can seek to unwind transactions made by a company that occurred in the lead up to a company's liquidation which are later deemed voidable for reasons of fraud or preference. However, unwinding the transfer of Crypto Assets recorded on a blockchain is, in most cases, close to impossible. By virtue of the way blockchain technology records information in an irreversible chronological manner, seeking to unwind a transaction on a blockchain, particularly public blockchains maintained by thousands of miners, would be impossible in most cases.⁴

Yet, in circumstances where an order sought by a Cayman Islands liquidator is impossible to enforce when confronted with such technological hurdles, liquidators do retain the ability to apply to the Grand Court of the Cayman Islands (the "Court") and seek alternative relief including, for example, orders for the payment of money, the transfer of Crypto Assets and other orders requiring a certain alternative action being taken which will assist in circumstances where the typical course of action is ultimately found to be impractical given the idiosyncrasies of this new asset class.

Cayman Islands liquidators can also at any time during the liquidation of a company apply to the Court to seek sanction in respect of any decision or particular course of action. There will no doubt be an increase in these types of sanction and/or validation applications being heard before the Court when the first crypto related liquidation proceedings commence in the Cayman Islands.

2.3 Who to enforce against?

Whilst certain options are available to Cayman Islands liquidators when seeking recourse during the liquidation of a Cayman Islands company that holds, or held, Crypto Assets (see Section 3 below), the availability of such options is dependent on the ability to identify the target to which such recourse will apply. Many Crypto Assets are created and transferred using pseudonymous⁵ blockchain technology, which typically means that one can identify the parties to a public Crypto Asset transaction but the names used by such parties are rarely their real, legal names. Such pseudonymity can make it difficult, if not impossible in some circumstances, to ascertain the underlying identity of transferors and transferees of Crypto Assets.

Whilst the availability of certain orders will depend on the circumstances and the orders being sought, in an entirely pseudonymous context, where the underlying identity of transferees and transferors of Crypto Assets cannot be ascertained, the ability to hold parties accountable, establish the legal and beneficial ownership of assets, retrieve dissipated Crypto Assets, compel certain action and enforce Court judgments/orders will inevitably decrease. For example, when dealing with the dissipation of Crypto Assets relating to a public blockchain used by thousands of pseudonymous parties, the ability to seek or compel the cooperation of those maintaining the blockchain and processing Crypto Asset transactions will be limited. However, engaging knowledgeable counsel and technical advisors, either from the outset or during distressed situations, can assist in minimising the impact of the above risks from a legal and financial perspective.

In circumstances where it is possible to identify those maintaining the blockchain for the purposes of compelling cooperation or enforcing a judgment which would result in a change to the blockchain, the costs and practicalities in such circumstances would often be disproportionate to the result sought. It also remains to be seen whether the Court would grant orders that would result in a change to a blockchain (if at all possible) considering the irreparable damage such change would have on legitimate transactions previously recorded on the blockchain and to the reputation of the blockchain and the Crypto Assets to which it relates.

⁴ Such impossibility stems from the requirement to obtain a consensus (in most cases) of more than 50% of the miners of that blockchain to reverse the transaction. Despite the majority of blockchains pegging their consensus threshold to more than 50%, we note that such threshold levels may differ when analysing different blockchains.

It is also unlikely that such consensus would be obtained as the reversal of transactions recorded on a blockchain would require a significant expenditure of resources and would unfairly impact legitimate transactions that have been previously recorded on the blockchain and consequently damage the reputation associated to that particular blockchain.

When dealing with private blockchains maintained by a central entity or very few identifiable entities, whilst compelling such entities to unwind a transaction may be legally possible, it would generally demand a disproportionate and extortionate expenditure of resources, mainly financial, computing power and time, and may also cause irreparable damage to the reputation of the blockchain and any affiliated companies, thus rendering such recourse inappropriate in many cases.

⁵ Anonymity means that someone's identity is completely unknown. Pseudonymous means you are not using your real, legal name to identify yourself (<https://english.stackexchange.com/questions/224254/whats-the-difference-between-anonymous-and-pseudonymous/224263>)



2.4 Where to enforce rights

Blockchain technology's decentralised, global and borderless nature which underpins the maintenance and transfer of many Crypto Assets can sometimes cause uncertainty when determining how and where to enforce rights relating to Crypto Assets held by a company in liquidation. Nevertheless, the default position when dealing with and conducting the liquidation of a Cayman Islands company is that the rights should be enforced in the Cayman Islands. Upon the appointment of liquidators resident in the Cayman Islands, the necessary investigations can then take place to determine if the involvement of other relevant jurisdictions is required in the circumstances.

The Mt Gox case, which was one of the first high profile insolvency proceedings involving a cryptocurrency exchange (noting that such insolvency proceedings have since converted to a civil rehabilitation plan in Japan due to the substantial increase in value of the bitcoin that was retrieved), illustrates the many cross-border issues that insolvency practitioners may confront when dealing with the liquidation of a cryptocurrency business. One of the key issues in this case involved the cross-border recognition of the Japanese proceedings. Upon appointment, the Japanese trustee applied for recognition under Chapter 15 of the U.S. Bankruptcy Code in the United States and sought equivalent recognition orders in Canada to stay pending and active class actions in these jurisdictions. The borderless nature of blockchain technology and the digital assets it underpins will inevitably result in applications for cross-border recognition of insolvency proceedings being made in order for insolvency practitioners to benefit from the moratorium available.

3. Liquidators' Toolbox

Understanding the Crypto Assets held by an entity and how such assets are traded, created and stored is of paramount importance when fulfilling one's duties as a liquidator and searching through a liquidator's toolbox for the right tool when doing so. Here are some examples of tools that may be useful but their availability will depend on the assets held and the facts involved:

3.1 Section 103 Order

Where a company holds crypto assets and its management is being uncooperative or its crypto assets have been dissipated, Cayman Islands liquidators are able to compel the cooperation of 'relevant persons' as detailed in Section 103 of the Cayman Islands Companies Law (as revised) ("Companies Law") who are under a statutory duty to cooperate with liquidators.⁶ An application can be made to the Court under Section 103 for the delivery up of property, documents and information belonging to the relevant company and/or seeking an order for an oral examination of any relevant person of the company. To the extent that a relevant person's disclosure obligations have not been adequately satisfied under the terms of any order granted under Section 103, an application could be made to endorse the order with a penal notice. Non-compliance with an order containing a penal notice may constitute a contempt of Court and ultimately render a person liable to be imprisoned.

So where, for example, Crypto Assets have been transferred by a director of the company to a personal E-Wallet or hardware wallet maintained or held by an identifiable third party or by a director, or the transfer of such assets was processed by an exchange or custodian, a Cayman Islands liquidator may be able to compel the cooperation of such persons in connection with the retrieval of such assets. However, in circumstances where a company has failed to establish appropriate protocols for storing its Crypto Assets, retrieving information may prove more difficult (as the court appointed monitor is currently facing in the case of QuadrigaCX).

3.2 Norwich Pharmacal Order

To the extent the liquidator requires information from an individual not covered by section 103, a liquidator can seek a disclosure order known as a "Norwich Pharmacal" order, which compels a party to disclose information in circumstances where one has knowledge of a wrongdoing but not of the identity of the wrongdoer, but can identify another who has such information. [Click here](#) for our article on how recent legislative modernisation in the Cayman Islands has enhanced the effectiveness of the Norwich Pharmacal jurisdiction.

3.3 Bankers Trusts Order

A Bankers Trusts Order can be used to compel a third party to disclose details of financial activities which would otherwise be protected by a duty of confidentiality. In situations where there might be fraud, a Bankers Trusts Order can be useful in obtaining information required to urgently trace, recover or preserve assets to support a proprietary asset claim. This tool may prove valuable where the legal entity in liquidation conducted much of its crypto related financial activities via a cryptocurrency exchange or other identifiable third party which would ordinarily be subject to duties of confidentiality.

⁶ Liquidators can hire service providers who can assist in investigating the source and destination of Crypto Asset transactions, increasing the likelihood of liquidators identifying targets to their ability to compel cooperation.



3.4 Anton Piller Orders

In addition to the availability of Mareva (asset freezing) injunctions in the Cayman Islands, an Anton Piller Order is an injunction (also known as a search and seizure order) designed to preserve evidence or property that is or might be the subject of an action or which may shed some light on the relevant circumstances. As with a Section 103 Order endorsed with a penal notice, a party who fails to comply with an Anton Piller Order may be held in contempt of court. Whilst seizing data may appear to be an attractive option if the location of the data is ascertained, implications surrounding data privacy and/or whether warrants are required to seize such information should be considered.

3.5 Gagging Order

Given the high risk of dissipation of digital assets due to the ease of their transferability (particularly to cold wallets and/or storage) and pseudonymous nature of such assets, gagging orders would be a particularly useful tool in avoiding tipping off certain parties.

3.6 Form of relief

Considering the borderless nature of Crypto Asset transactions, before seeking certain relief for creditors situated in onshore jurisdictions and making distributions in non-FIAT currency, Cayman Islands liquidators should seek onshore tax advice. This will ensure the relief sought marries up with the interests of such creditors, as Crypto Assets can attract different tax determinations with reference to the unique rights and characteristics associated with each type of Crypto Asset and the laws that apply to the transaction and to the creditor.

4. Class Remedies

Under the Cayman Islands Companies Winding Up Rules, 2018, creditors and contributories of a Cayman Islands company are able to present winding-up petitions in certain circumstances which, if successful, can place a company into official liquidation and potentially provide such creditors or contributories with an opportunity to realise what is owed to them by a company. Whilst establishing yourself as a creditor or contributory of a company, and then conducting the requisite legal analysis as to whether one should or can present a winding-up petition is usually relatively straightforward, conducting that analysis when evaluating debtor-creditor or debtor-contributory relationships in a Crypto Asset environment may not be straight forward. The approach of the Cayman Islands legal system to recognise the fungibility of Crypto Assets, whilst protecting the interests of Crypto Asset investors in the Cayman Islands, remains to be tested.

5. Conclusion

Whilst there has been an emerging trend for Crypto Asset projects, like ICOs, opting for more hospitable regulatory climates (like the Cayman Islands) than certain onshore jurisdictions, to date any enforcement proceedings against Cayman Islands linked projects have occurred onshore and not in the Cayman Islands. Positive sentiment, both from the public and private sector, surround the development of the Crypto Asset space in the Cayman Islands and we expect to see the development of a Crypto Asset regulatory framework in the near future. Against that background, when Cayman Islands token issuers and other entities holding Crypto Assets become unable to meet their liabilities the tools traditionally available to liquidators will be put to the test in a new, and potentially challenging, environment. Given the commercial and forward-looking approach of the Cayman Islands there is little doubt that this jurisdiction can and will rise to the challenge.

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