

LFI Other -

Special Situations: Crypto is the new distressed (Part 3 of 3): Lawyers

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*The following is the third in a three-part series "Crypto is the new distressed." **Part One** focused on investors, and **Part Two** on advisors.*

Darren Azman joined a group of panelists at the American Bankruptcy Institute's winter [conference](#) on Dec. 11 in Rancho Palos Verdes, Calif., to discuss – of all things – how cryptocurrency and blockchain apply to bankruptcies.

It is a crossover of expertise for which Azman has seen increasing demand as a restructuring partner at McDermott Will & Emery, which has been representing the unsecured creditors of Cred Inc., the crypto-based financial services company that filed for bankruptcy just over a year ago. As mentioned in Part 2, Cred stands out as the primary crypto-related chapter 11, with a mix of traditional and novel legal issues (see docket [here](#)). McDermott, working first for Cred's UCC and then for the liquidation trust, has scored a series of victories for its creditor clients - including the [recovery of \\$6 million](#) in stolen Bitcoin from a former Cred executive two months into its appointment - through the asset recovery process.

"I think it's a space that's begging for people to have substantive knowledge and expertise," Azman told LFI in an interview. "I don't think anybody's the expert in this space yet. The key is that you need to have people at your law firm or financial advisory firm who understand crypto and blockchain technology and are already advising in the space."

With corporate bankruptcy filings at an [11-year low](#), along with a surge in speculative and/or legally murky businesses involving blockchain, digital currencies, decentralized finance and "Web 3.0," restructuring lawyers are eyeing the inevitable blowups that will call for their expertise. The subject is increasingly part of the programming at the major bankruptcy and restructuring conferences: in addition to ABI's winter conference, it hosted a [webinar](#) on cryptocurrency valuation and market volatility in September, while the Turnaround Management Association is planning to host a [Bitcoin Meets Bankruptcy](#) panel at its Distressed Investing Conference in Las Vegas this February.

Many of the legal issues involved in crypto are typical of the bankruptcy process, including preference actions, fraudulent transfer and avoidance actions. Azman sees a continuing stream of business from the space, however, both for technological reasons, including hacks, and in light of the regulatory environment, such as the recent [creation of the National Cryptocurrency Enforcement Team](#) by the DOJ.

Cred

Azman's name was already stamped as an industry leader when he wrote an article in the ABI journal in 2018 on how Initial Coin Offerings might be treated in bankruptcy. At the time, his law practice included working with emerging companies, which was an ongoing interest for Azman, who'd once left law school to start a healthcare tech company.

"I was one of the few people who understood crypto and was also a bankruptcy lawyer," he said. "I didn't know there would be a major crypto bankruptcy at the time, but I think there are plenty more on the way."

At McDermott, there are half a dozen lawyers who have done work related to crypto and/or blockchain, including the team that did the [first SEC-registered security token offering](#) in September 2020. So when Cred filed for bankruptcy in November of last year, McDermott was the natural choice to serve as counsel to the official unsecured creditors committee, and subsequently as lead counsel to the litigation trust. In that capacity, Azman represents the beneficial interests of approximately 6,500 creditors who lost money to Cred.

Cred's unsecured lenders mainly comprise cryptocurrency holders who, seeking to generate interest on their crypto holdings, deposited them with Cred's "Earn" business, whose bank-like business model involved generating a higher return on deposits than it paid out in interest. Cred ran into trouble for reasons, as determined by an independent examiner, including mismanagement, theft, and a hedging program that didn't adequately protect against volatility in the cryptocurrency market in early 2020. The company listed \$140 million in liabilities upon filing, with the primary creditor constituency being the unsecured creditors committee.

The Cred case provided a number of chapter 11 firsts, including approval of a proof of claim form allowing the claimant to be paid in cryptocurrency. Much of the legal work in the space can involve the complicated process of asset recovery, which Azman has encountered advising the litigation trust. When digital currency exchanges are located outside of the U.S., with no requirement to know your customer, a unique set of problems comes up.

When the UCC in the Cred case successfully moved for an examiner, the head of Brown Rudnick's bankruptcy and restructuring practice, Robert Stark, was appointed as the successful applicant. Stark had less than two months to compile a report investigating allegations of "fraud,

dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the Debtors," per the examination order.

"I went in there asking, 'What is Cred? Is it a bank? Is it a brokerage? Is it a hedge fund? Is it an investment vehicle?' It was sort of somewhat reflective of an industry that's defining its own character," Stark told LFI in an interview. "There aren't a lot of institutions that are overseeing this. That was really what I was focused on when I went in there."

The [examiner's report](#) fleshes out many of the unique characters and accusations flying in the bankruptcy case: "Cred, on the one hand, pinned much of its troubles on its former Chief Capital Officer, failed investments in a Chinese entity named moKredit, and a failed investment in an entity named QuantCoin. Other case constituents have put blame elsewhere, raising allegations of gross mismanagement and potentially fraud," the report summarizes.

James Alexander, the chief capital officer at Cred referred to above, turned out to be an escaped convict from the U.K. who ultimately had to disgorge the \$6 million stolen bitcoin. McDermott's Azman at one point even moved for contempt when Alexander did not comply with discovery in District Court. While the judge didn't put him in jail, Azman's motion to transfer venue to Delaware for Alexander's personal bankruptcy – filed in California – was granted. The bankruptcy trustee is now in the process of selling Alexander's house.

Stark's examiner's report further described some of the questionable transactions that took place before the bankruptcy filing: "At least two entities purchased the bonds from Cred: JST279 and Winslow Strong, an individual investor. JST purchased approximately \$9 million worth of bonds in Bitcoin, and Strong purchased 500 BTC worth of bonds in January 2020....By the maturity date [June 30, 2020], Cred was aware of moKredit's [the microcredit lending company in Singapore and Shanghai run by Cred's cofounder] inability to pay any meaningful amount of its principal balance owed, let alone between \$14 million and \$15 million; but, according to the Base Prospectus, it bore no liability if the Luxembourg Bonds defaulted. Regardless, Cred agreed to purchase the bonds at par, thereby buying back more than \$14 million dollars of debt it knew could not be repaid...."

Stark commented to LFI that the burgeoning industry bears some similarities to earlier innovations that led to a wave of restructurings, including the MBS wave in the early 1990s:

"You get the sense that it's fairly 'wild west' because there's no regulatory oversight. There are many people who are big believers in digital currencies and they're trying to figure out an infrastructure to put in place to cater to that," he said. "[T]here is an element of crypto that resonates back into those 1990 [mortgage-backed securities] cases that there is a currency form that has wild ups and downs in terms of pricing and there are people who want to ride the wave, and there's going to be a period of fallout until the industry solidifies in a way that's more reliable."

Mt. Gox

The Brown Rudnick restructuring practice – known for representing minority creditor groups and equity committees in large bankruptcy cases – had another notable role in a crypto-related case. The first major insolvency of a cryptocurrency-related business was nearly eight years ago, in February 2014, when a Tokyo-based company called Mt. Gox, once the largest cryptocurrency exchange by market share, [filed for bankruptcy](#) in Japan. That was after losing nearly \$500 million worth of Bitcoin, valued at then-current prices. The company later filed for liquidation. Brown Rudnick represented the Japanese Bankruptcy Trustee in connection with the company's chapter 15 case in Bankruptcy Court in Texas and related litigation in the U.S.

The Mt. Gox case remains relevant, as even minor creditors in the case may yet become millionaires, while distressed investors who purchased the claims look to recover major windfalls, if the recently completed liquidation plan pays out in Bitcoin at current prices rather than the 2014 equivalent. The liquidation was administered in Japan, becoming final and binding [last month](#), with the trustee recovering at least 141,686 bitcoins as of the [latest public disclosures](#), among other assets with a market value in the billions of U.S. dollars. Distressed investors including funds of Fortress Investment Group and [507 Capital](#) are among those who purchased unpaid Mt. Gox claims and now stand to profit.

Other pockets of expertise in crypto and/or blockchain have cropped up at various corporate law firms involved in these above mentioned restructurings: Mt. Gox debtor counsel for the chapter 15 was Baker & McKenzie, which has a [section of its website](#) dedicated to blockchain and crypto. While Paul Hastings, the debtors counsel for Cred, recently [added](#) a fintech and capital markets lawyer [Eric Sibbitt](#) in its San Francisco office from O'Melveny.

While other firms with large restructuring practices have at the very least dipped their toe into litigation issues surrounding the space: Kirkland & Ellis, for one, represented Kik Interactive, during the investigation and subsequent lawsuit by the Securities and Exchange Commission accusing Kik of an illegal \$100 million securities offering. [The SEC obtained a judgment](#) in October 2020. The SEC also sued Ripple Labs (see docket [here](#)), which is represented by Cleary Gottlieb, while other Ripple parties are represented by counsel from Paul Weiss.

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